



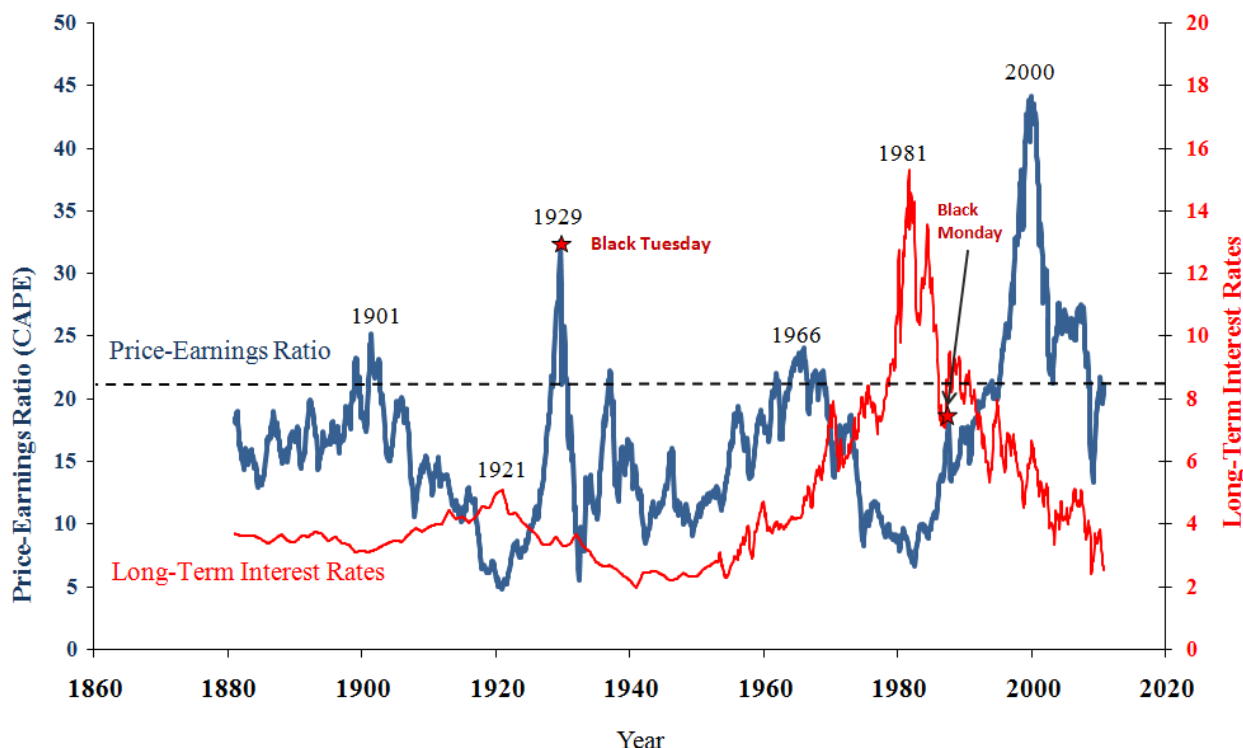
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## Valuation Matters

The Shiller price/earnings ratio (or P/E multiple) relates the stock prices of large US companies to their 10-year average earnings. Shown by the blue line in the chart below, it's our preferred basic valuation measure because by embracing a decade's profit data, it normalizes away the transitory influence of shorter-term business cycles. The red line below shows the yield on the benchmark 10-year Treasury note. Each measure can be seen as a summary statistic for absolute valuation of their respective assets classes – the Shiller P/E for stocks, the 10-year T-note for bonds. Summary statistics can't tell the whole story, but they at least give you a feel for the plot.



*Data Source:* [Robert Shiller](#), Department of Economics, Yale University. As of 10/5/2010.

Now look at the dotted horizontal line which intersects the current Shiller P/E level of 21.2. The historical average on this metric is about 16.4, which too easily leads to a naïve conclusion that stocks are currently some 29% overvalued and ripe for a fall. In the near-term, of course, the market doesn't give a hoot about how a 10-year ratio compares to its 130-year track record. But given that we don't own stocks for their near-term potential, the historical implications of a 21.2 Shiller P/E over periods longer than a couple of years should matter to us.

