The Stan Clark Financial Team's

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Asset Allocation

Shiller vs. Siegel: Is the stock market overvalued?

By Michael Chu, Investment Advisor

The big question for investors is often: Where is the stock market going next – up or down? At a conference in late 2018, Wharton finance Professor Jeremy Siegel and Yale economics Professor and Nobel Laureate Robert Shiller made their respective cases, which we'll review in this article.

We've often discussed the work of Siegel and Shiller. Siegel, author of *Stocks for the Long Run*, is usually seen as the perpetual bull and Shiller, author of *Irrational Exuberance*, as the perma-bear. (They both dispute these characterizations, noting that in 2000 they were both bears.) No matter what side you lean toward, it's important to be open-minded and consider both views. Interestingly, despite opposing outlooks, the two have been close personal friends since they met in the 1960s as grad students at the Massachusetts Institute of Technology.

Since the 1800s, stock returns have far outpaced any other asset class. That's good to know, but what about future returns – can they be predicted? Shiller summed it up well: "If you want to predict tomorrow's price change, it's very hard. But if you want to predict what's going to happen in 10 years, you have a better chance. It's the reverse of weather forecasting."

Both Shiller and Siegel believe longer-term future returns are somewhat predictable. They also agree that valuations – in particular, share price vs. earnings – matter. Lower valuations (lower price vs. earnings) tend to result in higher future returns, and higher valuations tend to result in lower future returns. However, Siegel and Shiller differ on the valuation method and interpretation, and as a result, have different conclusions.

Let's first examine Shiller's rather negative case. Shiller is famous for coming up with the CAPE (Cyclically Adjusted Price Earnings) ratio. This is calculated by taking the index price divided by the past 10-year average of inflation adjusted earnings. The 10-year average is used to smooth out business cycle fluctuations. Shiller uses data going back to 1871. For earnings he uses what is called *reported earnings*, as calculated using Generally Accepted Accounting Principles (GAAP). At the time of the conference, the CAPE ratio was near historic highs, indicating low future long-term returns. Shiller also looked at a variety of other measurements of valuation. All appear to have been somewhat correlated with future returns, but he views his original construction as being superior to all he tested.

Siegel felt Shiller's numbers are flawed, because of changes over time to a variety of things, such as accounting rules. Siegel also feels that valuations of stocks should be evaluated in comparison to their main competitor – longer-term bonds.

Siegel states that "CAPE methodology forecasts forward 10-year real returns on stocks of only 2.6%, about 40% of long-run average (but still more than bonds)." He thinks this is too low. Adjusting for these shows a different, and more positive, picture.

First, Siegel uses S&P operating earnings to calculate the *E* in P/E, that is, price-to-earnings ratio. He uses these earnings because they exclude many non-recurring items such as write-downs, which can significantly, and in his view artificially, depress GAAP earnings. He points out that billionaire Warren Buffett said the new mark-to-market rules make GAAP earnings, for analytical purposes, "useless."

Siegel notes that for the last 140 years, the P/E ratio of the S&P 500 averaged around 15, which corresponds to a 1/15 or 6.7% earnings yield. He further notes that this is exactly equal to the long-term real return on stocks of 6.7%. This is no accident, he says: "Earnings Yield (E/P) is a good predictor of long-term real returns."

From 1954 to 2018, the average P/E ratio was 17 times. At the time of the conference, according to Siegel, the P/E ratio was "not that high. We're in the low 20s," based on the last 12 months of earnings. Moreover, when using forecasted earnings, the ratio drops to 18 and further drops to 16 when using 2019 estimates.

According to Siegel, "the P/E ratio of 18 forecasts a real return of 5.5% for stocks (or about 7.5% nominal return with 2% inflation)."

Comparing to bonds, he adds, "This is more than 4.5% over Treasury bonds. This premium is also above the historical average of 3% to 3.5%."

So, who's right? Both cases make sense on the surface. On the other hand, there are also many criticisms when you get into the details. As examples: definitions of earnings data are different between the two methods; accounting standards have changed recently; and different assumptions about mean reversion.

The Shiller-Siegel debate has been going on for years and will likely continue for many more. At The Stan Clark Financial Team, rather than commit to one or the other, our approach is to diversify and use both. More on this soon! ■

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