Market Valuation From An Asset Allocation Perspective

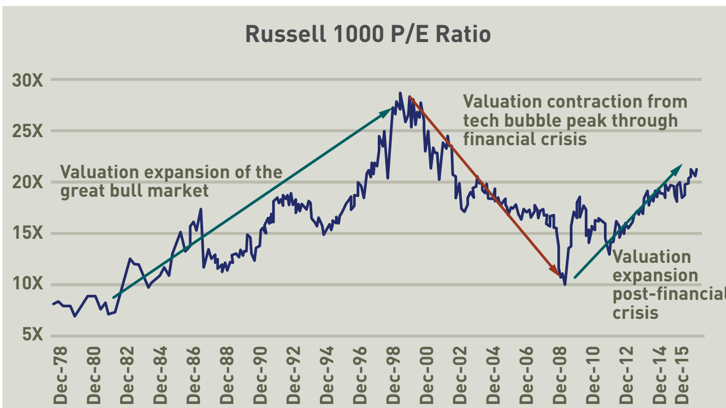
February 2017

Aneet Deshpande, CFA, Managing Director, Multi-Asset Strategies

The question of whether the broader domestic market is overvalued or undervalued at any particular moment in time requires an incredible amount of context. To learn more about the factors at play, we sat down with Aneet Deshpande, CFA, managing director, Multi-Asset Strategies, to discuss valuations in light of the current market, as well as the firm's overarching principles.

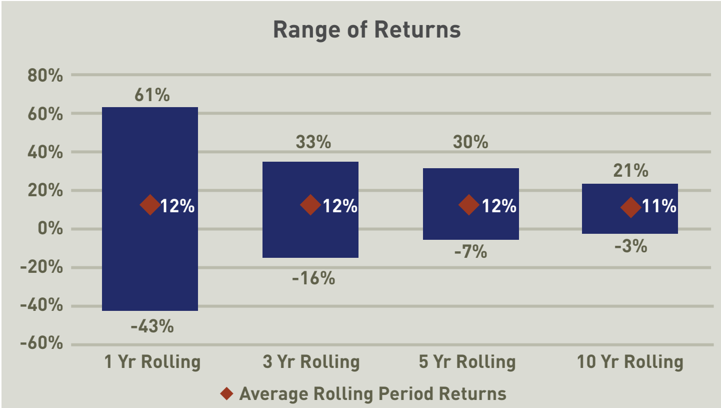
There seems to be increasing talk of valuation concerns in domestic markets. From an asset allocation perspective, what is your view?

When thinking about valuation, it's important to distinguish between short-term and long-term return expectations. So there are a couple different ways to address that question. If you're trying to conjoin the concepts of valuations and return expectations together into a formula, for instance valuations are A therefore returns should be Z, you can't do that with any real efficacy in the short term. Annual returns are chaotic and the range of returns is extraordinary.

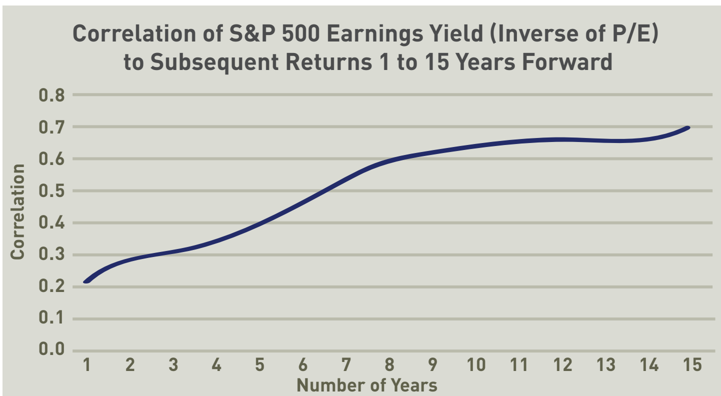


Source: PNC Capital Advisors, LLC, FTSE Russell
Price-to-trailing earnings excluding negative earnings

