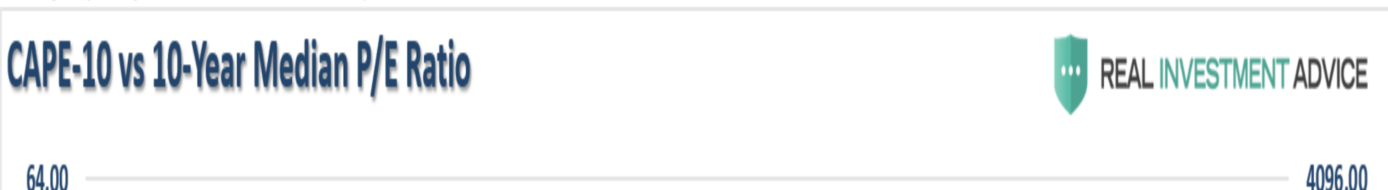
__?3 Things?__ is a weekly post of thoughts I am pondering, usually contrarian, with respect to the markets, economy or portfolio management. Comments and thoughts are always welcome via•email, •Twitter,•and/or•Facebook.

Peak Exuberance

There have been numerous articles out as of late emphatically stating this cannot be a bubble as valuations are not as elevated as they were in 1999 nor are investors as *"giddy"* about investments as they were then. While it is easy to point at the exceedingly high valuations of the late 90's as a benchmark for a *"bubble,"*•that just happened to be the case in history that*"blew the curve."*• If we look at a **10-year median of monthly P/E ratios**, we get a different picture of the price individuals are paying for stocks today.



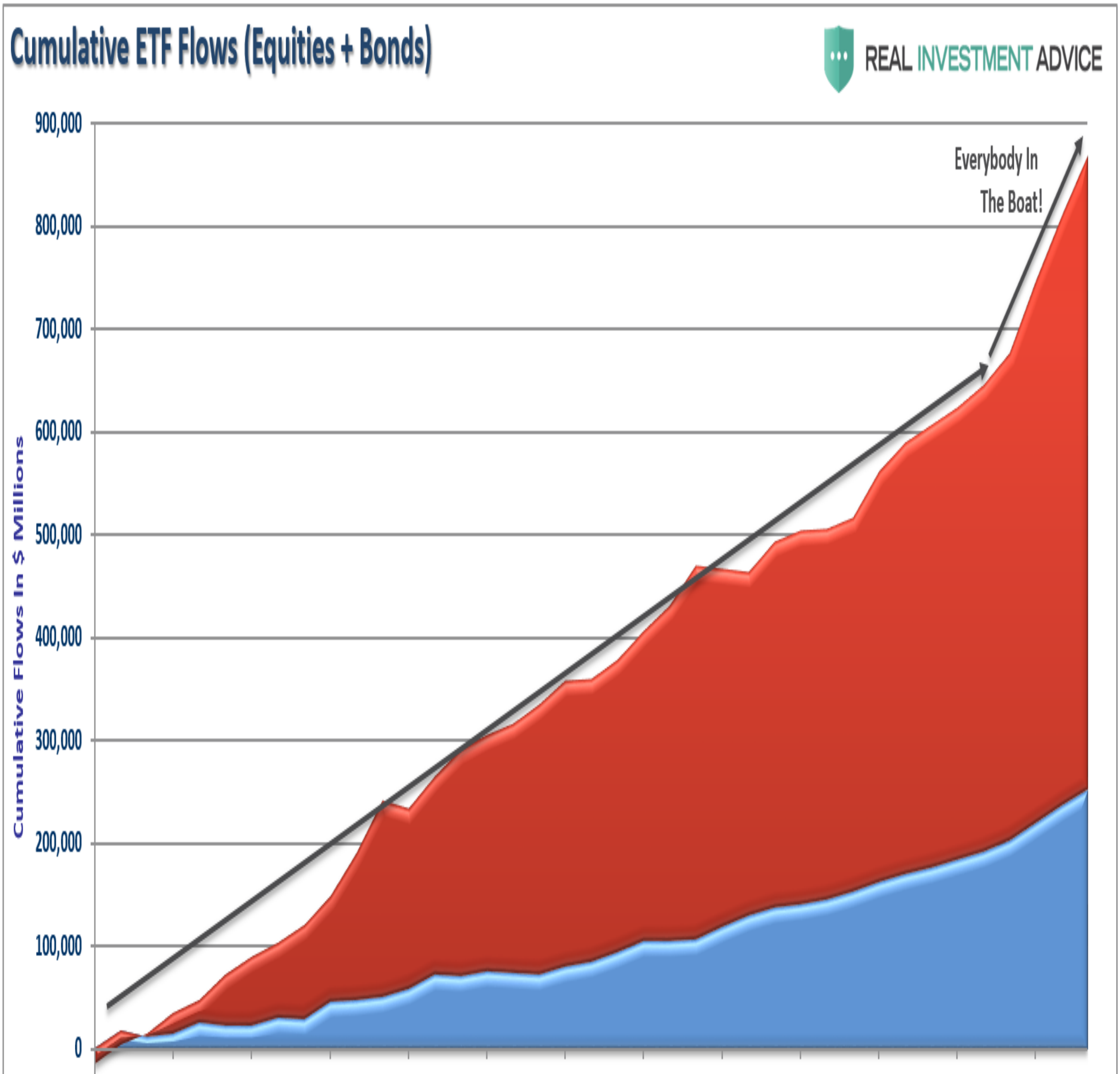
It was recently stated:

