WHEN TO TAKE PROFITS?

BY MAH CHING CHENG

Many financial advisers (FAs) face similar queries from clients from time to time. Clients ask questions such as 'When is the best time to take profits?' or 'Markets are falling now, I am worried, should I take profits?' The dilemma for many FAs is that plenty of time is needed to sieve through and analyze massive chunks of news and information on companies and markets disseminated on a daily basis. More often than not, these economic indicators or company news project conflicting and confusing signals as to what action should be taken. At times, some news items do actually affect markets, but only for a very short span of time (say one to two weeks). These shorter-term considerations might shape their decisions to sell their funds. Our advice to FAs when advising clients on taking profits would be to look at fundamentals such as earnings and valuations. Based on these fundamentals, they can decide whether to get out of the market or add further to their holdings. This approach is simple and has been proven rather effective over time. Besides earnings and valuations, there are other considerations including investment objective and time horizon, which we will be touching on later in this article.

Valuations

The market weighted price-earnings ratio (PE) or 'market valuations' as we commonly address it is a measurement of how 'expensive' or 'cheap' a market is at a particular point of time. The information on market valuations is easily available on the iFAST website. So how is the price-earnings ratio calculated? The price-earnings ratio is the current price of the market divided by the expected earnings per share for the market. Expected earnings are calculated on a weighted average basis (companies with a higher market capitalization will have a higher 'weight' in the calculation of expected earnings).

It is relatively straightforward to compare valuations. A market with a high PE is considered 'expensive' and a market with a low valuation is considered 'cheap'. However, bear in mind that this PE measurement is used on a relative basis. But we need to know whether the PE measurement of the market is compared to valuations across markets, or compared within the same market on a historical perspective. In the case of profit taking, comparing with historical valuations is more relevant, as it is a better gauge as to whether the market is overvalued or not.

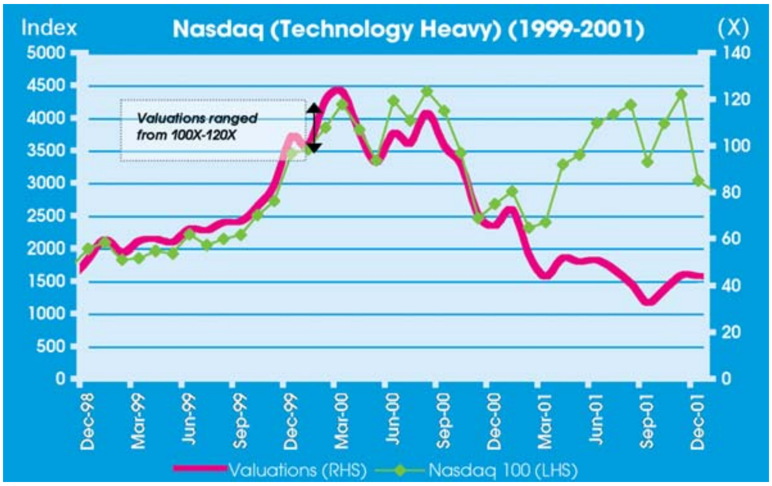
In other words, if the PE for market A is 25 times, on an absolute basis you cannot tell whether it is expensive or cheap. However, if a comparison is made vis-à-vis other regions and we find that valuations of other regions range from 30 times to 40 times, the valuation for this market is relatively attractive. But for the purpose of deciding whether or not to take profits, we can compare current valuations to the historical range of valuations. If historical valuations range from 10-15 times, we can say that market A is 'currently trading at a relatively high PE in comparison to the historical range'. In such a situation, investors may be recommended to take profits. Let us look at the example of the technology market (represented by NASDAQ 100) to illustrate the use of market valuation as an indicator to take profit.