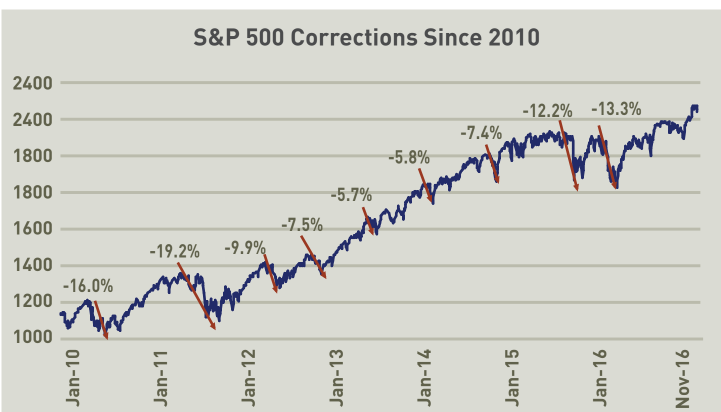
We believe that valuation measures (e.g. the price-to-book ratio or price-to-earnings ratio) are better barometers of longer-term (i.e. greater than 10 years) expectations and are highly path dependent. Given this, we tend to focus the process of asset allocation around longer-term expectations where asset class returns are more likely to produce an outcome that is within an acceptable range of expectations. "Range of expectations" being the operative words. Singular forecasts are not rational, at least to us. Rather think of it this way: Valuations are A, therefore returns over a subsequent period of 10-plus years should be between Y and Z, given a certain level of confidence.



Source: PNC Capital Advisors, LLC, Standard & Poors, Factset Research Systems
Rolling total returns for the S&P 500; CAGR, monthly 1945-2016



Source: PNC Capital Advisors, LLC, Robert J. Shiller
www.econ.yale.edu/-shiller/data/ie_data.xls
Rolling price returns; monthly 1945-2016



Source: PNC Capital Advisors, LLC, Factset Research Systems
Daily price return

With that disclaimer in mind, where are we today? We believe valuations aren't cheap. That's a comfortable statement to make. But what does it mean? We think the appropriate context is: Markets are not cheap, therefore we have a higher probability of earning a long-term return that is less than the historic average. There is a tendency for investors to link the concepts of "cheap" or "expensive" to explicit short-term market outcomes. Behaviorally – and probably incorrectly – it helps validate the need to trade.

If the market is in fact overvalued, does that mean a market correction is ahead?

First, we believe the answer is always yes. Irrespective of valuations, corrections are part of investing in risk assets such as equities. Second, high valuations by themselves don't cause stock prices to fall. The market needs a catalyst. Valuations may serve as a margin of safety or play a role in the depth of a decline, but simply having "high" valuations doesn't make the market go down. Nor does a "low" valuation necessarily mean the market will go higher. Typically, you need some kind of a cyclical catalyst (like a recession or a recovery) or an idiosyncratic event (such as the Taper Tantrum in 2013 or a geopolitical event). But let's take it one step further and separate declines into two buckets: corrections and bear markets.

For example, since 2010 the S&P 500 has increased +100% and +133% in price and total return terms, respectively, and that climb was accompanied by a number of corrections.

So, corrections happen with more regularity than one may recall or care to acknowledge.

The latter category of bear markets, where the market declines by more than 20%, are more times than not associated with prolonged monetary tightening, the end of a credit cycle, and recessions. However, there have been two non-recessionary bear markets: the Cuban Missile Crisis in 1962 and the Black Monday flash crash in 1987.

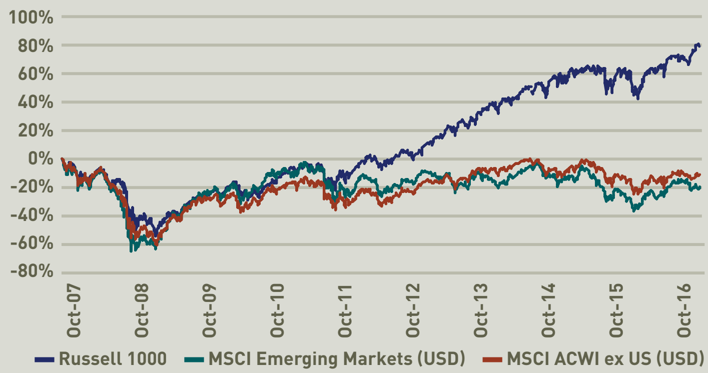
Past performance is no guarantee of future results.

