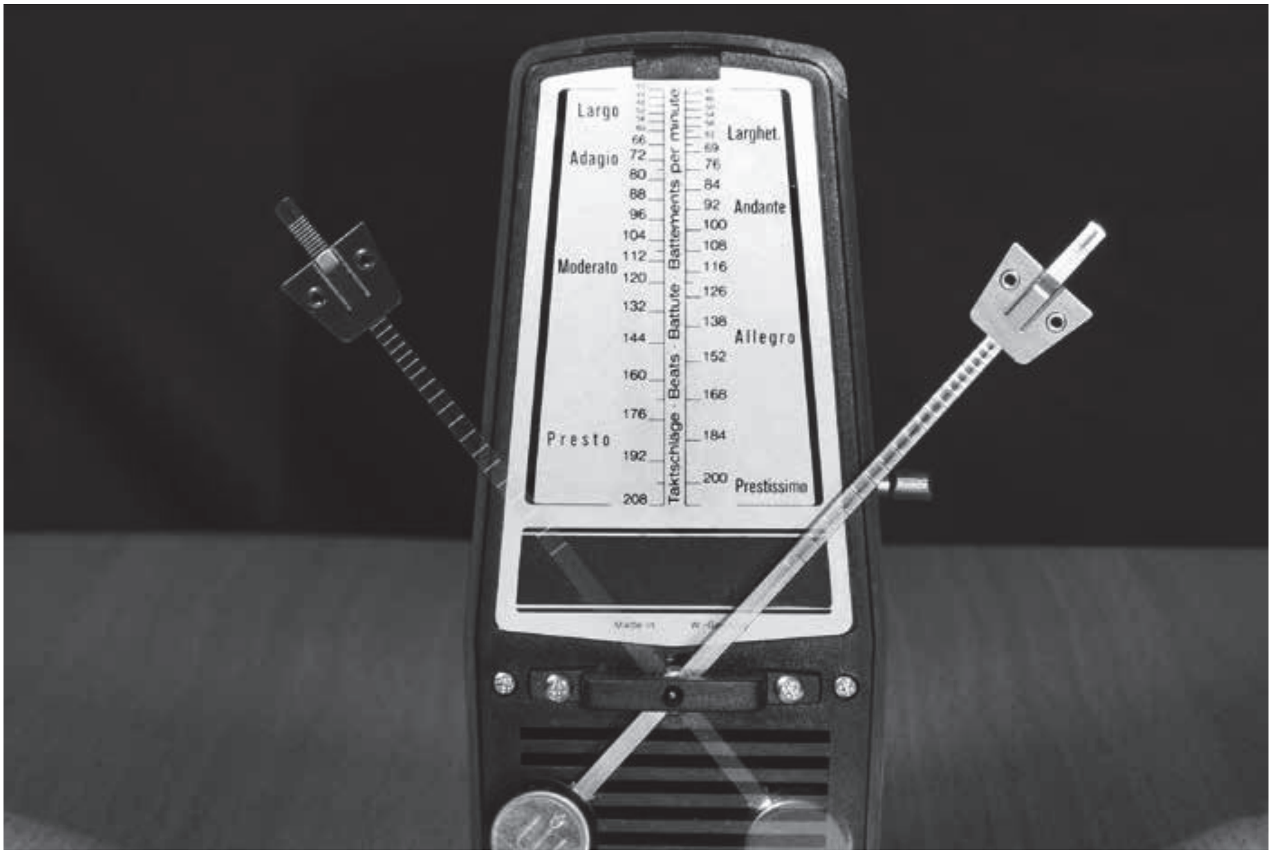

Time to take profit on the FTSE 100?

Above-average returns seem likely

John Kingham

Over the last 25 years or so, the FTSE 100 has repeatedly zig-zagged between 3500 and 7000, swinging back and forth between bull market and bear market.

As I write, the UK large-cap index sits at 7400, only slightly below its all-time high of 7800. And yet despite this seemingly high price, one interpretation of the dividend discount model suggests the FTSE 100 is attractively valued, implying that above-average returns are likely over the medium to longer-term.

At first glance that doesn't seem to make sense. How can the FTSE 100 be attractively valued at near-record prices? To answer that, we need to back up a bit and clarify the difference between the FTSE 100's price and its fair value.

The idea that price and fair value are not the same is common to all forms of trading or investing. This difference becomes obvious when sellers want to sell quickly for one reason or another.

