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11/20/2013	Value	YTD %
Dow Jones Industrial Avg	15967	21.8%
Vanguard 500 Index	165.28	27.6%
Vanguard Total Bond Index	10.67	-1.6%

NOVEMBER 20, 2013

RIDING THE CREST

As the graph below shows, investing at market highs can be very costly and take decades for recovery. In a recent on-line article on *Marketwatch*, financial writer Brett Arends stated:

> *"According to conventional wisdom, any attempt to time the market is fundamentally flawed. Stock markets follow a 'random walk', they say. No one can predict the market's next move, so trying to do so will end up costing you money. A lot of your long-term gains will come from a few big "up" days, and these are completely unpredictable — if you are out of the market when they happen you will miss out on a lot of profits.*
>
> *Money managers often push this idea to the clients. It has, from their point of view, a side benefit: It helps keeps the clients fully invested at all times, which means their assets are generating more fees.*
>
> *But is the idea correct?*
>
> *The simple answer: No."*

In other words, the stock market tends to follow multi-year trends of overvaluation followed by undervaluation. If you invest heavily in stock mutual funds when the market is undervalued, and have the patience to wait for the upturns, you can produce winning returns. On the other hand, if you stay heavily invested during the multi-year overvaluation periods, you are probably going to endure deep losses when the stock markets eventually correct.

I identified an overvaluation period last year, in July. Since then, the stock market has gone up a lot: 26%. Since I have moved our investment portfolios to increasingly defensive allocations, our investments have done well, but not as well as 26%. Why not?

I continue to believe deeply that we are in the midst of a multi-year overvaluation period. In fact, my guess is that we are in an asset bubble intentionally created by the Federal Reserve with its "quantitative easing" program, specifically designed to buoy the housing market and thus save the US economy from slipping back into recession or worse.

In other words, while I certainly might be wrong, my perception is that we remain at risk of a substantial stock market correction. That risk has only increased since last July. At that time, I expected a moderate correction. Now the possibility of something larger is quite real.

But these are often multi-year events. That's why we aren't 100% in cash. There's the genuine possibility that the Fed stimulus will keep the bull market on the upturn for years. We want to participate in some of that, even if we aren't willing to burden ourselves with excessive risk.

Meanwhile, the indicators continue to stack up.

Stock-targeting mutual funds have absorbed $76 billion in new money in 2013. That's more money than any year since 2004.

As of last Thursday, the Dow Jones hit its 37th record high for the year. That surpassed the 34 record highs of 2007, which was immediately followed by the Financial Panic of 2008.

By classic price-earnings measures, the stock market is overvalued. Pepsi has a 20 P/E, versus a market historical average of 15. Cereal maker Kellogg has a P/E of 23.8, Sprouts Farmers Markets has a P/E of 116, and Amazon has a stunning P/E of 1250. Linkedin is valued at 769 times earnings. Nutrisystems sports a P/E of 500. Historically, these valuations are simply bizarre.

Asia remains undervalued, but of course Asia is first in line for a downturn if such an event happens.

And, of course, 2013 has been a bumper crop year for initial public offerings. In 2013, $51 billion has been raised in U.S. stock IPO's, according to Dealogic. This has been the best year for IPO's since 2000, when $63 billion was raised. Of course, 2000 was followed by the crashing of the tech bubble in 2000-2001.

Most importantly, I am staring at a Value Line Manager's Appreciation Potential statistic (VLMAP) of 30%. This is a 2007 number, a true storm warning.

However, once again, we aren't in a position to guess when any storm might arrive. It may take years. So, based on history, we should stay at least partially invested in the stock market, and prepare to buy when a multi-year undervaluation occurs. My first guess is that a downturn in both stock and bond markets is quite probable when the Federal Reserve finally ends quantitative easing, possibly as early as spring 2014. ■