

# Economic and Market Perspective

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## Sell Some Popularity and Buy a Bit of Disappointment



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In the last year, the relative price of success has risen considerably within the stock market. The median stock within the top performing quintile of the S&P 500 Index (i.e., the “Popularity portfolio”) has risen to its highest one-year forward price-earnings (P/E) multiple in more than a decade. Indeed, the Popularity portfolio has only been pricier than it is today about 15% of the time since 1990. At the same time, the current median company valuation of the “Disappointing portfolio” (i.e., the worst performing quintile of the S&P 500 Index in the last year) has only been cheaper about 30% of the time in the last 25 years. Is it time to sell some popularity and buy a bit of disappointment?

### A valuation history

Chart 1 compares the median P/E multiples (based on one-year forward IBES mean earnings estimates) of the Popularity and Disappointing portfolios every quarter since 1990 and Chart 2 displays the ratio of these two portfolio valuations. Often the valuations of the two portfolios tend to rise and fall together with the Popular portfolio usually at a slight premium P/E multiple. However, occasionally, the valuations of the best and worst performing stocks within the S&P 500 Index have diverged significantly. In 1990, 1995, 2005, and from 2009 to 2012, the valuation spread widened primarily because the valuation of the Disappointing portfolio declined while the P/E multiple for the Popular portfolio trended sideways. That is, these spikes in the valuation ratio shown in Chart 2 were due mostly to reduced values among the disappointing stocks.

From 2001 to 2003, and again between 2007 and 2009, the valuation spread widened (Chart 2) even though the P/E multiples on both portfolios moved directionally similar. That is, in 2003, although P/E multiples rose throughout the stock

market, they tended to rise much more aggressively among popular stocks, whereas in 2007 and 2008, P/E multiples fell for most stocks but declined much more significantly for disappointing stocks.

The most recent spike in the valuation spread, however, is similar only to what occurred in the late 1990s. Like then, the valuations of the two portfolios have moved in opposite directions during the last year. P/E multiples on popular stocks have increased while P/E multiples have declined among disappointing stocks. In the last 25 years, only during the dot-com bull market of the late 1990s did the valuation ratio behave as it has in the last year.

### Chart 1

#### Median S&P 500 Index P/E multiple by performance group\*

\*Solid — Median P/E multiple of the bottom quintile S&P 500 previous year performers.

Dotted — Median P/E multiple of the top quintile S&P 500 previous year performers.

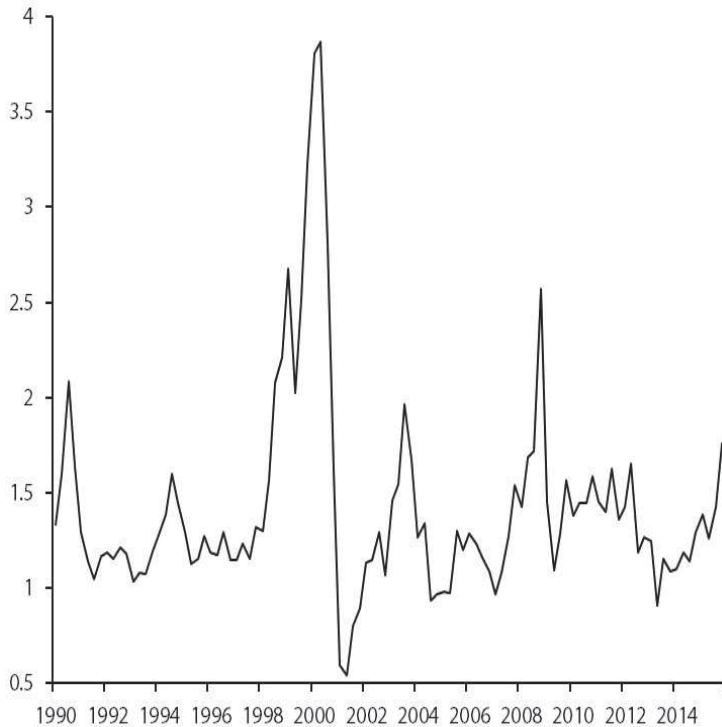
Median P/E based on one-year forward mean IBES earnings estimates.



