Why You Should Be Concerned About High Stock Prices

Since early March, stocks have been trading in a relatively narrow range. Although the media has been making a big deal about the new highs for the Dow Jones average, that index has gained little more than 2% in the interim, not exactly an earthshaking advance.

The bigger concern is the current level of valuation for the leading indicators. A recent check of the S&P500, which is far broader than the Dow, shows its price-earnings multiple at 26.1 times earnings reported for the latest 12 months. That's rich by anyone's measure.

The main arguments in support of the currently high stock valuations are the continuation of low interest rates and the improvement in underlying earnings. There's some merit to this reasoning, but rates will be rising and expectations of higher earnings are almost always tempered over the course of the year. Analysts spend far too much time looking ahead through rose-colored glasses.

Although most investors would be thrilled to watch the averages climb steadily over the months ahead, that may well be the worst possible scenario. We saw that kind of advance during 1999-2000 and recall far too much talk about how "It's Different This Time."

Trust me. It's not.

If I had my druthers, I'd hope for the market to move sideways through the remainder of the year and perhaps well into 2018 so that earnings can catch up and bring valuations down to more reasonable levels. But if I had to bet, I think it far more likely that there will be a significant pullback between now and then. Looking back over the past few decades, the odds are that there will be a correction of 10% or so in two out of three years. Given where valuations are now, it seems likely that that the near-term probability is even higher.

Is that something to worry about? Not really, though it suggests that it would be best to ignore thoughts about missing the rally and instead prepare for the better opportunities that will be available when prices come down to more reasonable levels. The problem, of course, is that most investors do the opposite of what makes sense.

When stocks are on sale, as they are when prices hit the skids, they're too nervous to take advantage of bargains. Yet, when prices soar, they can't wait to pay up.

The strange part is that this behavior is counterintuitive. In every other part of our financial lives, we all look for the best deals. But with investing, most people tend to buy high and sell low. Not surprisingly, studies have shown that this tendency usually backfires. The latest Dalbar study of investor returns showed that while the S&P500 had a return of 12.0% in 2016, the average mutual fund investor earned only 7.3%. Why? Because fear resulting from the January plunge kept them from staying aboard during the rally taking place during the last few months of the year. Once again, investors were their own worst enemies.

When prices are as high as they are now, efforts to dial down risk will probably be well rewarded. A word to the wise.