> *"Trying to judge whether a market is overvalued is a fool?s errand. Pricey stocks can and do get pricier, often for years. If your strategy is to wait for prices to decline to where you think they should be before buying, the market might very well outlast your patience."*

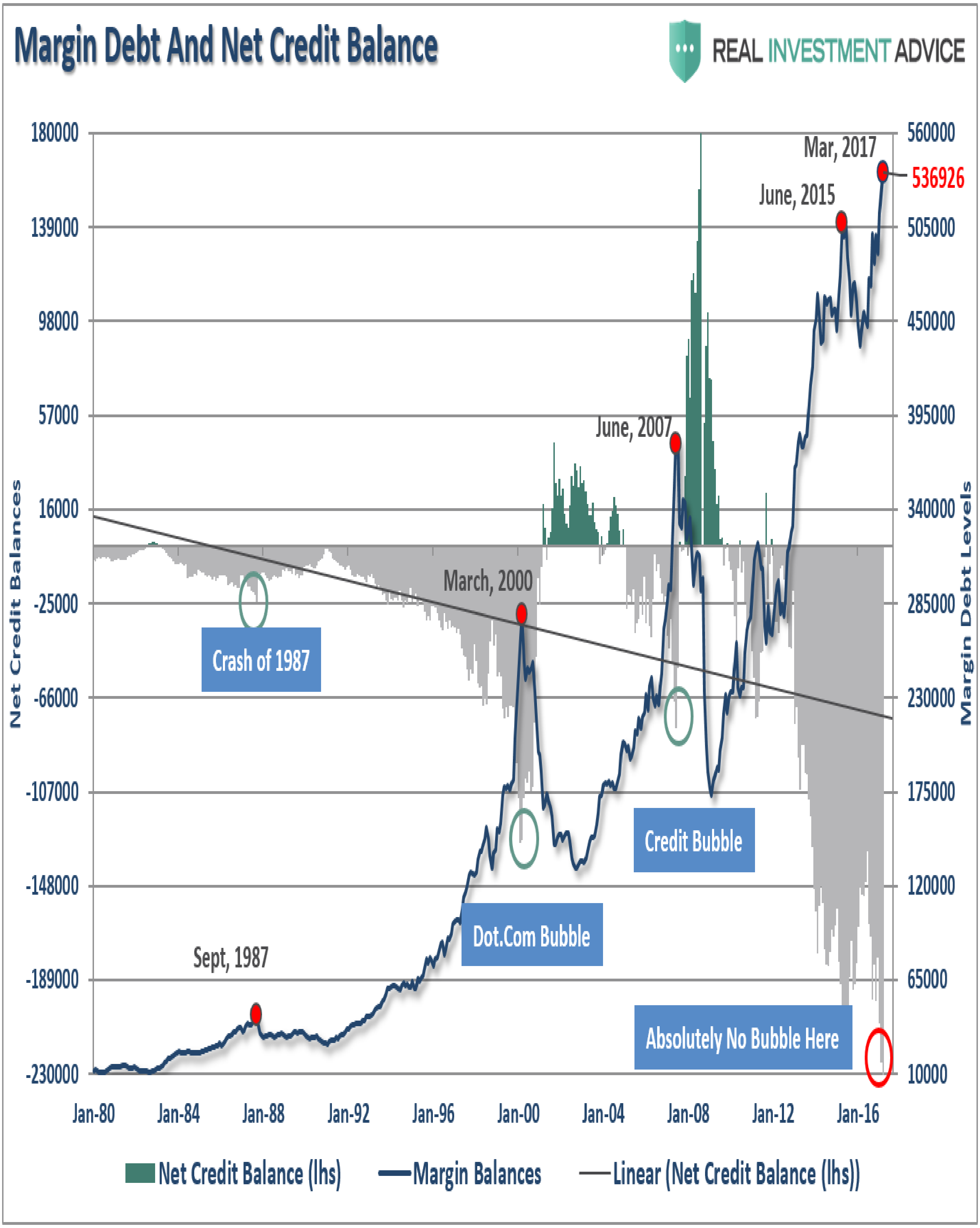
There are two huge fallacies with that statement:

