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ARE U.S. STOCKS A GREAT BUY? THE ANSWER MAY SURPRISE YOU

By Steve Scoles

In mid-November, I went to a local store to buy some running shoes. When the clerk heard I was in the investment business, he quickly said, "I hear it's a buying opportunity." I couldn't help but chuckle a bit—2008 should go down as "the year of the buying opportunity."

Right from the start of 2008, everyone has been telling me how great a buying opportunity stocks were. In January, with the S&P500 at 1310, local financial personalities came on TV to tell the uninformed public that this was a buying opportunity. In July, with the S&P at 1200, infamous TV personality Jim Cramer told CNBC viewers that the bottom was in. In early October, at 1100, even Canadian Prime Minister Stephen Harper chimed in that people should use this as a buying opportunity. Later that same month, at 940, legendary investor Warren Buffett, in a New York Times article, said it was time to buy. And now, with the S&P hitting 850, the store clerk told me about the great buying opportunity.

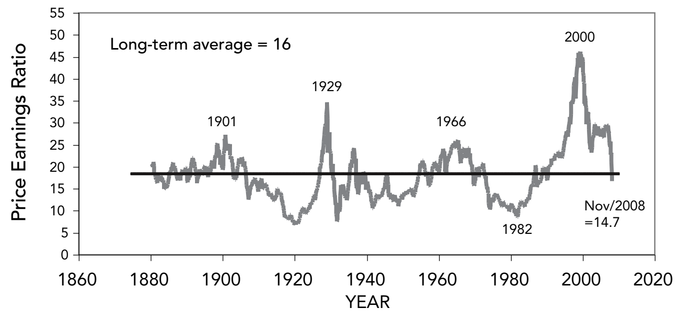
How lucky it was in 2008 to have so many buying opportunities!

Over the last 20 years, many people have learned that when stock prices drop, you should buy. But is it really a buying opportunity? And why do so many think it is? The answer may really surprise you.

HISTORICAL PERSPECTIVE

To add some historical perspective to these questions, there is an extremely useful (and likely startling to most) graph of price-earnings ratios that gives us a sense of whether U.S. stocks are really a buying opportunity. While price-earnings ratios are a very crude way to look at how expensive or inexpensive individual stocks are, they have proven to be useful on an aggregate basis, and if the earnings are normalized, they do not overdo recent high or low earnings levels. Ben Graham, a former mentor of Warren Buffett, used a price earnings ratio where he would take an average of the previous 10 years earnings in order to normalize earnings (often referred to as P/E10). Robert Shiller, in his book Irrational Exuberance (published in 2000 and revised in 2005), calculated P/E10 ratios for the S&P 500 from 1880 to current times.

Price Earnings Ratios - 1880 to 2008



Several important conclusions can be drawn from the above graph:

1) Even with the recent historic panic and forced liquidation, stocks have only now returned to about their historical average valuation levels of a 16 P/E10 ratio. That is, stocks only recently became a slightly above average buying opportunity. At the S&P level of 750 reached on November 21, the P/E10 ratio reached down to 12—a moderately above average buy on an historical basis.
2) The great stock market boom of the last 20 years (where the normalized price-earnings ratio peaked at 45 in the year 2000) has finally come back to earth.
3) Stocks not only have a tendency to revert to the mean, but they must revert beyond the mean. And often dramatically beyond the mean for many years.
4) Historical lows in the P/E10 ratio is around seven. At current normalized earnings levels, that would suggest an S&P level of about 400 or so. There is no certainty that we will see this level, but it should be considered a distinct possibility.
5) The graph does not give any reasonable timing indicator for when reversion beyond the mean happens. It can happen in years or in decades after the top or bottom. Imagine someone who sold their equities in 1995 when the ratio was first hitting 25 and the S&P500 was at 600. They would have had to have waited 13 years before they might have felt they made the right decision. But perhaps someone buying now will have to wait just as long before they feel they made the right decision.

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Now, this is only one set of data points. You may even dismiss this graph saying that historical averages no longer apply in current times. However, when Robert Shiller's book first came out in 2000 (when the ratio was in the 40s), many dismissed the graph, pointing out the dramatic productivity improvements made in recent times and the central bank's ability to maintain economic stability.

As well, price-earnings ratios do not need to drop for stock prices to fall further—earnings could fall. Perhaps the high leverage and low borrowing spreads of the last 10 years have helped keep earnings much higher than they will be going forward.

ANCHORING

One very strong behavioral tendency humans have is anchoring. Anchoring is our behavior of judging things relative to some arbitrary value or anchor. Humans are great at relative and proximate comparisons, but not so good at absolute evaluations. This is why you get pro athletes who are upset when they earn $10 million but find another player on their team earns $11 million.

Anchoring also explains why so many people felt 2008 was filled with such great buying opportunities. It seemed like such a great buying opportunity because so many people are still anchored to the greatest stock bull market of all time.

It may be hard to acknowledge that so many were so wrong, but anchoring is a very common mistake in financial markets. For example, in the mid 1980s it was deemed ridiculous by many investment professionals to match long-term liabilities with bonds yielding a "very low" 10 percent. At that time, many people were anchored to the much higher interest rates of a few years earlier. Yet here we are with long-term U.S. treasuries currently hitting multi-decade lows below 4 percent.

JAPAN REDUX?

Most people hate when I bring out the dreaded Japan Scenario, but it does provide a scenario that should be considered. Japan's Nikkei index peaked at 39,000 at the end of 1989 and now, almost 20 years later, it sits at about 20 percent of that level. For fun, the following graph compares the paths of the S&P500 to the Nikkei with their respective 2000 and 1989 peaks lined up.

S&P500 vs. Nikkei 225 offset by 10 years

I'm not trying to say that the future path of the S&P500 will be the same as the Nikkei, but rather that it should be considered a possible path or at least a possible set of future destinations.

I recall back in 1998, when a financial commentator suggested the United States might be on a similar path as Japan partly because Japan's aging demographic was about 10 years ahead of where the United States' was. At that time it was dismissed by many that it couldn't happen here. Yet, here we are 10 years later and things are starting to look similar to Japan. But many still dismiss a Japan Scenario as a possibility.

Financial writer Bill Bonner suggests what may be the closest we have to a physical law in financial markets: "the force of a correction is equal and opposite to the delusion that preceded it." Is it not at least slightly possible that the biggest stock market boom in history could be followed by one of the greatest busts of all time? It may very well turn out that this bust ends up looking different than Japan's. Western governments may be so determined to avoid a Japan-like downturn, they may just create other serious problems!

ARE U.S. STOCKS A BUYING OPPORTUNITY?

Stocks have likely only recently entered the buying opportunity range on an aggregate basis. However, from a psychological and risk management perspective, we should strongly consider that stock prices will revert beyond the mean for many years, perhaps even decades, before they get better. Why is this so possible? At a true long-term bottom in stock prices, it will be very difficult to find anyone who calls it a buying opportunity.

REFERENCES AND SOURCES:

Robert Shiller's price-earnings data:
www.econ.yale.edu/~shiller/data.htm
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