FIS GROUP

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FIS VIEWS

Irrational Exuberance Versus Stocks for the Long Run

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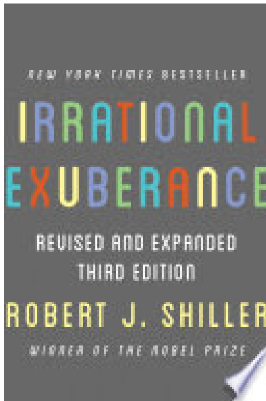
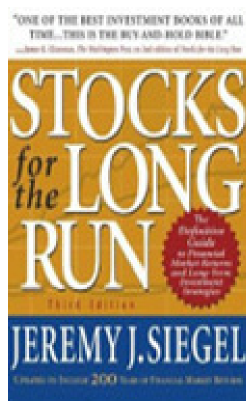




GOOD INVESTORS PUT A LOT OF THOUGHT INTO THEIR DECISIONS

Good investors put a lot of thought into their decisions as investment management is a cerebral endeavor. They think not just about specific trades or positions, but about the markets at large and the world in which they reside. As an investment manager, we thought it would be beneficial to share some of what we are thinking about with you. In that light, this is a first attempt in what we hope will be a regular undertaking to share recent thoughts on the markets, analysis tools, geopolitics or anything that we run across that is thought provoking and makes us a better investment manager. As an initial topic, we could think of no better topic to write about than a lecture turned debate that we attended at the annual CFA conference last month.

The debate featured a pair of giants from the world of finance. The participants were Robert Schiller and Jeremy Siegel. Schiller is a Yale professor, sports a Nobel Prize, and has authored a book titled Irrational Exuberance. He has made headlines over the years for his extremely bearish view of the stock market. Siegel, on the other hand, is a professor at the University of Pennsylvania, has authored numerous books, and founded a mutual fund company. He too has made headlines, but for his bullish views on the stock market which are epitomized by the title of his most famous book, Stocks for the Long Run. At issue in this discussion was a particular stock market valuation technique, the Cyclically Adjusted Price to Earnings (CAPE) Ratio, and its ramifications for the market. The pair took the stage in front of over 2000 strong minded investment professionals to plead their cases.

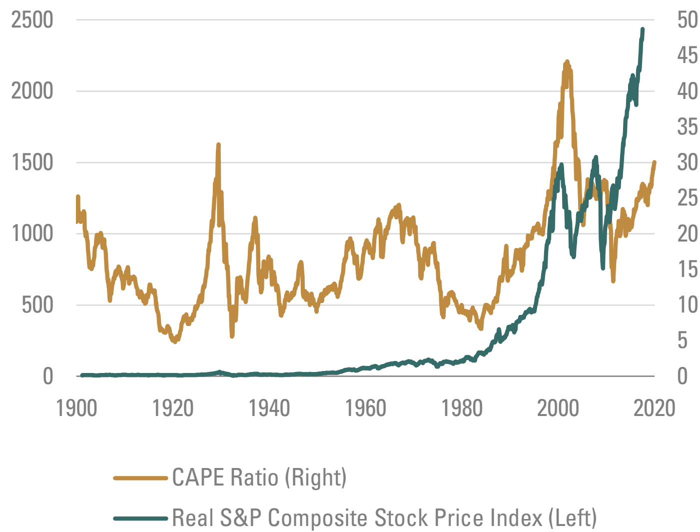
The CAPE Ratio was developed by Schiller and his associate John Campbell to identify long-term over or under valuations of the equity markets. It is calculated by dividing an index price by the 10 year average of inflation adjusted index earnings. [1] Schiller explained that it is similar to a price to earnings ratio (P/E), but uses a long term average of earnings to allow for mean reversion over the business cycle. Essentially, it smooths earnings. He then showed that the CAPE Ratio has a historically superior record of predicting market corrections and movements when compared to the P/E Ratio and other ratios commonly used to value the market. Finally and most importantly, Schiller noted that the CAPE ratio shows that the S&P 500 is currently overvalued. This is where the disagreement began.

Siegel acknowledged the CAPE Ratio's strong track record, but posited that it is currently too bearish. Siegel's view is that looking ahead, it will not be as accurate as in the past and used several arguments to support his position. First, he said that the accounting methods used to calculate earnings have changed. He explained that changes to accounting principles include write-downs and impairments in assets without any offsetting "write-ups" of appreciated assets. He thinks this makes earnings overly conservative and skews the CAPE ratio's market valuation. Next, he argued that the low interest rate environment makes stocks attractive relative to alternatives, noting that the equity risk premium was still high on a historical basis. Finally, he offered that the cost to enter the stock market is substantially lower than in the past which should add to investors' return. Schiller countered all three points as the pair passionately exchanged technical arguments in a manner substantially more civil than most political debates. It must have helped that the two have been friends for close to fifty years and have been engaged in this argument for a good part of that time. At the core of the discussion was the market's current valuation with both participants taking the positions for which they have become famous.

So what do we make of all this? While readers may be disappointed that we will not pick a side, there are some important points that we did take away from the event. Even if we put aside the fact that the debate was designed as theater for geeky investment professionals, the debate showed two intellectual

1 Campbell and Schiller. 1988, "Stock Prices, Earnings and Expected Dividends." Journal of Finance, Vol 43.

Real S&P Composite Stock Price Index and CAPE Ratio
As of May 31, 2017



Source: http://www.econ.yale.edu/~shiller/data.htm, Standard & Poors

heavyweights from the world of finance not only disagreeing on the efficacy of an analysis tool, but on the valuation of the market itself. This brings us to our first point.

THE INVESTMENT FIELD IS FORWARD LOOKING

It is too easy to forget, but investing is about predicting the future. Investment analysis is really nothing more than creating proverbial crystal balls that are able to provide the future price of a security or market. This is not meant to belittle the investment analysis process, rather to remind us of the true nature of the effort. That intellectual heavy weights disagree on the future reminds us of just how difficult predicting the future is. That they were willing to debate their views in public brings us to our second point.

PREDICTIONS REQUIRE EFFORT AND THOUGHTFULNESS

Predicting the future is not easy. Investors need to be willing to put a lot of work into their analysis, test their models honestly and subject them to intellectual criticism. This is not to suggest that all investors should publicly debate their ideas as Schiller and Siegel did, but to promote the idea that good investors will evaluate their work with intellectual integrity. The goal needs to be creating the best possible analysis and the most accurate prediction, which brings us to our final point.

NO PREDICTION CAN BE MADE WITH CERTAINTY

Regardless of how robust a model or thorough an analysis, the future is unknown. The best possible prediction that can be achieved is "highly probable". Whether quantitative or qualitative, there is always the potential for an unknown factor or variable to impact the outcome. Predicting the future can be humbling; however, knowledge, thoughtfulness and hard work can shift the odds in investors' favor.

So that brings us full circle back to good investment management. While we may not be able to predict the future with certainty, we can ensure that we are working hard to stay current, analyze information, and of course, think. We look forward to sharing more of what we are thinking about with you.

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