1. *If you waited until stocks went from 15x to 25x earnings before thinking about buying stocks, there is your first problem.*•
2. *Valuations have EVERYTHING to do with your forward returns. The more you pay today, the less you will earn tomorrow.* •

At 18.85x trailing 10-year median valuations it is hard to suggest that investors are paying rational prices for future cash flows. But *"exuberance"* is not measured by valuations paid but rather by the psychology behind it. At each major market peak throughout history, there has always been something that became *"the"* subject of speculative investment. **Rather it was railroads, real estate, emerging markets, technology stocks or tulip bulbs, the end result was always the same as the rush to get into those markets also led to the rush to get out.** Today, the rush to buy *"ETF's"* has clearly taken that mantle, as I discussed last week,•and as shown in the chart below.

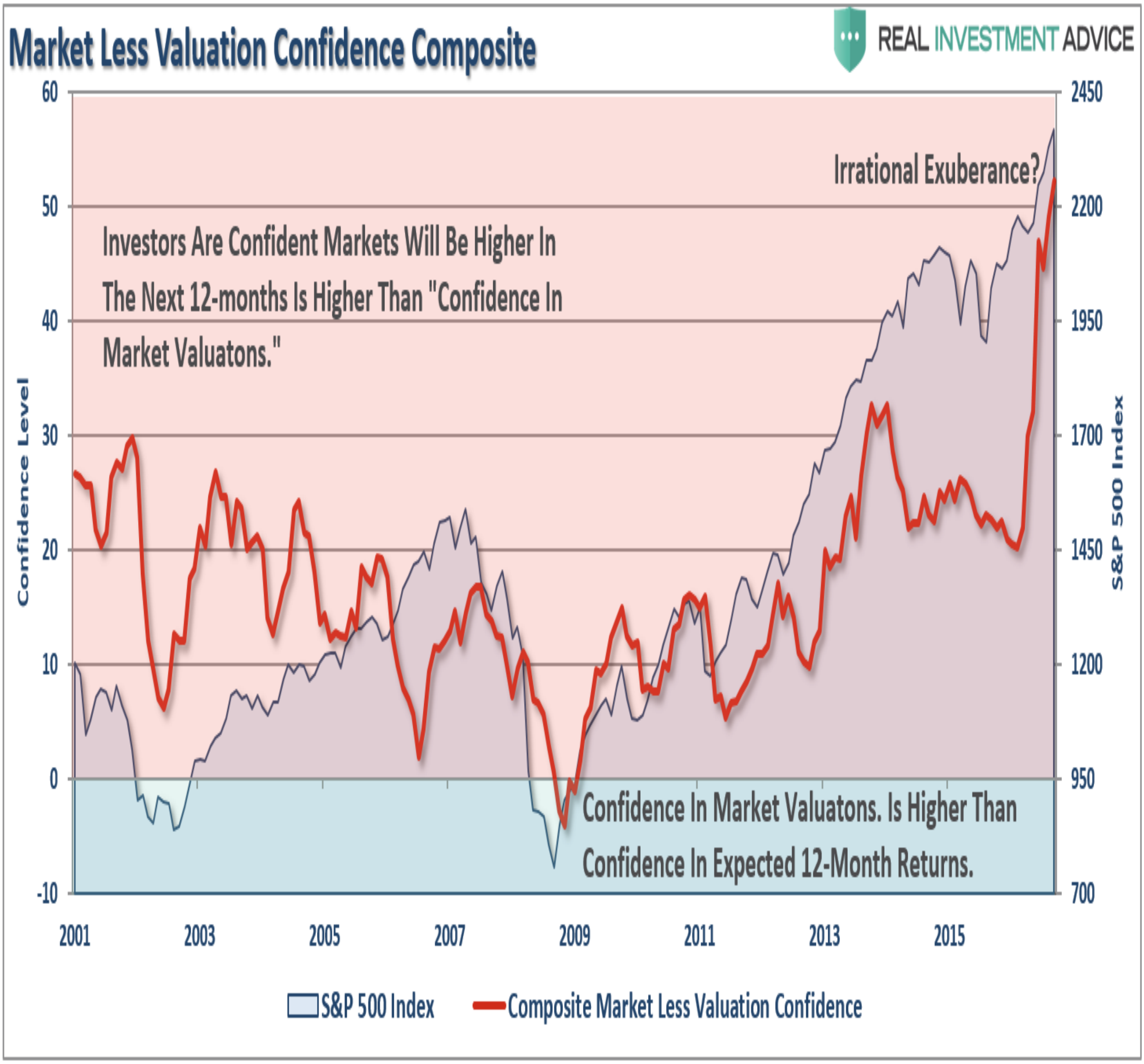


It isn't the surge into equity ETF's which should give rise to concern about future outcomes, but the components of *"psychology"* behind it. The following charts clearly *"tell the tale."* As discussed recently, [the combined surge of both visible and "shadow" leverage] suggests that investors have once again thrown caution to the wind. **While margin debt is NOT a leading indicator of future declines, it is the fuel that magnifies the inevitable reversion as forced liquidation occurs.•**



The surge in investor confidence is also pushing levels that can only be described as "exuberant."

The chart below is the difference between the number of people "confident" the markets will be higher in 12-months versus those who are confident in current valuations. *(Data source: Dr. Roberts Shiller/Yale)*



In other words, investors have bought into the media driven mindset that *"valuations no longer matter"* and the market can only *"go up"* from here. The chart below is my composite Market Greed/Fear Indicator. The chart displays•the 4-week average of the composite index comprised of the AAII Bull/Bear Ratio, MarketVane Bullish Indicator, Institutional Investors Bull/Bear Ratio, National Association Of Active Investment Managers Exposure Index and the Volatility Index.

Lastly, it isn't just investors that are all *"levered up with nowhere to go,"* but corporations as well.

Yes, this time is different. The catalyst and culprit will be different but the end result will be the same as it always has been.