So with that context in mind, is a correction ahead? History tells us yes. When? We don't know. They are unavoidable, so having a disciplined process with a long-term approach to asset allocation can help guide us through those moments.

Relating back to today, we believe earnings need to grow into valuations given what we've seen in markets, particularly in the post-election period. Moreover, depending on potential regulatory and tax reforms and/or a fiscal push over the years ahead, the U.S. economy may be able to grow at a faster rate than we have recently experienced. Such a growth rate may aid profitability. We think these are rational views for today.

There are relative bright spots. International markets have favorable valuations relative to the U.S. on a long-term basis. We believe multiple years of underperformance post-financial crisis have helped create the opportunity. The key here, however, is one of path. In the near term, foreign exchange and other macro variables may influence returns on a short-term basis. But, we believe there is a higher return potential in emerging and developed international markets relative to domestic markets given a long-term horizon.

Cumulative Total Return from Prior Peak (Oct 2007-Dec 2016)



	P/E	P/S	P/B	Div Yld
Russell 1000	19.2	1.9	2.9	2.0%
MSCI ACWI ex US	16.0	1.1	1.5	3.0%
MSCI EM	13.5	1.2	1.4	2.6%

Source: PNC Capital Advisors LLC, Bloomberg, Factset Research Systems
P/E = Price/Trailing 12m, P/S = Price/Trailing 12 month
12 month P/B = Price/Weighted Book Value Per Share, Div Yld = Trailing 12 month Dividends/Price

So with this market and valuation backdrop, how to you approach asset allocation?

Well, we adhere to a systematic process centered on the objective of the product or client whose assets we are managing. As a firm we strive to create and promote disciplined processes within our investment teams. That virtue is carried over to asset allocation as well. We think that the objectives of a product or client are best solved for through carefully thought out and well-parameterized processes. We believe having such a systematic mindset helps us limit, if not eliminate, noise or behavioral biases.

We think it's also important to point out that how information like valuations is incorporated, if at all, into a process can be highly dependent on the objective of the client. In any case, our capital market expectations and portfolio construction follow iterative and disciplined processes so that we are always thinking about things as they may relate to the portfolio's objective, whether that be valuations or otherwise.

Past performance is no guarantee of future results.

Market Valuation From An Asset Allocation Perspective

International investments are subject to special risks not ordinarily associated with domestic investments, including currency fluctuations, economic and political change and differing accounting standards that may adversely affect portfolio securities. These risks may be heightened in emerging markets. Because frontier markets are among the smallest, least mature and least liquid of the emerging markets, investments in frontier markets generally are subject to a greater risk of loss than investments in developed markets or traditional emerging markets. To the extent that the Fund invests directly in foreign currencies or in securities that trade in, and pay revenues in, foreign currencies, or derivatives that provide exposure to foreign currencies, the Fund will be exposed to the risk that the currencies will decline in value relative to the U.S. dollar, or, in the case of hedging positions, that the U.S. dollar will decline in value relative to the hedged currency. Investments in growth companies can be more sensitive to the company's earnings and more volatile than the stock market in general. The Fund may invest a portion of its assets in derivatives. Derivative instruments include options, futures and options on futures. A small investment in derivatives could have a potentially large impact on the Fund's performance. The Fund may be unable to terminate or sell a derivatives position. Derivative counterparties may suffer financial difficulties and may not fulfill their contractual obligations. The Fund's investments in securities that are or become illiquid may reduce the returns of the Fund because it may be unable to sell the illiquid securities at an advantageous time or price.

You should consider the investment objectives, risk, charges, and expenses of PNC Funds carefully before investing. A prospectus or summary prospectus with this and other information may be obtained at 800-622-FUND (3863) or pncfunds.com. Please read the prospectus carefully before investing.

PNC Capital Advisors, LLC, a subsidiary of The PNC Financial Services Group, Inc., serves as investment adviser and co-administrator to PNC Funds and receives fees for its services. PNC Funds are distributed by PNC Funds Distributor, LLC, which is not affiliated with the adviser and is not a bank.