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Imagine you have a window in your house. Whenever you look through the window, you see only what you desire. Is having that window a good thing or a bad thing?

When Wall Street strategists discuss market valuation, the context of their analysis usually is the past 20 years or so.

Why 20 years? We have many respected, traditional indicators of stock market valuation with more than 60 years of history. Why should we restrict ourselves only to the past two decades in thinking about whether the market is cheap or expensive?

Market reporters seldom ask that question. When they do, the answer usually includes musings about accounting changes and profit margins in a changed economy.

Yes, the character of the economy has changed in the past two decades, but it is always changing. Technological revolution is a constant in the U.S. economy. Accounting changes have been a fixture in the markets for a long time too. We should keep variations in the economy and accounting methods in mind, and make adjustments when necessary.

Investing is a social science, though, and we want to look at as much history of human behavior as we have available.

If these rationalizations are insufficient to explain the pervasiveness of the 20-year valuation lookback, what is the answer? Ponder our question about the magic window.

Investment strategists want to claim the market is not expensive; their employers create investment products and have an interest in keeping clients fully invested and optimistic about the future.

The 20-year period is a magic window promoting optimism.

Consider the S&P 500 price relative to the average of the previous 10-year's earnings, called the "Shiller P/E" after the Nobel Prize winning economist Robert Shiller who updates the indicator on his web site.

Shiller P/E data goes back to 1881, and the current level is in the most expensive four percent of historical readings in that 136 year period.

If we really were concerned about recent accounting changes, we would look only at the past 10 or 15 years, but then the current reading is the most expensive during those look-back periods, hardly encouraging for investor optimism..

Looking at trailing periods or 30 years or longer also makes the market look *very* expensive now. Only by restricting our gaze to the past 20 or 25 years makes the market look less egregiously priced.

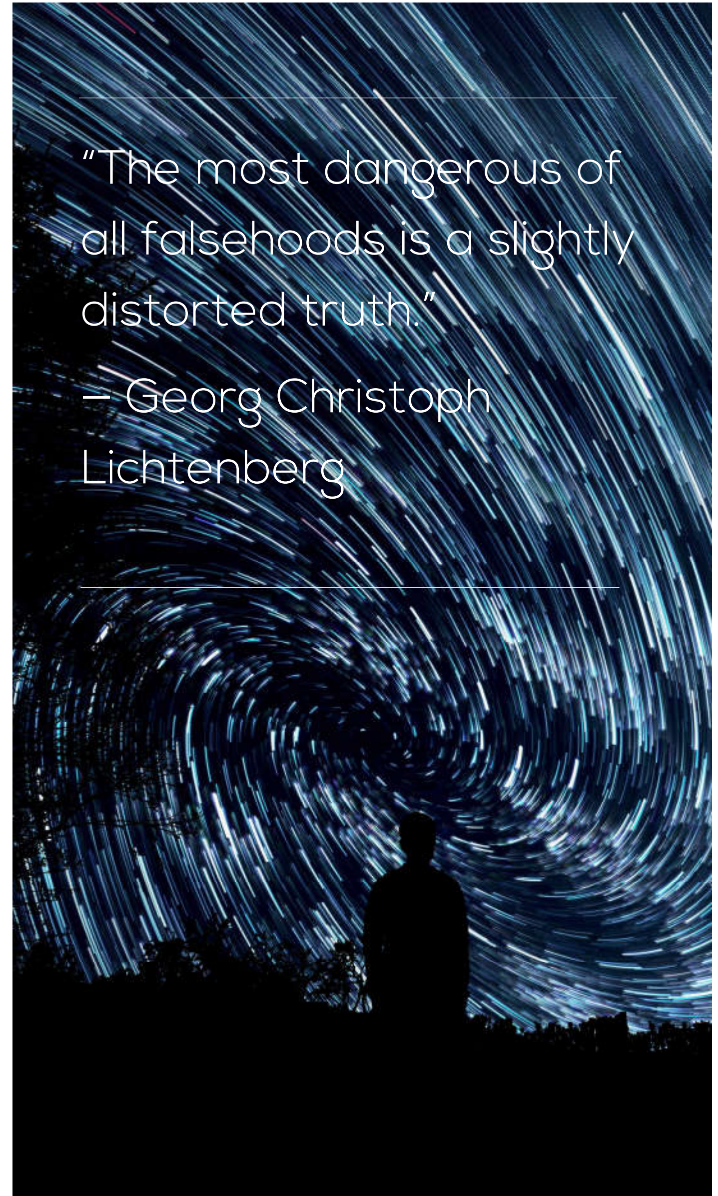
Why? The technology bubble of the 1990s resulted in the most expensive market, by far, in U.S. financial history. On historical charts, the overvaluation during the tech bubble clearly is an anomaly.

NBA centers are tall, but if you put one next to the Empire State building, he will look short by comparison.

Any market valuation, even one in expensive markets like 1929 or a decade ago, before the global financial crisis, will look cheap if the basis for comparison is the late 1990s.

The "magic" of the 20 or 25-year window is that it is long enough to include the abnormal period, but not so long to dilute the effect of the anomaly.

You can decide whether the ubiquity of the 20-year history for valuation is a cynical attempt by Wall Street to distort or just the result of wishful optimism.



The immediate lesson is to consider *why* you are seeing what somebody shows you in an analysis about market valuation or anything else. Few people are inclined to question the selection of the period covered in a pretty chart.

Consider how much "magic" was added, and why - because the magic window is not a good thing if it keeps you from knowing the truth.