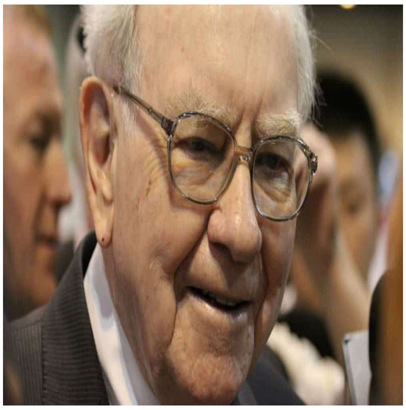

Warren Buffett: How to Invest in an Overvalued Stock Market

Description

Are we dealing with an overvalued stock market? If we consider the actions and warnings of investors like Buffett, yes. He has been saying for some years now that the market is aggressively overpriced. Many people thought a crash would rectify the situation, but it has actually made it worse (though it can't be said about all the underlying sectors).

The **S&P/TSX Composite Index** reached its pre-pandemic high earlier this month. Stock markets across the border, especially **NASDAQ**, has catapulted after the market crash. The NASDAQ index has grown 37% *more* than its pre-pandemic peak. If according to Buffett, the U.S. stock market was overpriced even before the market crash happened, it might now be considered a bubble just ready to burst.

The situation isn't as dire here, but since the underlying economy is weak, the market can be considered overpriced. There are a few things you need to keep in mind when investing in an overvalued stock market.

Buffett's investment principles

Warren Buffett has always been a value investor. It means he prefers to buy undervalued stocks that have the potential to recover in the future and offer good returns in the long run. And you can find many such stocks in an overvalued market as well, i.e., sectors and industries that are going through a tough time right now (like energy).

Buffett also prefers to focus on valuation compared to the chance of rapid growth. The stocks that are on a tear are usually overpriced, but people still keep buying them, hoping that the rapid growth will make up for the overvaluation. But Buffett recommends focusing on stocks that are trading at a discount compared to their intrinsic values instead.

But perhaps one of the most important principles of all is taking a long-term approach to invest. Instead of thinking about what might be a good investment a few months or a couple of years from now, investors might want to consider which investments would over good returns over the next few decades. The long-term view of assets keeps people from worrying too much about temporary market fluctuations.

An undervalued opportunity

The real estate sector is undergoing some trouble at the moment, which has placed a discount tag on good companies like **Killam Apartment REIT** (TSX:KMP). The current share price is over 23% down from its pre-pandemic peak, and it has been almost static since the market crash. It's trading at a price-to-book of 1.1 times and a price-to-earnings of 8.3 times.

It has also been growing its dividends steadily for the past four years, and the payout ratio is very secure, 31.4%. The yield of 3.73% might pale compared to what some of the other REITs are offering, but that's not the only reason to consider Killam. Before the crash, it was one of the most steady growth stocks in the sector. Its strong balance sheet and consistently growing revenues indicate that the company is moving in the right direction.

As Buffett says to invest in profitable businesses and the stock would follow, there is a high probability that Killam might resume its pre-pandemic growth and deliver excellent returns in the long-run.

Foolish takeaway

It's important to note that not every undervalued business is not worth investing in, however. Take the energy sector, for example. If you believe that a shift toward green will push the oil businesses down to obscurity, buying undervalued energy stocks (even the ones with stellar histories) might not be in-line with Buffett's approach to value investing.

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