Downside Risk – It's Time For Some Perspective

As investors, we periodically need to assess risk and ask ourselves how expensive (or cheap) assets are priced. Given the U.S. dollar is the world's primary reserve currency and the U.S. markets dominate global market share, the U.S. stock market (S&P 500) is an important bellwether to consider. If we know how expensive the largest U.S. companies are, we can gauge the risks and probabilities of losing money on our portfolio, and in preparation, position ourselves defensively.

The following graph shows the per share ratio of price to sales for the largest 500 companies in the United States*. It measures how much investors are willing to pay, on average, for company revenues. A larger number carries higher valuation and higher associated risk, conversely, a smaller number carries lower valuation and lower associated risk.

As you can see from the 20 year chart above, **U.S. stock prices are more expensive today than at any other time in the past 17 years**. Only in the 1999-2000 time frame were prices higher than they are now. As a result, in my opinion valuation levels are stretched and risk levels appear relatively high, due to the fact that holding expensive stocks often leads to underperformance over time. So the risk/reward of owning U.S. stocks is poor. Be very careful!!

* The logic in analyzing price to sales over price to earnings is that earnings can easily be massaged by flexible accounting rules. Costs can be capitalized or expensed under various scenarios that can then distort earnings.