Chart 1 shows the market valuations and index for NASDAQ 100 from December 1998 to December 2001, which was during the technology bubble. At that point of time, PE ratios reached the range of 100-120 times (from January 2000 to October 2000). Relative to other markets at that point of time, such a valuation was extremely high. More importantly, if we compare on a historical basis, such a range represents an astronomical level. The euphoria surrounding technology stocks resulted in investors frantically snapping up these technology stocks without regards to the valuation of these technology companies. This was especially so for investors buying up shares of 'dot-com' companies. Eventually, nearing the end of year 2000, the euphoria cooled down and the tech market started to fall. Technology stock investors also frantically followed a 'herd mentality' and sold off their holdings causing a further plunge in the technology market. The lesson learnt here is that investors should always look at valuations to determine if the market is overvalued. In such a situation, if the market valuation approach were used, investors would have identified that the technology market was overvalued and was bound to decline eventually. In this case, it would have been clear to investors that they should be avoiding or selling out of technology funds by end 1999.

Interest rates could also affect the valuations of stock markets. When market interest rates are relatively low, the valuation of the market tends to be higher. One good example would be the Japanese market. Interest rates for the Japanese market are low historically. As at 14 June 2005, the yield of the 10-year Japan Treasury bond is about 1.235%. In this situation, Japanese investors would rather invest in equities rather than fixed income instruments that offer low rates of returns. As a result of that, the absolute valuation of the Japanese market is likely to be higher than other regions (which offer better rates of returns for their fixed income instruments). Table 1 shows that the 2005 forward valuation is 18.5 times.

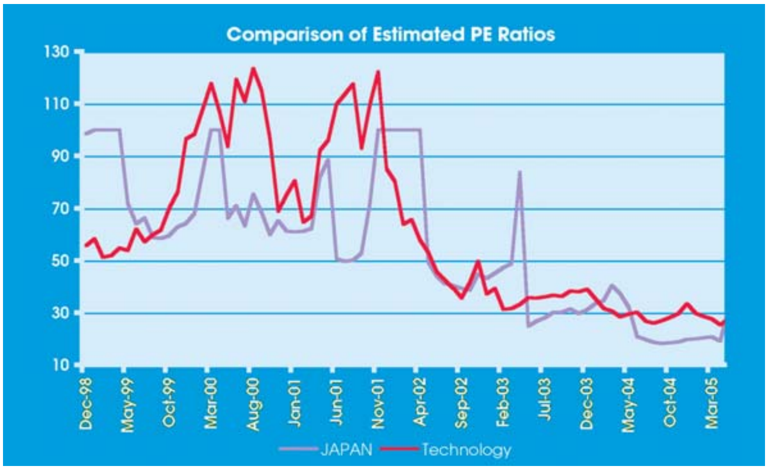
What can current market valuations tell us? Charts 2 and 3, and Table 1, show the market valuations for four regions and

CHART 1: ILLUSTRATING MARKET VALUATIONS



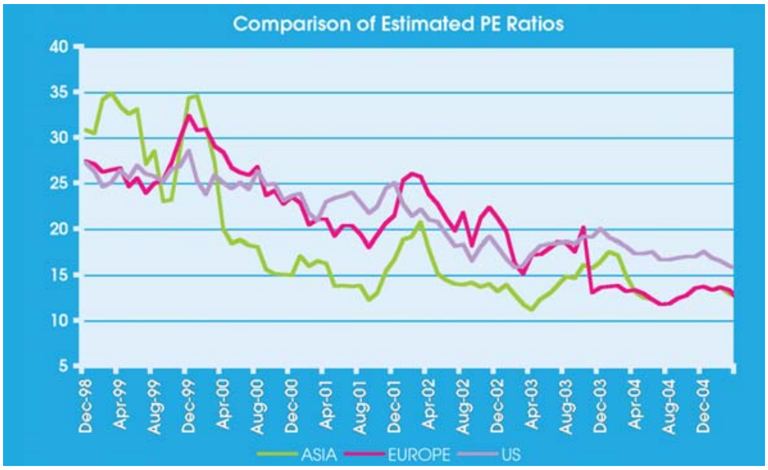
SOURCE: BLOOMBERG

CHART 2: CURRENT MARKET VALUATION
TECHNOLOGY (NASDAQ 100) & JAPAN (NIKKEI 225)