Peak Expectations

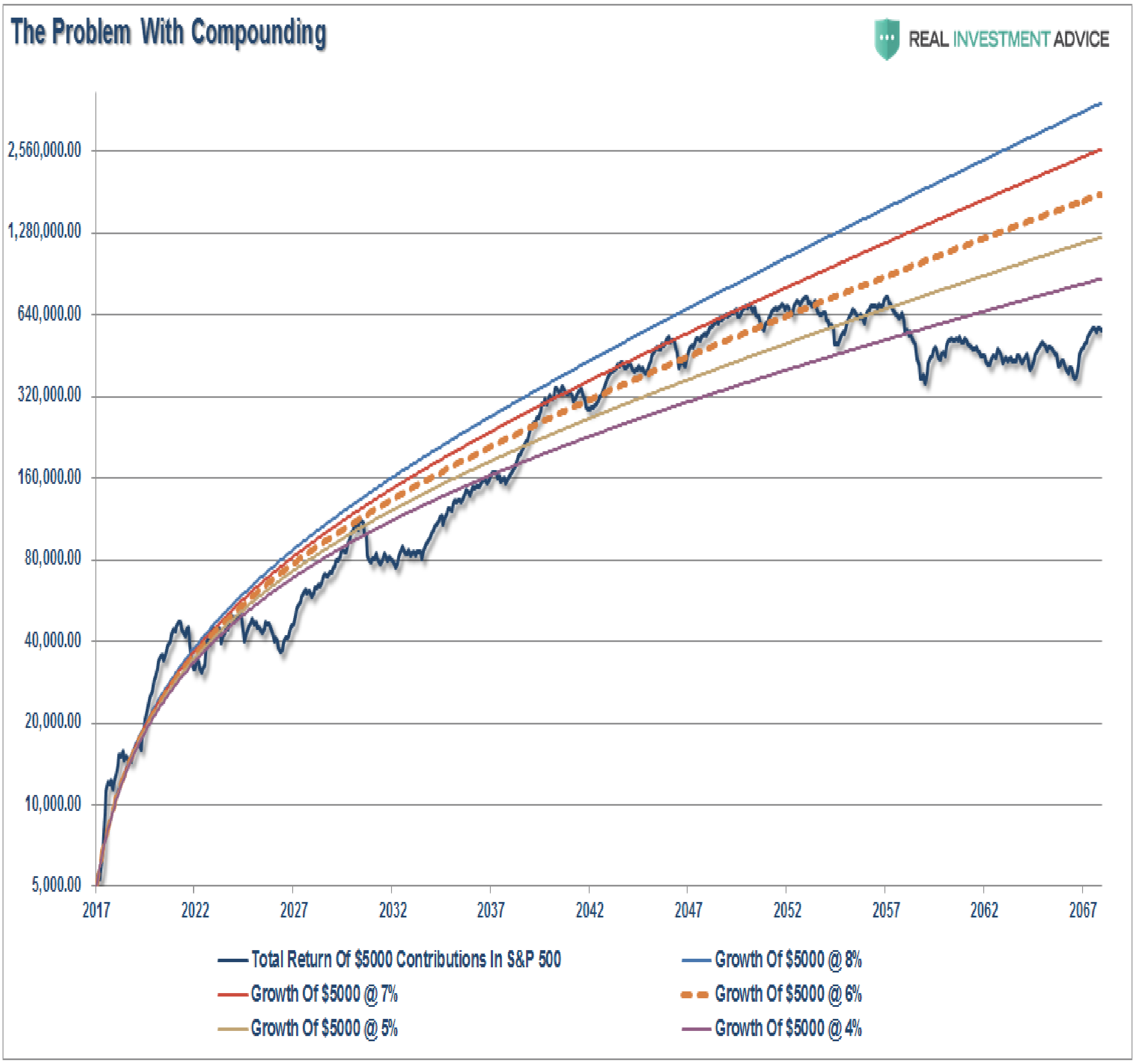
Following along with the "peak exuberance" meme, Jason Zweig published a fantastic article in the WSJ last week entitled: ["Whatever You Do, Don't Read This Column."] I highly suggest you do.

