APRIL 12, 2013

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Is It Different This Time

The great pioneer of global investing Sir John Templeton said that “The four most dangerous words in investing are ‘this time it’s different.’”

By this, he meant to warn against counting on the power of any new paradigm to invalidate lessons of the past and extrapolate *ad infinitum* the prevailing dynamic of the moment.

The temptation to mistake temporary forces for permanent ones can seduce pessimists when things are bad, such as in the early 1980s when runaway inflation was feared permanent and the bulk of investors missed generational lows in bond prices and stock valuations. And it can seduce optimists when things are good, such as at the turn of the millennium, when the internet seemed to have “changed everything” such that old metrics of valuation were ridiculed in favor of new ones contrapted to justify stock prices at truly stunning highs relative to actual cash flows.

We find a salutary alternative to “this time it’s different” in an older text: *there is no new thing under the sun.*

This isn’t to say that each market cycle doesn’t differ in its particular details and how they combine. Rather, it’s that no combination of factors can permanently repeal the inexorable dynamics of self-interest filtering through a rationality-addling echo chamber of greed and fear. Over-investment in one area gets funded by over-divestment from another. Things get overdone at the extremes of ebullience and revulsion until, inevitably, prices snap back at some point unknowable in advance.

The new stock market highs we’ve just reached don’t even compare to the tech bubble’s derangement in valuation – today’s Shiller P/E of 23.3 is well north of its 16.5 historical average, but that’s downright sober-looking compared to the 44.2 level reached in December 1999. Even so, at 40% above the long-term average, it’s running at a level whose historical antecedents have ended badly, and with stock prices (its numerator) scaled against company profits (its denominator) that *are* at stunning high margins due to earnings growth outrunning sales growth.

What’s different this time? Well, as suggested above, the new paradigm extrapolates record profit margins – dubious, because unwavering margins would imply a competitive stasis where companies stopped trying to grab market share. It also takes the following for granted:

1. The US Federal Reserve can engineer whatever interest rates it wants via open market operations, whereby it buys up bond supply using monetary reserves created expressly for that purpose;
2. The market effects of those operations are predictable, repeatable, and beneficial;
3. Any unintended consequences can be tamped down with a more vigorous application of reserve-funded open market operations as described in #1 above.

The closed-loop circularity of the process seems to insure against the danger of surprises: *the Fed buys up securities, and if anything goes wrong with that, it can just buy more to fix it*. It’s as if the Fed has perfected the financial equivalent of a perpetual motion machine… such seductive and easy-seeming ingenuity. So we’re at new highs, and until something knocks us off this trajectory (even something as simple as just going too far), we’ll make *new* new ones. All of which can be at least temporarily rewarding the more aggressively one speculates.

What isn’t different this time? When speculation trumps investment fundamentals, gains are made *in spite* of risk-taking rather than because of it. Spec rallies can be rented and ridden, but their gains not easily held onto.