SOURCE: BLOOMBERG

CHART 3: CURRENT MARKET VALUATION
ASIA EXCLUDING JAPAN (MSCI ASIA EXCLUDING JAPAN INDEX), US (S&P 500)& EUROPE (DJ STOXX 50)



SOURCE: BLOOMBERG, IFAST COMPILATIONS

TABLE 1
ESTIMATED PRICE EARNINGS RATIOS (AS AT JUNE 2005)

	Estd PE 2005	Estd PE 2006
US	16.4X	15.6X
Europe	14.6X	13.6X
Japan*	18.5X	16.7X
Asia ex Japan	12.5X	11.0X

SOURCE: IFAST COMPILATIONS
PLEASE NOTE THAT VALUATIONS FOR THE TECHNOLOGY SECTOR ARE NOT COMPILED BY IFAST.
* FOR JAPAN VALUATIONS ARE FOR FINANCIAL YEAR ENDING MARCH 2006 AND MARCH 2007.

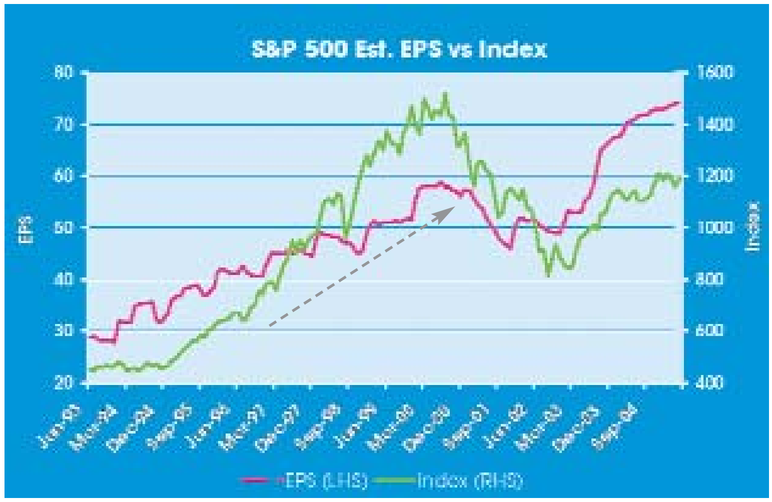
the technology sector. The valuations for these markets are at the lower end of the historical range. Thus, there is no actual need to worry about having to rush to take profits at the time of writing. However, it is good practice for advisers to re-balance their clients' portfolio over time to maintain a well-diversified portfolio. What is the other factor that advisers can look at when deciding whether to take profits?

EARNINGS TREND

Earnings trend is an important consideration investors should take note of when deciding whether or not to take profits. Consolidated earnings growth of companies that makes up the market index is compiled by iFAST and presented to advisers on a periodic basis. What does future earning trends tell us? A strong sustainable earnings stream means that the health of the underlying companies is likely to remain strong. Thus, there is a strong potential that the value of these underlying companies would improve. However, we should look at the sustainability of the future earnings trend rather than focusing on shorter-term trends.

For example, chart 4 shows us the earnings trend and the S&P 500 index for the past 12 years. We can see that market earning follows an upward trend in the long term. Secondly, earnings seem to be trending up at this point of time. There are many diverse factors that cause earnings to trend down instead of up. One of these many factors would include a recession in the economy. Another factor would be when market conditions fundamentally change. For example, if the government decides to restrict foreign

CHART 4
S&P 500 ESTIMATED EPS VERSUS INDEX LEVEL



SOURCE: BLOOMBERG, IFAST COMPILATIONS

CHART 5
MSCI ASIA EXCLUDING JAPAN, INDEX LEVEL AND FORWARD EARNINGS

SOURCE: IFAST COMPILATIONS, BLOOMBERG

direct investment inflows into a market that depends heavily on these inflows, this would probably exert a negative impact on the earnings trend.