> *"Investors believe the darnedest•things.In one recent survey, wealthy individuals said they* ***expect their portfolios to earn a long-run average of 8.5% annually after inflation. With bonds yielding roughly 2.5%, a typical stock-and-bond portfolio would need stocks to grow at 12.5% annually in order to hit that overall 8.5% target.*** *Net of fees and inflation, that would require approximately doubling the 7% annual gain stocks have produced over the long term. Individuals aren?t the only*

investors who believe in the improbable. ***One in six institutional investors, in another survey, projected gains of more than 20% annually on their investments in venture capital*** *? even though such funds, on average, have [underperformed the stock market]for much of the 2000s. Although almost nothing is impossible in the financial markets, these expectations are so far-fetched they border on fantasy."*

He is absolutely right. THE battle I consistently fight regarding the *"buy and hold/passive indexing"* media driven commentary that over the long-term investors can earn 7%, 8%, 10%, or 12% *(if you're a Dave Ramsey fan)* on your investments. **You won't for the following three reasons:**

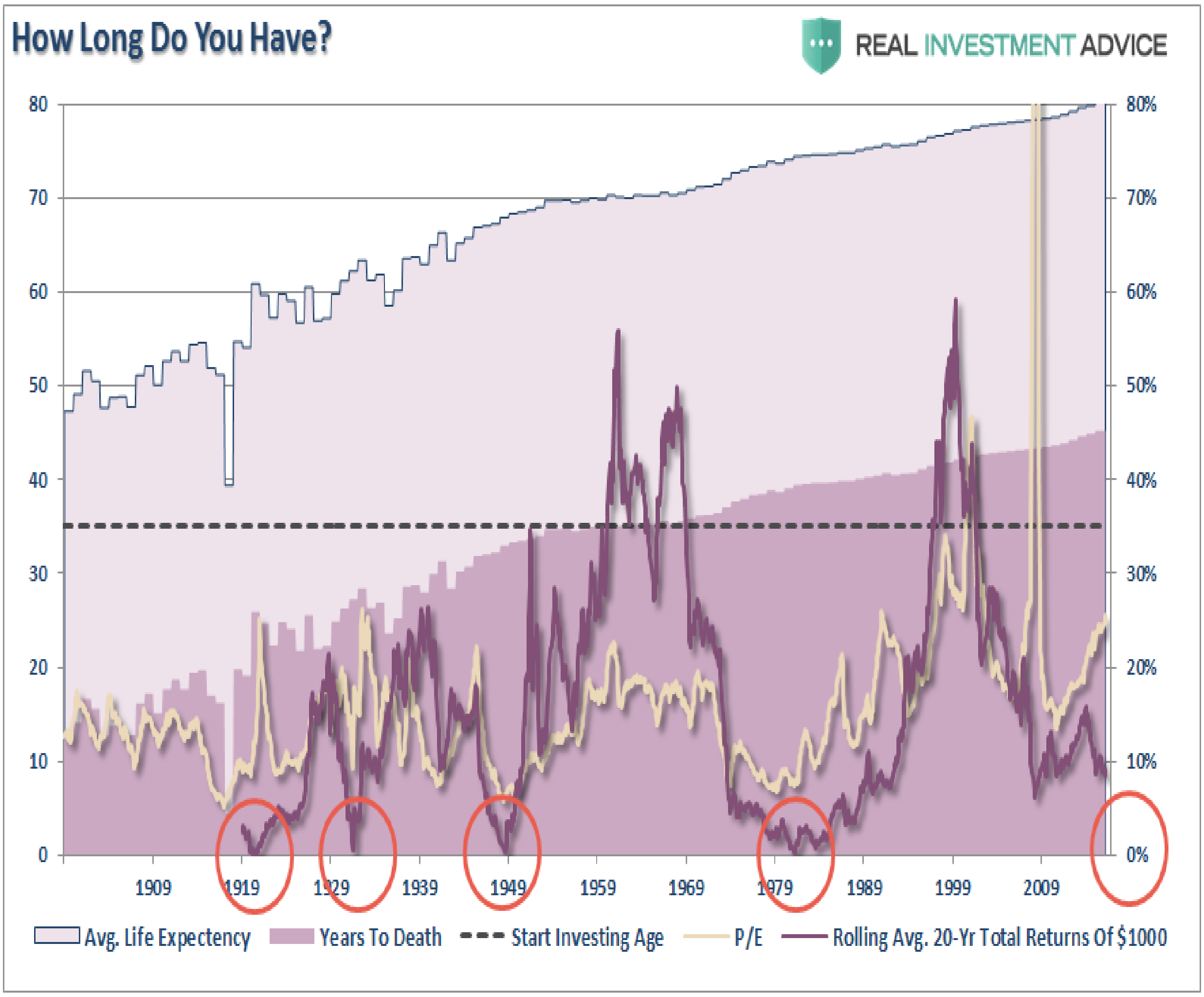
1. **Markets Do Not Compound Returns:•**The biggest mistake you are making in your retirement planning by buying into the ?myth? that markets ?compound returns? over time.•**They don?t. They never have. They never will.**I have adjusted the [chart I showed you last week] to show a compound return rate of 6%, $5000 annual, made monthly, contributions *(10% of $50,000 which is roughly the median wage)*•and using variable rates of return from current valuation levels. ***(Chart assumes 35 years of age to start saving and expiring at 85)***



