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Good Bets, Bad Bets, Winning Bets and Losing Bets

One of the ways the financial services industry fails its customers is by projecting an aura of certainty. Talking heads on CNBC or *Wall Street Week* rarely hedge their predictions with any suggestion of the uncertainty involved, even if you accept the questionable premise that the future can be predicted with useful accuracy. We analogize stock market investing to flipping a coin that comes up heads 55 percent of the time -- a real advantage, but you don't bet the farm on the next flip of the coin.

"It may be that the race is not always to the swift, nor the battle to the strong -- but that's the way to bet." -- Damon Runyon

Our musing on this point was sparked by a recent speech from one of the most ubiquitous financial talking heads, the queen bee of the current bull market. After neglecting mention of stock market valuation measures in her bullish projections, she was asked about them. She replied such measures were too simplistic, "proving" this by pointing out that they had not correctly predicted the strong bull market of the last couple of years. Well, is that an adequate answer?

Sigma conducted a study that correlates the "value" of the stock market with subsequent market performance. We used earnings, dividends and book value measures. Our conclusion, which would be unsurprising in any area of human endeavor other than the stock market, is that investors who buy when the market is cheap do better than investors who buy when the market is expensive. This conclusion, however, does not allow you to predict with certainty. One year after the market is "expensive," the market has returned more than the long term average about 55 percent of the time, about the same as for all other years. For the five years after expensive markets, the long-term average was beat less than 28 percent of the time. For 10 year periods, buying when the market is expensive beat the long-term average only about 8 percent of the time.

More than one time in four, an investor who buys an expensive market "wins" by outperforming the benchmark over a five year period. That doesn't make him smart, just lucky. He had a winning bet, but it wasn't a good bet. On the other hand, investors who buy when the market is cheap beat the benchmark almost 92 percent of the time over five years. About one out of 12 years, the investor who made the good bet of buying a cheap market had a losing bet, in that she didn't beat the long-term average return. That doesn't make her stupid, just unlucky. We believe our study shows that valuation historically has been a powerful, but not perfectly prescient, predictor of future stock market returns.

Turning from the market as a whole to individual stocks, the research of James O'Shaughnessy looks at a variety of both valuation and growth indicators for common stocks between 1951 and 1994 to see which factors best predicted future stock returns.* His work meshes nicely with Sigma's overall market valuation study. Looking at the universe of large U.S. stocks, O'Shaughnessy found that stocks that were cheap relative to earnings, book value, cash flow and sales performed substantially better than the "index" of large stocks as a whole. Stocks selling at expensive prices relative to those four measures performed worse than the benchmark.

"It ain't so much what people know that hurts as what they know that ain't so." -- Artemus Ward

As with Sigma's valuation study, these results did not reflect certainty. Between 24 and 38 percent of the time (depending on the valuation measure used), expensive stocks did better than the benchmark over ten year periods, compared to between 88 and 94 percent of the time for cheap stocks. About one time in three, the expensive stock buyer was lucky and did OK. For example, using all four valuation measures, the buyer of expensive stocks did better than the benchmark in 1965-67, 1969 and for the decade of the 1960's taken as a whole. Holders of expensive stocks did substantially worse than the benchmark in the 1970's and 1980's.

Think about a young financial analyst in 1965 who is diligent enough to not just buy into the then-current rampant optimism about the dawning of a new era of finance. She decides to actually check the behavior of stocks relative to traditional valuation measures. By the end of 1969, she makes up her mind. She has five years of her own experience and a decade of data (swayed by the most recent five years) telling her that value doesn't matter, that she was in a new era where the rules were changed. She would have been precisely wrong for the next quarter century.

The queen bee has been correctly bullish for a few years. She may even be right that traditional valuation measures no longer work. History tells us, however, that this is not a conclusion you should make based solely upon only recent data in a rampant bull market. You also have to be able to distinguish current times from previous new eras where valuation was ignored, only to be thrust into the limelight again as investor portfolios were savaged. How many flips of our 55 percent coin would have to come up tails for you to conclude that the coin no longer works? Performance is important, but it comes as the by-product of a careful process that does more than merely extrapolate the recent past. If you're interested in an investment process that considers the past (and your future) to be longer than a few years, contact us.

* O'Shaughnessy's research is detailed in his book *What Works on Wall Street*, published by McGraw Hill in 1997. Quotations in the text boxes are from this book.