## Chart 2

### Valuation ratio — Popularity to Disappointment\*

\*Median P/E multiple of the top quintile S&P 500 previous year performers divided by the median P/E multiple of the bottom quintile previous year performers.



### An opportunity?

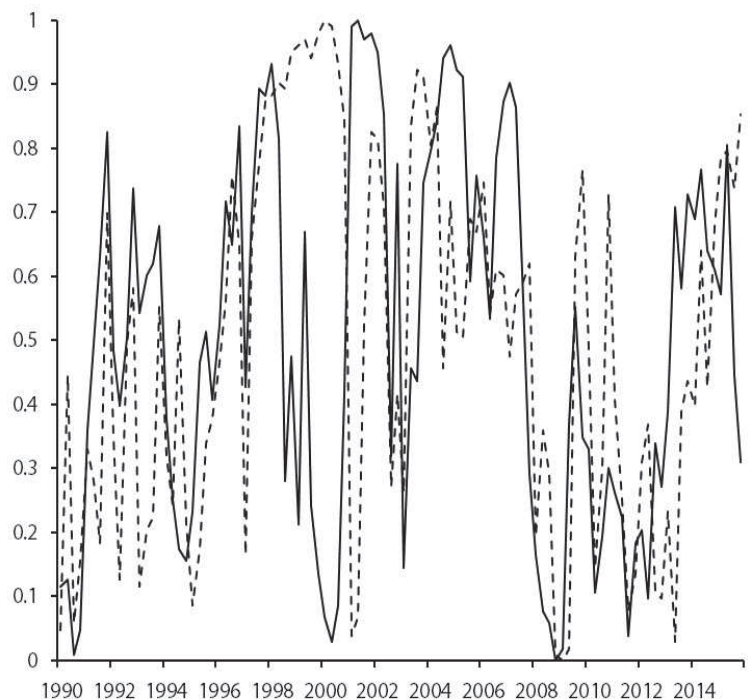
Chart 3 illustrates a potential opportunity for investors to lift some profits from their most successful but increasingly pricey stocks and reposition the funds into “someone else’s” disappointment. This chart shows the percentile ranking of each portfolio’s median P/E multiple since 1990. A 1.0 percentile rank represents the highest P/E multiple the portfolio reached since 1990, and 0.0 represents the lowest P/E multiple reached in the last 25 years.

Although the relative valuation of popular and disappointing stocks clearly change over time, rarely as shown in Chart 3, have popular stocks been so expensive when disappointing stocks have been so cheap. For example, in 1990, while the P/E multiple on popular stocks was more than two times higher compared to disappointing stocks (Chart 2), both portfolios were extremely cheap. That is, in 1990 (from Chart 3), the percentile rankings of the P/E multiples on both portfolios were below 0.1. Conversely, Chart 2 shows that although popular stocks were a good relative value in 1997, the P/E multiples on both the Popular and Disappointing portfolios were expensive. Both were near the 80th percentile of their respective historic ranges (from Chart 3).

## Chart 3

### Percentile ranking of group median P/E since 1990\*

\*Solid — Percentile ranking of the median P/E multiple of the bottom quintile S&P 500 previous year performers.  
Dotted — Percentile ranking of the median P/E multiple of the top quintile S&P 500 previous year performers.  
Percentile of 1.0 represents highest P/E multiple since 1990 and 0.0 represents the lowest P/E multiple.



Today, like the late 1990s, the relative valuation favors disappointing stocks and disappointment is also cheaply priced on an absolute basis while popular stocks are expensive. Consequently, investors currently have a rare opportunity (at least during the last 25 years) to sell popularity when it is both relatively and absolutely expensive and buy disappointment when it is both relatively and absolutely cheap. Currently, the median P/E multiple on the Popular portfolio is in the 85th percentile of its historic range at about 23 times forward earnings estimates. Only during the dot-com era were popular stocks more expensive than they are today. Conversely, the Disappointing portfolio currently sells at only 13 times forward earnings, a P/E multiple which is lower than 70% of the time during the last 25 years.

