How Investors Can Stay Disciplined After a Full Market Recovery

After less than six months, the stock market has surpassed where it started the year. As of this writing the S&P 500 has hit a new record high. This steep climb has occurred despite on-going economic, market and policy uncertainty and is further evidence that investors who are able to stay disciplined and invested, rather than over-react to short-term news or try to time the market, are more likely to achieve their financial goals.

Perhaps the most important principle for disciplined investing is to focus on economic and market fundamentals rather than day-to-day price changes. This has been difficult to do given all of the unknowns surrounding the COVID-19 crisis and the government response. For instance, it's still unclear when another round of economic stimulus will be passed by Congress, whether those cities and states facing an uptick in coronavirus cases will re-open soon, and how new trends in retail investing will affect individual stocks and the market as a whole.

These uncertainties have also made it difficult to gauge stock market valuations. Over long timeframes, valuations are possibly the best tools investors have to judge stock market opportunities. This is because buying the stock market when valuations are cheap means that you’re paying less for each dollar of earnings - or any other fundamental measure. Investors who are willing and able to do so when others aren’t are often rewarded in the years and decades ahead.

At the moment, not only has the market rebounded significantly, but the lack of clarity around corporate earnings has meant that valuations for the overall stock market are elevated. The Shiller P/E ratio for instance, which measure the stock market’s price to earnings while also adjusting for inflation, is still close to cycle highs.

While this can change quickly if there is either another episode of market volatility or if the economy recovers even faster than expected, this suggests that the stock market is not cheap at the moment, per se.

However, the traditional Shiller P/E only applies to the overall market. There are other important ways for long-term investors to maintain a balanced portfolio while focusing on valuation measures for specific sectors, industries, investment styles and companies within the markets itself.

Various parts of the U.S. stock market are being valued differently. For instance, large-cap growth stocks have outpaced other parts of the market resulting in significantly higher valuations than both their peers and compared to their historical averages. This is partly because many tech stocks that have fared well during the recent crisis belong to this group.

This means that value stocks are in many cases significantly cheaper. There are also interesting dynamics among other size and style categories. For instance, mid-cap growth stocks are expected to see lower earnings growth than mid-cap value ones, despite significantly higher valuation levels. Small-cap value stocks are expected to experience the highest levels of earnings growth over the next twelve months across the board.

As is always the case, there are no guarantees that earnings projections or valuation levels will predict returns over the next few months or even years. From tactical and secular perspectives, there may be reasons
to invest in higher-valued areas. However, over long periods of time, managing a portfolio with a disciplined investment strategy focused on quality fundamentals and a focus on areas that are under-valued by the market, and away from ones that are over-valued, has been one of the key principles to achieving long-term investment success.

With the overall stock market near record highs and with valuations at elevated levels, it's more important than ever for investors to avoid complacency, stay disciplined and re-focus on fundamentals. Below are two charts that put these fundamentals in perspective.

The Shiller P/E ratio, which measure the price-to-earnings for the S&P 500 adjusted for ten years of inflation, is still elevated. Although it is not as high as it was during the dot-com bubble, it is still near a cycle peak. This is because the stock market has recovered swiftly over the past six months, boosting the numerator in the ratio. The denominator has also fallen due to economic uncertainty from on-going economic shutdowns, which also increases the Shiller P/E.

Various parts of the U.S. stock market are valued quite differently at the moment, in no small part because earnings expectations differ dramatically. Although large-cap growth stocks have dominated headlines and recent performance statistics, other parts of the market are either much more cheaply valued or are expected to see much higher earnings growth. The chart below illustrates the earnings growth and forward price to earnings estimates for the next 12 months relative to size and investment style.
The Bottom line? With the stock market reaching new record highs, it’s important for long-term investors to stay disciplined and re-focus on fundamentals.