Are Stock Prices in La La Land?

One can only marvel at the nonstop advance of the leading market averages. It's almost as if the law of stock market gravity has been repealed. Triple-digit stock price quotes abound and it seems that there must be a ban on daily retrenchments, much less a substantial correction.

The history of the Standard & Poor's 500 Index, which dates back to 1926, has always included a process of interim movement in both directions. On the way up, shares are driven by confidence in the path of underlying progress. On the way down, the tide turns in the direction of uncertainty and disappointment. Over time, these swings in psychology have often been broad ranging, moving prices far above and below what might be considered reasonable valuation.

Here we are, eight years and counting from the depths of the Great Recession of 2008-9 and judging from the ongoing news from Wall Street, one would think that it is indeed the best of times. Although there is some support for current optimism, there are weighty factors on both sides of the equation. And for that reason, investors would be well advised to exercise increased care at the current market juncture.

Much of the good news is that corporate earnings continue to climb at a comfortable rate. When corporate America is moving ahead, its shares generally reflect that progress over time. Even so, there's a difference between recognizing gains and pricing for perfection. That latter simply means planning for the best and ignoring the possibility that there may be disappointments. More often than not, this approach backfires.

When prices reasonably reflect underlying progress, there's no rush to jump ship. When they get stretched, as they are now, it's time to consider bailing out. That's not to suggest it's time to liquidate everything. More likely, it's a good time to pare those parts of portfolios that have gained excessively or simply haven't done as well as hoped for. Like farming, it's time to prune, weed, and replant.

What to replant? With price-earnings multiples on U.S. equities averaging almost 20 times earnings, folks would do well to consider developed international markets, where valuations are about one-third lower, or emerging international markets, which are selling at a discount of about 50%.

A partial repositioning from the U.S. market to more reasonably priced markets abroad would seem to be a worthwhile step in the right direction. In addition, some consideration should be given to alternative investments, such as covered call or covered put exchange-traded funds and long-short exchange-traded funds. Part of the allocation that would be devoted to fixed-income might focus on short-term, high-yield, exchange-traded funds, as well as discounted closed-end funds that even now have current yields in excess of 5%.

By repositioning in this fashion, reduced exposure to the U.S. market would lower risk while increasing exposure to international markets would boost reward potential. At the same time, the addition of alternatives would buffer the inevitable volatility that lies ahead.