At times, earnings might temporarily follow a downward trend for 1-2 years due to a cyclical downturn or a brief recessionary period in selected industries. However, once the economy recovers, earnings are likely to trend up again. It is important for advisers to look into the long-term earnings growth trend when deciding whether or not to take profits.

Let's take a look at the earnings trend for Asian markets. Chart 5 shows that there is an uptrend in earnings. However, there were times when earnings growth took a breather. During the 1997-1998 period, earnings declined sharply as the Asian financial crisis hit the profitability of many Asian companies. However, even then, after the crisis, earnings started to trend up again. Today, most of the Asian economies are still developing countries with strong potential for growth. These developing Asian economies have the advantage of having relatively low cost labour in comparison to developed economies. In addition, efforts are taken by Asian governments in spending on infrastructure to attract multinationals to invest domestically. We think that if fundamentals of the underlying economies remain strong, these positive factors are unlikely to change in the next 3-5 years. Thus, we expect that the positive earnings trend for Asian companies is likely to continue.

RISK PROFILE AND TIME HORIZON ARE IMPORTANT CONSIDERATIONS

Examining the two fundamental factors such as earnings growth and valuations before taking profit is important for investors. However, there are also other factors, which might affect the decision of the investor to switch funds or take profits. Advisers might already be familiar with these factors. As an investor grows older, the risk profile for the investor would inevitably change. For example, a young married couple might take up a more gung-ho approach in investing, whilst a couple with kids would seek more capital preservation to save up for their children's university education. Thus, as the considerations and responsibilities change for an individual, the risk profile of the individual also gradually changes.

The expected time horizon of investment also changes. For example, a 25-year-old investor who invests right after she started work would be able to take on more aggressive portfolios. The investment horizon for this investor is long - perhaps 30 years (till she retires at 55 years). However, as an investor grows older, and approaches her retirement age, she would actually seek to preserve the capital that she had previously invested. The changing nature of both the risk profile and time horizon of the investor are important factors to consider when we are looking at portfolio construction and advising clients. Thus, it is important to recognize these factors and continuously shift towards less risky assets such as bonds when the client gets older.

Rebalancing can also be part of the profit taking strategy taken by investors. When a certain market performs well, the allocation to that particular market might be higher than what the investor initially started out with. Rebalancing would be able to help the investor in keeping the portfolio diversified.

CONCLUSION

Investment portfolios can radically change due to changes in investment objectives, which comprise components such as the projected investment time horizon and risk profile. However, during times when investment objectives and investment time horizon do not change, but the market fluctuates, investors might start to worry about this shorter-term volatility. In many instances, investors get caught up with chasing the market and following a 'herd mentality' in investing. Worries over short-term trends should not overshadow fundamental factors, including whether a market is over-valued, and whether earnings growth is sustainable.

Therefore, the two main variables that investors should look at in analyzing markets are future earnings and valuations. News and information are disseminated in the market place causing short-term movements on a daily basis. But the significance of these pieces of news would depend on how they could affect earnings and valuations. To summarize, advisers can advise clients to take profits when:

1) Valuations of the market have gone from fairly valued to overvalued relative to historical valuations.
2) The market is expected to experience a sustainable downtrend in earnings.

At this point of time, our view is that the valuations for most of the regional markets (Japan, US, Asia & Europe) appear either attractive or reasonable relative to historical valuations and considering the low interest rate environment. In addition, there is still a visible uptrend in expected earnings. If valuations remain this way and there is a sustainable positive earnings trend, investors should not worry too much about taking profits when they see short-term volatility in the market. In addition, we would like to emphasize that rebalancing of portfolios is still necessary to maintain a well-diversified portfolio.

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