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The Single Fundamental Question and the Fallacy of False Alternatives

Traditional stock market valuation measures compare recent prices to the underlying earnings, dividends and book value of the businesses that make up the market. Anyone mentioning business valuation in connection with stock market prices risks being branded as a brain dead bear. The stock market has looked pricey relative to these traditional measures for the last several years of the raging bull market. Ever gluttons for punishment, we looked at 13 measures of valuation from Ned Davis Research, some with data going back as far as 1904. Measures included earnings, sales, dividends, book value, replacement cost, earnings adjusted for write-offs and inventory adjustments, cash flow, and others.

***"Facts do not cease to exist
because they are ignored."
-- Aldous Huxley***

In each case, we asked how far the stock market would have to fall to reach historically normal levels. The answers were unsettling. On average, the indicators projected a 58 percent decline for the market to be priced at historic norms of business fundamentals. Even data only from the "modern era" since 1970 projected losses of 54 percent.

There has been a lot of discounting of dividend and book value measures due to changed circumstances, but how do we argue around earnings, cash flow and sales? One striking aspect of our review of traditional valuation measures is how tightly bunched were the projections; it almost made no difference which indicator was used. As a result, if you reject one indicator, you are pretty much rejecting them all.

But don't take our word for it -- ask the demigod of the current bull market, Alan Greenspan. He asked his staff to develop a valuation indicator to measure the degree of "irrational exuberance." The result was described (briefly) in the Federal Reserve's Monetary Report to Congress in July 1997 and relates the 10 year Treasury bond yield to expected operating earnings for the S&P 500. Unlike most other valuation indicators we analyzed, the Fed's indicator "worked" in 1998, indicating just about the right amount of overvaluation in the summer and just about the right amount of undervaluation in the fall after the market declined. Recently, the Fed's indicator judged the market to be about 45 percent overvalued.

So what the heck is going on here? Either the market is dramatically overvalued, or something has happened recently that means that all historical measures of stock prices relative to their business value should be ignored. Which of these is correct is the single fundamental question facing equity investors today, whether they realize it or not.

Our problem is that if we reject the notion that stock price should be related to business value, what do we replace it with? We need some method of deciding if now is a good time to invest and, if so, what to buy. Merely concluding that traditional valuation measures "haven't worked" in the recent past suffers from the fallacy of false alternatives -- it doesn't give you anything to put after the words "and therefore." Therefore, are we supposed to conclude that stock market value has, or should have, no discernable relationship to the economic value of the underlying business?

"What ails the truth is that it is mainly uncomfortable, and often dull. The human mind seeks something more amusing, and more caressing." -- H.L. Mencken

And it's just not satisfactory to murmur we-are-in-a-new-era arguments like "demographics" "the economy looks good" or "technology." The disastrous, from an investment standpoint, 1970's were supposed to be an investment nirvana because of the baby boomers coming of age. The economy has always looked good just before long periods of investor disappointment. Investors had a rough time after a technology-driven market peaked in 1929. It wasn't that the technology (electricity, the incandescent light bulb, radio and the automobile) wasn't important, it was that investors were paying too high a price for it.

Nobody can see into the future, but we all can handicap how much we are being paid for the risks we are being asked to assume as investors. In 1982, for example, we were being paid four times more (in terms of amount invested per dollar of earnings or dividends in the underlying business) than we were this summer. In the past, whenever investors believed they had the best visibility into the future (by infinitely extrapolating the recent past, good or bad), they were the most wrong. On the other hand, the investor scared at a 58 percent overvaluation was probably scared at a 40 percent overvaluation and missed the most recent market rise. Investors focusing on traditional valuation measures have always suffered perceived opportunity costs for their caution in the last stages of market euphoria.

Contrary to some comments we hear, we keep an open mind on such issues. Trust us, the valuation measures give us the same feeling they give you, but we continue to have clients invested (cautiously) in equities. We find ourselves unable, however, to throw out a model with a long history of success without first finding an adequate replacement. And we haven't yet. If you're interested in learning more about our valuation studies or our other musings on these topics, contact us.

* Text box quotes from James P. O'Shaughnessy, *What Works on Wall Street*, McGraw Hill, 1997.