As you can see, markets do not compound average returns over time.**Most importantly, just as with *?pension funds,?* the issue of using above average rates of return into the future suggests one can *?save less?* today because the *?growth?* will make up for the**

difference.

2. **You Don't Live That Long:** Unfortunately, while the science of health care continues to extend our life expectancy rates, there has yet to be a solution for immortality. **So, the next time that someone shows you a chart of 130-year stock market returns and suggesting that *"you too can get those returns,"* just remember you will die long before you get there.** Your expected rate of return is clearly defined by the valuation level you pay for an invest today versus what you will receive in the future between now and the time you expire.•



3. **Psychology Kills:** Despite the mainstream media's consistent drivel•investors should just *"passively index"* and forget about actually managing the risk of catastrophic capital loss, the reality is that investors *"buy high and sell low"* for a reason. ***"Greed"* and *"Fear"* are far more powerful in driving our investment•decisions versus *"Logic"* and *"Discipline."*•**

As Jason states:

"The traditional explanations for believing in an investing tooth fairy who will leave money under your pillow are optimism and overconfidence: *Hope springs eternal, and each of us thinks we?re better than the other investors out there. There?s another reason so many investors believe in magic:* ***We can?t handle the truth."***

Newton's Law Of Gravity

Irrational exuberance and unrealistic expectations are extremely dangerous when combined together. But they are always found *"hanging out"* at the peaks•of previous major bull market cycles.

A recent article by Vishal Khandelwal discussed an interesting point in this regard:

> *"During bull markets, or when bubbles are building up, most people come to the stock market because they desire to earn money fast because they are envious of seeing others doing so. If geniuses like Druckenmiller and Newton couldn?t stand to watch as others made money, and they carried on with full knowledge that they were purely speculating,* ***what chance do we non-geniuses have to survive a bubble and its subsequent and certain burst?"***

> ***"You see, the real tragedy of our life is not that someone else is getting richer or healthier than us, but that he is getting there faster than us. Another tragedy is that when we fall into this comparison trap, it?s hard to stop.*** *Look at fund managers. Most of them have similar stocks in their portfolios, and most still claim to have the skills to outperform others. Read stock forums. Most of them are filled with the noise of people comparing their portfolios with others?.* ***This habit of unintelligently buying things because someone else is making fast money on them comes to the fore when the markets have been rising for some time****. So, even as people know that things are not right around them, they keep dancing to the bubble?s music because everyone else is dancing and making merry.* ***But if you can?t ignore and avoid the temptation that comes from watching other people get rich due to a sharp rise in stock prices, it?s best to know sooner than later that that?s often a path to destruction."***

As•Citigroup?s Chuck Prince said to a newspaper in July 2007, shortly before the subprime bubble burst?

> ***"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you?ve got to get up and dance. We?re still dancing."***

If you are just now showing up to the dance....you are already too late. Just some things I am thinking about.