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A Few Words about Valuation versus Price

By: Dr. Luke T Miller

After my last article in The Durango Herald, I received numerous e-mails regarding my comments about the stock and housing market.
After reviewing my last article, I believe the concept of valuation versus price should be discussed. As most of you know, the price of an asset is the amount of money that someone is willing to pay for that asset. The intrinsic value of an asset may be higher or lower than its price, but is always dependent upon that asset's ability to generate cash flows.

> … you could view an asset's intrinsic value as the relaxed position of a rubber band - the further you pull the rubber band away from its relaxed state, the quicker it snaps back.

Investors understand this difference between price and intrinsic value (like the famed Warren Buffett). The value of any asset, whether it is stocks, housing or businesses, is a function of that asset's ability to generate cash flows.

As long as economists have tracked asset prices, prices have fluctuated around this intrinsic value.

Sometimes, the price is significantly above an asset's intrinsic value (we call this an asset bubble), and sometimes, the price is significantly below its intrinsic value (we call this a "screaming deal"). In one sense, you could view an asset's intrinsic value as the relaxed position of a rubber band - the further you pull the rubber band away from its relaxed state, the quicker it snaps back.

Similarly, the further an asset's price moves away from its intrinsic value, the quicker it returns to that intrinsic value.

This explains why price corrections from bubble heights correct downward so violently. It also explains the V-shaped price recoveries from market bottoms.

For example, let's take the value of an average U.S. home in 'normal' economic conditions. The intrinsic value of that home is related to its ability to generate cash flows, or rent (whether you plan on renting the home or not).

If that home is capable of generating $1,500 per month in rent, assuming reasonable estimates of rent appreciation and mortgage rates, the intrinsic value of that home is approximately 12 times annual cash flows, or $216,000.

Now keep in mind this is a broad valuation estimate for all U.S. real estate.

We all know that real estate is local, so it is important to determine the intrinsic value of a home in the Durango area. Using data for the region covering the last 20 years (and similar mountain communities), the intrinsic value of a home in this area is 15 times annual rents.

For example, a home in this area with an average $1,500 monthly rent would be intrinsically valued at $270,000. Comparing this intrinsic value to the second quarter in 2010 in-town Durango home median prices of $335,000 would imply prices in Durango have further to drop before price and intrinsic value are aligned.

A quick study of home prices in the nation and Durango pre-bubble years (before 2003), eerily show that prices have fluctuated almost exactly around rent-based intrinsic values.

As I concluded in my last article, I continue to advise my clients to sell into any strength this year across all asset classes - stocks, bonds, real estate and commodities.

If you are looking for screaming deals, wait for the rubber band to be stretched in the other direction.

The Next 3 Years Will Be Rough on The Economy

By: Luke T Miller

Earlier this year, I laid out my economic expectations for 2010.

I stand by my projections. World economies were given a burst of life since 2008 with the unprecedented amount of government stimulus programs. As these programs wind down, we will see if the economy can stand on its own. I am an optimist, but we face rough times.
As an investment adviser, I advise my clients to sell into any strength this year across all asset classes - stocks, bonds, real estate and commodities. Investors have been given a gift at the expense of taxpayers and would be wise to take it. This gift presently exists in the form of artificially inflated asset prices. Use this time to lock in gains and/or minimize losses on your 2000s investments. In the long run, asset prices return to their steady state valuations determined by the cash flow generation of the asset, known as an asset's intrinsic value. We get excited and bid prices of assets significantly above and below an asset's intrinsic value. We invent reasons to justify price levels. Looking at stock, bond, real estate and commodity prices, we are still above respective intrinsic values.

This last decade, we have had three significant asset bubbles. The first was the technology boom of the 2000s. The story was that the world had changed and we would no longer need brick-and-mortar businesses. However, here it is 10 years later and technology stocks sell for less than half their prices at the bubble's peak. The second was housing. The story was that houses were "real assets" and they didn't go down in value. As we now know, it wasn't these excuses that pushed home values higher, but the failed policies of the Federal Reserve, banks and regulatory bodies. Home prices have dropped more than 30 percent from their peak and most likely will drop another 20 percent from today's prices as the entire gains in real estate prices since 2000 are erased. The third was oil prices. Demand exceeding supply pushed prices up to $147 per barrel and crashed down to $40 per barrel in less than one year.

Play the hand you have been dealt. The economic gods dealt a very favorable hand from 2001 to 2007. Now the deck is thin on aces and face cards, with the smart play to lock in gains, if you have them. Unfortunately, over the next two years, our nation will probably have to deal with a second recession, falling home prices and a stock market that could lose 50 percent or more from today's levels.

Like all asset price patterns in history, time is allotted to implement a value maximizing strategy. I believe stock prices will be stuck in a trading range for the remainder of the year and even challenge the highs of early 2010. Later this year or early next year, I believe stocks will begin a one to two year bear market as the world learns that our economies need more time to heal. Position yourself to sell into strength this year and then during the next bear market, take advantage of valuable assets selling for less than their intrinsic value. Position yourselves accordingly today, and buy when there is blood in the streets in 2011 and 2012.

Fear creates opportunities. Fear of missing the next run higher keeps asset prices high for savvy investors to sell, and fear of a recession's depth will keep prices lower than warranted for the savvy investor to buy.

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