

Client's Corner

Bishop Berkeley's Tree, Robert Shiller's CAPE Ratio, and Other Conundrums

From the August 2018 issue

GEORGE BERKELEY WAS AN ANGLICAN BISHOP, PHILOSOPHER and writer who lived from 1685 to 1753. He is remembered (if at all) for coining the deep philosophical question, "If a tree falls in the forest and no one hears it, does it make a sound?"

I've no idea what the good bishop concluded, much less why, but his gnomic inquiry came to mind again recently, while I was in the act of formulating a not entirely unrelated conundrum of my own. To wit:

If a thousand financial journalists write that the equity market is overvalued, does the market hear them? And if they all write it often enough—say 10 times each multiplied by a thousand scribes equals **ten thousand repetitions**—will that make it true?

You, your financial advisor and I probably have the same intuitive answer, but let's give this conundrum the benefit of the doubt for just a moment. Let us ask: on what do the chroniclers of overvaluation base their uniform conclusion? My guess is that if we examined each of the ten thousand hypothetical inputs in this experiment, the answer would be the same—all ten thousand times.

I believe that in every instance they'd be hanging their "proof" of overvaluation on just one slender reed: the Nobel laureate economist Robert Shiller's CAPE, which stands for cyclically adjusted price-to-earnings ratio. (The "ratio" is silent.)

Shiller's CAPE is based on *average inflation-adjusted earnings from the previous 10 years*. It will not have escaped your notice that the critical word in that definition—allow me to give it the proper emphasis just once more—is *previous*. In other words, Shiller's CAPE is *backward-looking*, in that it relates today's price to earnings from years (and years) past.

Call me old fashioned—you will anyway—but I've always thought of investing as being essentially *forward-looking*. That is, I happily acquired the habit, 50 years or so ago, of investing for *earnings (and dividends) yet to come*, not least of all because, if I invest today, I cannot capture the earnings (and dividends) of yesteryear. Nor would I wish to. I therefore—with all due respect to Dr. Shiller—entirely fail to apprehend the relevance of relating today's equity prices to yesteryear's earnings.

Which is not to say that I don't understand why journalism loves Shiller's CAPE. Indeed, I understand that perfectly. It is because the CAPE—looking back, as it does, on earnings far below today's and potentially even farther below tomorrow's—*virtually always gives a reading of "overvalued."*

Thus, it will or will not surprise you to learn that Shiller's CAPE has read "**overvalued**" virtually without interruption since March

2009—since which month the Standard & Poor's 500-Stock Index, even ignoring dividends, has at this writing quadrupled.

Nor was this a momentary aberration, or some sort of statistical quirk. Even Dr. Shiller's bosom personal friend, Dr. Jeremy Siegel of the University of Pennsylvania's Wharton School, noted in early 2016 that during the 35-year period 1981 to 2015, while the S&P 500 was going from 136 to a high of 2,130, the CAPE flashed "**overvalued**" *in all but perhaps six months*. Were one to read those hypothetical ten thousand media citations of the CAPE, I'm guessing that the number of times its spectacularly dreadful track record would be acknowledged might go as high as zero.

So if we conclude that the Shiller CAPE is grievously if not fatally flawed, what measure(s) of valuation might you, your financial advisor and I think preferable? Personally, I'm quite content with two.

First, I look at the forward 12-month price/earnings ratio: today's market level divided by the aggregate of analysts' earnings estimates for the next 12 months. As I write, these are roughly 2,800 and \$169, respectively. Dividing the former by the latter, I get a 12-month forward P/E—assuming the consensus earnings estimate turns out to be right, and rounding to one decimal place—of **16.6**.

I then ask, for perspective and scale, "What has the average 12-month forward P/E been for, say, the last 25 years?" The correct answer is **16.1**. That might lead a dispassionate observer to conclude that the current forward P/E is somewhat akin to Goldilocks' porridge: not too cold (overvalued), not too hot (undervalued), but just about "right."

Ah, but I said I look at *two* indicators. My second measure—which I hold to be, if anything, even more meaningful—is *the earnings yield of the S&P 500 compared to the current yield of Moody's seasoned BAA corporate bond index*. (These are good corporate bonds with maturities of 20 years and up.)

The earnings yield of equities is the inverse of the P/E ratio, which is to say it's the **E divided by the P**. Dividing the E (\$169) by the P (2,800) gives us an earnings yield of **6.0%**. And what do Moody's seasoned BAA corporates yield? Well, at this writing it's about **4.8%**.

OK, so the earnings yield of equities today is about 1.2% higher than the yield on the bonds. (That is, it's 25% higher.) What do we do with that number? How do we assess its implications? Again for consistency, let's compare it to the average spread over the last 25 years. And we find that for that period, *the average earnings yield of equities has actually been two tenths of a percent LESS than the yield on the bonds*.

If you're still with me—if your eyes haven't completely glazed

over—permit me to summarize. If we accept the consensus 12-month forward earnings estimate, we are bound to conclude that (a) stocks are fairly valued relative to their 25-year average P/E, and (b) they're historically more than a little undervalued relative to the most directly comparable corporate bonds.

As a native and lifelong New Yorker, it is my privilege to inform you that all these data plus three American dollars will get you one ride anywhere you want to go on the New York City subway system. (It's actually even better than that: when you get where you're going, you can usually cross the platform and ride all the way back for no additional cost.)

Valuation just isn't a market timing tool. Neither Dr. Shiller's valuation methodology, nor mine, nor anybody else's, can tell you when and where a rising market will top out, or a falling market

will turn to the upside. Nor is anything in this essay to be taken as me forecasting that the market is going to go up from here anytime soon, just because I hold valuations to be, on net, relatively attractive. I am also—though you didn't ask this—not forecasting that the sun will come up tomorrow, nor that any of us will be here to see it if it does. I don't do forecasting, period.

Rather, I'm venting—as I have found myself doing fairly often of late in these little essays—about financial journalism's all-consuming need to try to talk the equity market down. Or, failing that, just to scare us out of it, using a valuation tool that has never had a scintilla of predictive validity.

Thanks for letting me vent. I'm feeling much better now.

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