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Rich valuation refers to a security that is priced above expected levels without a logical explanation. The term is applicable to the valuation of any asset, but it is most commonly used with reference to stock valuations.

An asset that is trading at a rich valuation may have a risk/reward payoff that is not particularly attractive to value investors.

Rich valuation can be used in several contexts in finance. Each context refers to a situation where an asset, usually a stock, has a high current market price compared to a particular benchmark; either a historical average, peers or valuation modelling based upon earnings multiples, or free cash flows (FCF).

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Stocks that are trading at very high multiples in relation to their earnings or book value (price-to-earnings or price-to-book ratios), compared to their peers, are considered to be trading at rich valuations.

Similarly, a real estate investment trust (REIT) would be considered to be richly valued if it is trading at a high multiple of its funds from operations (FFO); calculated by adding depreciation and amortization to earnings and then subtracting any gains on sales.

A company becomes richly valued when investors are confident and buy lots of its stock. Bullish sentiment pushes the company's share price up to a level that might not be justified by current figures, such as revenue, cash flow, and profit, reported in financial statements.

Rich valuations are usually triggered by bullish analyst growth projections, optimistic company guidance, and positive media commentary.

When a company commands a rich valuation, it often suggests that investors are betting on it achieving all of its lofty goals in the future. That invariably means that the slightest hint of a slip-up can have disastrous consequences for the share price. As a result, some investors view rich valuations as a good opportunity to sell.

Examples of Rich Valuation

Assets tend to achieve rich valuations during bubbles. During the tech bubble of the early 2000s, stocks hit prices that weren't supported by typical valuation models and prices were incredibly high compared to historic norms.

The increased stock valuations were a mix of speculation and excess venture capital money that was funding startups. These companies never actually made any revenue or profits, leading to the collapse.

Likewise, during the housing bubble that predated the Great Recession, home prices saw incredibly rich valuations compared to historic averages. The Dotcom bubble was partially responsible for the housing bubble as investors moved their investment capital into real estate.

This combined with lower interest rates led to a beeline to home purchases, which dramatically increased housing prices.

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