What jumps off the page is how short-lived P/Es above 21.2 have been. The sole instance of sustained multiple expansion (i.e. higher P/E ratios) from this level happened with long-term interest rates marching down from 8%+ in the early 1990s. In every other instance, multiple expansion beyond today's level has been brief, with severe multiple compression ensuing either innocuously (as from 1901) because of a higher denominator in the



ratio (i.e. earnings, the “E” in P/E, trending higher in real terms), or more often painfully (as from 1929, 1966, or 2000) because of a struggling numerator (stocks prices, the “P” in P/E, collapsing or stagnating). Indeed, considering subsequent stock price performance in real, inflation-adjusted terms, we find that stocks did not regain their 1929 level for a quarter century, or their late 1960s levels for two decades. And – again adjusting for inflation – they have yet to reclaim their 2000 peak.

At least earlier generations of investors could take solace in decent dividends as they ground their teeth waiting for prices to recover (did you know dividend yields averaged over 5% in the 1930s?), but our post-2000 cohort has had to make do with dividend yields averaging under 2% since the tech bubble burst.

So if the Shiller P/E is high from an historical perspective, and if the current dividend yield on large company stocks is meager at about 2%, what explains the market’s recent rally? Here are some viewpoints.

- One hope is that low long-term interest rates (under 2.5% on the 10-year Treasury) might enable above-average P/E multiples to persist. After all, the march down the right side of the interest rate Matterhorn commencing in 1981 coincided with two decades of extraordinary stock market returns; in this interpretation, low bond yields affirm the durability of a high Shiller P/E. A return to easy financing at rock bottom rates could yet revive the animal spirits of consumers and risk-takers alike, and fulfill Ben Bernanke’s efforts to get aggregate demand growing again. **The rationale: Strong bonds mean low rates, which are good for stocks.** The problem here is that we can’t keep descending from today’s low rates the way we did from 1981’s mid-teen yields; as we approach the zero bound, stocks’ benefit from falling rates is mostly behind us.
- On the other hand, a lot of people think the ballooning Federal Reserve balance sheet and rising fiscal deficits financed by ever-more-wanton Treasury issuance mean inflation is imminent. Since inflation is bad for bonds, they conclude, stocks must be the better bet because equity represents a claim on real assets and moreover can benefit from the monetary stimulus and currency debasement to whatever extent they get nominal GDP growing again. **The rationale: The prospect of a crumbling bond market makes stocks the better relative value.** On this count I’ll say two things. First off, inflation does not automatically *immediately* destroy bond values; for instance, a dramatic inflation followed WW II and saw prices rise by over a third from 1945 to 1948, yet bond rates stayed below 2.5%. Second, inflation can hurt stocks too by causing P/E multiples to compress, as the rate at which future cash flows are discounted matters for equity valuation too – it’s a mathematical identity that discounting future returns at a higher rate lowers present value. Look at the 1973-1982 to see what inflation can do to P/Es.
- A third rosy scenario is one in which old-fashioned American pluck and newfangled whiz-bang technology combine to kick off a revolution in new industry and productivity, enabling stocks to chug along because of strength in the P/E’s denominator, earnings. **The rationale: This is America, by gum, and we’ll pull ourselves up by our bootstraps and find a better way to do things.** This appeals to our patriotism, but we’d have more confidence if ingenuity seemed to be ascendant and unimpeded; persistent low confidence among small businesses (the cradle of new employment and innovation) and regulatory uncertainty across many industries and a profoundly murky tax outlook keep us from betting on it just yet.

Altogether, we see it as a red flag that stock investors lately seem to be too much in a have-my-cake-and-eat-it-too mindset: “If bonds stay strong (rates stay low), that’s good for stocks. If inflation damages the bond market, well that’s good for stocks too because they’ll benefit from the nominal growth that comes with inflation.” Or, “Seeing lower unemployment claims is good because they show the economy reviving, which will be good for stocks. See higher unemployment claims is good too because it means the Fed will intervene, which is likewise good for stocks.” For us, this widespread tendency to celebrate not just good news as good news, but bad news as good news, is the hallmark of a market rally getting long in the tooth. A Shiller P/E above 20 can last a long while, but judging by market history, the returns likely to ensue from that level aren’t enticing.