Measuring the Market

How to tell what’s really happening with your investments

Market volatility, the daily change to stock and bond prices, is a normal part of investing. On any given day, you can find both optimists and doomsayers. So how does the savvy investor decide whether to feel worried or encouraged? There are any number of sophisticated measures investing experts use to evaluate the stock market, but most relate to one of three fundamental principles: earnings, valuation and sentiment.

What you get for your money: Earnings per share.

Earnings per share (EPS) represents a company’s profitability. Analysts calculate EPS to not only evaluate individual stocks, but also the health of the stock market overall.

Simply done, analysts calculate EPS by taking a company’s net income, or earnings, and dividing it by the number of common shares. To make the estimate more sophisticated, they may also:

- Subtract dividends paid on preferred stock (if any).
- Use a weighted average number of outstanding common stock shares (to reflect changes over time).
- Assume any outstanding stock options, warrants or restricted stock units were exercised, as this would increase the number of outstanding stocks and reduce the earnings per share.

Some investors believe that growth often follows earnings and consider EPS one of the predictors of longer-term investment performance. While EPS has value by itself, the number also plays an additional part in evaluating a stock’s share price or valuation.
Is it worth it? Valuation.

There are a number of ways to evaluate the price, or valuation, of a stock, but one of the most common is the price to earnings (P/E) ratio. The calculation of P/E divides a stock’s per share price by the company’s earnings per share. By itself, P/E simply tells an investor the amount of money he or she must pay for a dollar of earnings. It can, however, be an indicator of how much the marketplace values a stock and many investors use P/E ratios as predictors of intermediate-term market performance. For example, the average P/E ratio for stocks in the S&P 500 index is around 15. A higher number may indicate that the market anticipates a stock will experience significant growth and the price is increasing, as a result. A lower number might suggest that the market does not anticipate growth for the company or that the market is undervaluing the company’s stock.

Ultimately, a P/E ratio is just a number and it is up to the individual investor to decide whether a stock is under- or overvalued. This is where market sentiment can come into play.

The bulls and the bears.

Investors’ attitude about the direction stock prices will take is market sentiment. If they feel prices will be going up, they are bullish. More pessimistic investors are bearish. While sentiment is tied to emotions, analysts often try to evaluate it by looking at numeric indicators such as market trading activity and short-term price volatility; or more speculative measures like investor surveys, social media and news headlines. Because evaluation of market sentiment is so subjective, it can be the most difficult to predict. Sentiment has been known to drive stock prices down when every other indicator is positive, and vice versa, but sentiment usually has only a short-term effect on market prices.

The importance of strategy.

There is no perfect algorithm to predict how the market will perform. Because of this, most investors make their investment decisions independently of short-term measures and based on their investment objectives, time horizon and risk tolerance. They avoid making changes to their strategy based on day-to-day fluctuations in price because they realize time in the market tends to outperform timing of the market.
Our Mission | To be the worldwide value and service leader in insurance brokerage, risk management, employee benefits and retirement services

Our Goal | To be the best place to do business and to work