Stocks are Expensive

The stock market goes up because earnings have increased, or investors suspect that earnings will increase soon. In 2024, the market is up over 23% for the second straight year because the market is anticipating that earnings will increase and not because earnings have already increased. Over the past year, the price-to-earnings (P/E) ratio of the S&P 500 has increased significantly.

As of December 16, 2024, the P/E ratio stands at approximately 31.11, up from 24.35 on December 1, 2023. This represents an expansion of about 6.76 points, or a 27.8% increase. That means the gains in the stock market for 2024 are attributable entirely to earnings multiple expansion not an increase in earnings. This rise indicates that investors are now paying more for each dollar of corporate earnings compared to a year ago, suggesting increased market optimism and therefore higher valuations.

Investors are optimistic that earnings will be increasing, which is why they are willing to pay more for their current earnings. The problem for stock investors is if earnings growth does not materialize as expected, stocks could become overvalued and vulnerable to corrections. For the P/E ratio to remain sustainable, companies will need to deliver strong earnings growth. This puts pressure on businesses to outperform expectations.

One way to pay less for current earnings is to invest in private equity funds. These funds are paying much less for current earnings because private equity traditionally trades at a lower multiple than public equity. Also, the price of private equity funds is not affected by investor sentiment in the same way that public markets are affected. Therefore, private equity has more attractive valuations at this point.

Since 2000, there have been five occurrences in which public markets have generated a three-year trailing performance interval that outperformed private equity. That public market outperformance was typically short-lived, with private equity returns most often reverting ahead in the year that followed. On average, the subsequent three-to-five-year periods following the stronger public market performance interval produced an average outperformance for private equity that ranged between 850-1,050 bps. (8.5-10.5%)*

Source: Hamilton Lane

Have you heard about our Vision Quest Process? Watch the video below to learn more!

We are committed to helping you achieve your financial goals. Please feel free to contact us with any questions, comments, or a more in-depth discussion.

Sincerely,
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