QUICK MARKET UPDATE

Lucky Number 13 (Thousand)

Jaco Jordaan, CFA®, CFP®, ChFC, Senior Portfolio Manager *February 28, 2012*

Investors are emotional creatures in that we often attach emotional value to numbers. Think about the many articles you have read, or the many financial broadcasts you have seen, which highlight arbitrary prices and market values. The financial media likes to point out the best month for US markets in a certain number of years, or the highest and lowest levels within a certain period. Even small changes in markets are often described as soaring or plummeting. That rhetoric seems to get worse around milestones and significant market events.

On November 21, 1995, the Dow Jones Industrial Average (DJIA) closed above 5,000 for the first time ever. On March 29, 1999, less than four years later, the DJIA closed above 10,000 for the first time ever. 11,000 was reached in May 1999, 12,000 in October 2006, 13,000 in April 2007, and the highest closing level ever for the DJIA – 14,164, was reached on October 9, 2007.[1] All these key index milestones were accompanied by editorials regarding the significance of the current "first time ever."

The march towards higher market levels has been anything but smooth. Often, there are retracements, some worse than others. Those retracements set the tone for the media to revisit milestones. Instead of the "first time ever" news, headlines change to "the highest level since."

We currently find ourselves in "the highest level since" territory. From October 8, 2007, through March 9, 2009, the DJIA fell precipitously to close at 6,547, a decline of nearly 54%. Since then, the media and investors have been focused on a recapture of each milestone – 10,000 in October 2009, 11,000 in April 2010, 12,000 in February 2011. Now, the market has oscillated around 13,000 for the past few days, only to falter in the last minutes of trading to close below that level.

The world is watching the number with misplaced anticipation. I only need to look at my anticipation of breaching the 13,000 level to realize there's a psychological value to the number. As I am writing this piece, the DJIA has spent most of the trading day above the 13,000 level. I have questioned myself - do I spend the time to write this piece and risk that the DJIA does not close above 13,000? Should I wait to write this until there is a confirmed close above 13,000?

I decided to continue writing to prove a point - whether or not the DJIA closes above 13,000 should not matter (and by the time this is published, the DJIA may be above that level or it may still be short). 13,000 is an arbitrary number – by itself it is meaningless. Yet the financial media will focus on the number and the idea that this is the "highest level since" 2008. That treatment by the media unfortunately misses the more important point for investors – valuation.

Instead of focusing on the absolute level of the index, it is arguably more important to add context to the level of 13,000 - we have to ask whether 13,000 today represents better value to investors than the last time the DJIA was at 13,000 (May 2008), the first time the DJIA was at 13,000 (April 2007), or, to pick another psychologically important number, the first time the DJIA crossed the 10,000 level (November 1999).

[1] All Dow Jones Industrial Average data throughout from Bloomberg

Not only is 13,000 less than 13,000, it is also less than 10,000

At first glance, the heading above is clearly mathematically flawed. However, examination of the fundamentals of the thirty companies which together make up the DJIA quickly proves the statement to be correct.

Investment strategists like to look at index levels as the price paid to own that slice of the market. As with any buying decision, investors have to ask what they are getting for their money. We will start by examining the most common valuation measure, the Price/Earnings multiple, often referred to as the P/E ratio. The P/E ratio is calculated by dividing the price, or level of the index, by the prior 12 months earnings of the index constituents. The result gives the price that investors are willing to pay for a dollar in earnings.

Currently, the DJIA is near 13,000. The earnings per share for the 30 companies in the DJIA is approximately $977, which means the P/E ratio for the DJIA currently is approximately 13.3x earnings. Said another way, it currently costs $13.33 to buy $1 in earnings for the companies in the DJIA. We can compare that ratio with historical P/E ratios and determine whether the DJIA currently is attractively valued or more expensive than those historical points.

DJIA Level	10,000	13,000	13,000	Avg 1998 to Current	Current
Date	3/99	4/07	5/08		
P/E Ratio	22.13x	16.19x	15.66x	17.91x	13.33x
Current Discount to Prior	40%	18%	15%	25%	

DJIA Data from Bloomberg. Discount calculated as: 1 minus current P/E divided by prior P/E

Based on the P/E ratio, the current level of the DJIA is 40% below the valuation when the index reached 10,000 in March 1999. It is 18% below the valuation of the index when it first reached 13,000 in April 2007, and 15% below the valuation the last time the index was above 13,000 in May 2008. Compared to the average P/E ratio from January 1998 to now, the current P/E ratio is 25% below the average P/E ratio over that period. Therefore, 13,000 is less than 13,000, and also less than 10,000.

Earnings are a measure which comes from a company’s income statement. However, we can also look at the company’s balance sheet to determine relative value. A common measure of balance sheet value is a company’s book value. Book value represents the value of a company’s assets, minus intangible assets (such as goodwill), depreciation, and liabilities. Again, we can look at the ratio of the index price to book value, or the P/BV ratio.

DJIA Level	10,000	13,000	13,000	Avg 1998 to Jan 2012	Jan 31, 2012
Date	3/99	4/07	5/08		
P/BV	4.3x	3.78x	3.5x	3.49x	2.74
Current Discount to Prior	36%	28%	22%	22%	

DJIA Data from Bloomberg. Discount calculated as: 1 minus current P/BV divided by prior P/BV

Based on the P/BV ratio, the current level of the DJIA is between 22% to 36% below the valuation of the index on prior key milestone dates. Therefore, 13,000 is less than 13,000, and also less than 10,000.

There are many other measures of valuation and quality which can be compared to historical numbers. Many of these measures add to the point made by examining P/E and P/BV ratios above. That point is that investors should not consider the level of an index in a vacuum. What is more important is the valuation represented by that psychologically important level, and on the basis of P/E and P/BV, the DJIA currently is priced below recent milestones.

Various equity market indices may reach new milestones in the years ahead, and the financial media will often cover the milestone without the proper context of valuation. We caution investors not to react to the absolute levels of market indices outside of the context of valuation. We continue to recommend a diversified approach to investing which includes a portfolio consisting of various asset classes and which is rebalanced as needed. As always, we suggest addressing any concerns by starting or updating a financial plan which addresses your specific goals and objectives. Should you have questions about the implications of market levels, we suggest discussing your concerns with your H.D. Vest Advisor.

Update:

After submitting this piece, the market did finally close above 13,000. A headline in the *Wall Street Journal*, posted within 30 minutes of market close, reads “Dow Ends at 13000 for First Time since May 2008.” and does not include a discussion of valuation or market fundamentals.

The information and opinions in this report was prepared by Jaco Jordaan, Senior Portfolio Manager for H.D. Vest Advisory Services℠ (HDVAS). Information and opinions have been obtained or derived from sources considered reliable, but their accuracy or completeness cannot be guaranteed. Opinions represent Jaco Jordaan’s opinion as of the date of this report and are for general information purposes only. HDVAS does not undertake to advise you of any change in opinion or the information contained in this report. Reports and opinions prepared by other sources may be inconsistent with, and may reach different conclusions from, this report.

Securities offered through H.D. Vest Investment Services℠, Member: SIPC
Advisory services offered through H.D. Vest Advisory Services℠
6333 N. State Highway 161, Fourth Floor, Irving, TX 75038, (972) 870-6000