## The valuation ratio and the stock market

Typically, as illustrated in Chart 4, a spike in the relative valuation ratio (Chart 2) has been associated with stock market tops. Frequently, at market peaks, stock market participation thins and the performers (the Popular portfolio) tend to gain an increasing share of investment flows pushing their relative valuation higher.

This has certainly been evident in the contemporary period. In the last year, as the stock market has trended sideways near all-time record highs, stock market participation has thinned considerably and the valuation ratio has spiked to one of its higher levels since at least 1990. While a spike in the valuation ratio does often signal a market peak, it does not necessarily suggest a bear market (although it can as it did in 1990, 2000, and 2008). For example, the valuation ratio spiked in 1994, 1998, 2003, and multiple times earlier in this recovery (i.e., minor spikes in 2009, 2011, and 2012) that ultimately proved to be only temporary corrections in an ongoing bull market. Moreover, as suggested by Chart 4, if the current correction proves temporary and the bull market soon resumes, the valuation ratio should decline. That is, if this bull market is not yet over, the Disappointing portfolio may soon outpace the Popular portfolio.

### Chart 4

#### Valuation Ratio — Popularity to Disappointment\*

\*Solid (left scale) — Valuation ratio: Median P/E multiple of top quintile S&P 500 previous year performers divided by the median P/E multiple of the bottom quintile previous year performers.  
Dotted (right scale) — S&P 500 stock price index, natural log scale.



### Chart 5

#### Current portfolio sector composition — Popular Portfolio vs. Disappointing Portfolio

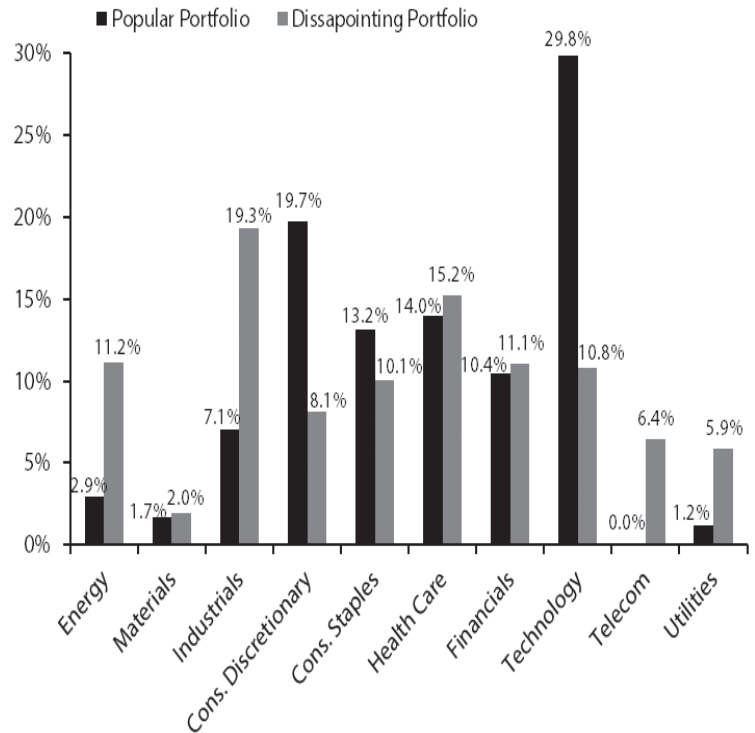


Chart 5 shows the current sector composition of both portfolios. Not surprisingly, stocks in the technology and the consumer discretionary sectors comprise almost 50% of the Popular portfolio. The Disappointing portfolio, by contrast, has slightly less than 20% in these sectors and almost 40% in the industrials, energy, and utilities sectors. Investors who wish to take advantage of the current wide spread in the valuation ratio probably need to sell some popular technology and consumer discretionary stocks and buy some disappointing industrials and energy shares.

*Thanks for taking a look!!*  
*Jim*

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An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.

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