For example, someone might part exchange their old car and accept a price far below fair value because they want to get rid of the old car immediately, in order to buy a new car today. The buyer can then make a profit by putting the car on the forecourt and waiting (perhaps for several weeks) until a buyer appears who is willing to pay fair value.

Another example would be someone who inherits a house and then sells it for less than its fair market value. They do this because they want to turn the property into cash now, rather than spending months trying to sell the property for its fair market value.

The same thing occurs in the stock market. Sometimes share prices accurately reflect fair value, but much of the time they don't. Prices can be below fair value for all manner of reasons, perhaps because people are selling shares to invest their money elsewhere, or they need the cash, or they're afraid. On the other hand, prices can be above fair value too – typically when the market has had a good run and everyone wants to jump on the bandwagon.

As investors, if we're looking to get above-average returns, then one proven way to do that is to invest when prices are below average, i.e. below fair value. This holds true whether you're buying and selling cars, houses, entire companies, or just the small pieces of companies we call shares. To buy below fair value, we obviously need to know what the price is and what fair value is.

Price is easy to work out. In the case of the FTSE 100, it's published online and in newspapers every day. As for fair value, for cars you could look at the Parkers Car Price Guide and for houses you could look at HM Land Registry's price paid data. But for the stock market, there is no equivalent – and accurately calculating fair value is impossible.

However, we can estimate fair value, and one way to do that is with dividends.

A technical description of fair value is that it is the sum of all expected future cash returns from an investment, discounted at an appropriate rate (based on the uncertainty and timing of those expected future cash flows). The main cash returns from shares are dividends, so it's sensible to use dividends to estimate fair value. This is often called the dividend discount model of valuation.

A very simple way to estimate fair value is to assume that fair value is the price at which investors can reasonably expect to receive returns which are close to their historical average.

To estimate historically average returns for the FTSE 100, we can use the old dividend yield plus dividend growth model. This states that the long-run return from a dividend paying investment is equal to its dividend yield plus the long-term dividend growth rate.

Since 1985, the FTSE 100's dividend yield has averaged 3.3%, while its dividend growth rate has averaged 6% per year. On that basis, we can assume that on average, investors expect to get a return of 9.3% per year.

Of course, we don't know if the FTSE 100's dividend will continue to grow at 6% per year in the future, but it seems like a reasonable assumption given that we don't have a crystal ball. Now that we have an estimated expected return (9.3% per year), we can work out the FTSE 100's fair value at various points in time, both in the past and today.

Today, we all know that in 1999 the FTSE 100 was caught up in the dot-com bubble. But it was also possible to know that at the time, and therefore to avoid investing in what was a very overheated market.

In 1999, the FTSE 100's price was around 7000 and its dividend yield was 2.0%. Remember, that was its price, not its fair value. Its fair value, according to this dividend discount model, would be the price which its dividend growth rate (about 6%) plus its dividend yield equalled, so about 9.3% (or thereabouts).

That would occur if the index had a dividend yield of 3.3%, and that's the yield the FTSE 100 would have had if its price were 4250.

So according to this approach, the FTSE 100's fair value in 1999 was 4250, significantly less than the actual price at the time of 7000.

That's all very interesting, but what about the FTSE 100 today?

If dividends do continue to grow at 6% per year, as they have for at least 35 years, then fair value for the FTSE 100 today is around 9750, far above the index's current price.

Thanks to the index's inflated price in 1999, it has failed to make any significant price gains in 20 years. However, although the index's price has gone nowhere for 20 years, the same is not true of its dividend.

Since 1999 the FTSE 100's total dividend has more than doubled, to the point where today, with a price of 7400, the index has a dividend yield of 4.3%. That's well above the 3.3% average since 1985, suggesting that future returns will be above average if the dividend can grow at the historically average rate of 6% per year.

And if dividends do continue to grow at 6% per year, as they have for at least 35 years, then fair value for the FTSE 100 today is around 9750, far above the index's current price.

Of course, none of this is set in stone and the future will always be uncertain, but according to this dividend-based valuation model, the FTSE 100 is attractively priced at 7400. And, rather than revisiting the sub-4000 lows of the last two bear markets, it seems much more likely that the FTSE 100 will instead return to fair value by moving up to, and beyond, 10000 at some point in the next few years.

John Kingham is the editor of *UK Value Investor*, the investment newsletter for defensive value investors.