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The Elephant in the Living Room

You hear the same thing over and over -- stock market prices are ridiculously low, there are tremendous opportunities out there, the economy is in good shape and getting better, profits are expected to rebound, and the like. Ultimately, though, on CNBC and in the financial media, various people are talking past one another about wonderful news, never really saying what, exactly, is behind their optimistic forecasts. Everyone is trying hard to avert their eyes from the elephant sitting in the living room, the issue of the overall valuation of the stock market.

Market pundits try very hard to ignore the elephant in the living room, the valuation of the market.

After long hours of engaging in the guilty pleasure of watching the talking heads, we determined there are five types of opinions with respect to market valuations. Two types are serious, while three are not. Let us start with the non-serious opinions. First, some people measure valuation based upon the share price today versus the share price in the past -- e.g. "ABC Digital used to sell at \$200 per share, so it must be a buy since it sells at \$1 today." These people are idiots and should be shooed away from the door if they come knocking. Just because folks were delusional in the past has no bearing on what you should do today. Second, some market strategists, even some famous ones, use a proprietary system -- they give you their forecast, but tell you nothing about their methodology. How are you to determine if the "black box" is not working this time? These people might be right, but we're not betting our hard-earned money on a wizard behind a curtain. Third is the type of market bull that quotes some statistic you've never heard of from an obscure government report that they claim presents a better picture of corporate earnings or performance than more widely followed statistics. This is interesting, but where were they with that number three years ago? You can always find a statistic somewhere to support your view.

There are two serious approaches to market valuation. First is the old-time religion of traditional valuation measures, ratios like price/earnings, price/sales, price/cash flow, price/dividends, price/book value and the like. Data on these measures go back, in some cases, to the 19th century. Traditionalists have a long history on their side, but these valuation measures started indicating the market was expensive in the early to mid-1990s, before the last manic stage of the bull market run of the late 1990s had even started. The other serious valuation approach, reportedly the favorite of Alan Greenspan, compares the stock market's earnings yield (the inverse of the price/earnings ratio), using estimates of next year's earnings, to the yield on the 10-year Treasury Bond. This measure is more sensitive than the traditional valuation measures. While it had a fairly good track record over the past decade, it was bearish through the last year and a half of the

boom and was bullish going into this year. Because of the tie to Greenspan, this is sometimes called the “Fed model”

The new-era Fed model, however, was constructed using data after World War II, an inflationary era when stock and bond returns were highly correlated. It would not have worked in deflationary eras like Japan over the past 12 years or in the U.S. markets in the 1930's, when stock and bond returns were negatively correlated. The very element that makes it so positive (interest rates declining as inflation approaches zero) could make the model blow up if we tip into deflation. Followers of the Fed model claim that low inflation means that the traditional measures no longer apply, but reviewing the historical record reveals that low inflation conditions allow for only a modest expansion in traditional valuation levels. It also seems paradoxical now to rely on a measure based upon earnings estimates. Given recent events, Wall Street analysts making those estimates are regarded as optimistic fools at best and liars at worst. We believe the burden of proof is with the folks following the Fed model, not the blunt but tried-and-true traditional valuation measures.

The Fed valuation model could look more and more bullish – right up until the time it breaks.

So where does this leave us? Using data from Ned Davis Research, Inc., we analyzed the price of the U.S. stock market relative to six valuation measures (earnings, operating earnings, cash flow, sales, dividends and book value). Each of these traditional measures has flaws, but they say the same thing – despite recent declines, the market remains richly valued. As a group, these measures indicate that the market is about 25 percent above the average long-term market value and about 50 percent above the undervalued levels at which bull markets typically start. The Fed model, in contrast, says the market is about 30 percent *under* its fair valuation. The valuation question is not trivial – which model you follow determines your overall view of the market.

Even if you believe the more traditional measures, this does not say that the market cannot go up or investors have no hope of making money. Valuation is a long-term measure, and many sentiment indicators have recently reached levels that could lead to a rising market in the short to intermediate term. When you hear people talking about great values, though, please be careful. Most people making that claim think we are in a new era in which traditional business valuation measures are irrelevant, but they rarely explicitly state that or make a case for it.

Imagine we were trying to sell you an ordinary television set for \$5,000. We can tell you what a good television set it is (the economy is in good shape). We can tell you that this new model is better than last year's model (the economy is improving). Somebody arguing against you buying it may make the point that they caught us using puffery to try and sell it to you (some CEO's and accounting methods are corrupt). But isn't the big issue that \$5,000 is too high a price to pay for a television? If you would like an investment adviser adept at discerning elephants, in the living room or elsewhere, contact us.