

Jeremy Siegel is Brilliant, Uplifting and Just Plain Wrong!

By Vitaliy Katsenelson
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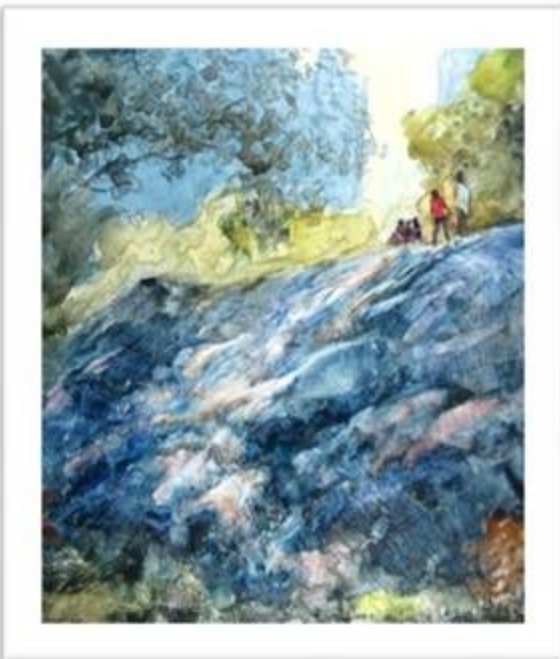
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I received quite a few emails asking my thoughts on Jeremy Siegel's open [editorial](#) in the Wall Street Journal last week. I responded to Siegel's article by submitting op-ed to the Wall Street Journal, but I found out that the WSJ doesn't publish an op-ed in response to another op-ed. Here is my response to Siegel's op-ed.



S&P 500 earnings topped out at about \$84 a share in June 2007, while corporate profit margins were 44% above their average since 1980. At the time, these numbers were inflated by global bubbles in real-estate, commodities, liquidity, and growth expectations--a lot of global bubbles.

Since 2007, most of the bubbles deflated, stocks plunged, profit margins reverted to their mean (i.e. declined from above to below average), which in turn caused earnings to collapse. S&P 500 earnings estimates for 2008 were revised down to \$28--a 67% drop from the highs. Suddenly, investors found that at 20-plus times earnings, the market is not that cheap, even after the markets' precipitous drop.



As every action movie needs a hero, every cyclical bear market needs its bull. Bull we've got--Jeremy Siegel, a Wharton professor, who wrote an op-ed article in the *Wall Street Journal* proclaiming that for the most part, the aforementioned factors were not the main causes of the earnings collapse. Instead, the flawed computation of the earnings of the S&P 500 is at fault. He



explains that because Standard and Poor's, the creator of the S&P 500 index, doesn't weight earnings by market cap but simply aggregates them together, earnings misrepresent the true reality of corporate profitability and thus overstate the market's true valuation.

Siegel suggests weighting earnings by (today's) market capitalization instead. When he does just that, all of a sudden reported earnings skyrocket to \$71.10 a share. His conclusion is the market is dirt cheap. It is brilliant, it is uplifting and it is just plain wrong.

If you exclude the losers, the market will always be cheap. In September 2007, General Electric was the second largest company in the S&P 500 index, Citigroup was number five, and Bank of America was number six. Today GE is number nine, and its weight in the index declined from 3.15% to 1.42%; Bank of America and Citigroup are numbers 41 and 111, respectively. Financials (GE is a semi-financial stock, as a good chunk of its earnings--or now losses--come from GE Money) have dropped from almost a 20% weight in the September 2007 index to obscurity today as their losses ballooned. Some of these losses are driven by market distortion but a majority of them are real. And, yes, those fat profits of late 2007 will be remembered, longed for, but not repeated for a long time.

By favoring the largest companies in the index (Siegel's suggestion) you will always over-report the index's earnings. Higher earnings will drive valuations (market cap) higher and will result in higher weights in the index--earnings numbers will matter more. At the same time, companies that suffer losses will be punished by the market and thus their market cap weight will be lower and their (negative) contribution to overall earnings will be less. This is exactly what happened to Citigroup, Bank of America, GE and many other losers.

There is a good reason why S&P doesn't weight earnings by market cap. Siegel's suggestion makes as much sense as a university, for instance, calculating an average GPA score for the school by attributing higher weight to magna cum laude and summa cum laude students.

Market capitalization weighting makes no sense. Ironically, Mr. Siegel starts his article explaining how bizarre market weighted calculations are (S&P computes S&P 500 performance based on market cap, but computes earnings by adding all earnings for companies in the index, not by market cap). He explains that the performance of mega cap companies like Exxon completely overshadows the rest of the index where performance of smaller companies becomes irrelevant. I agree. Stock market indexes that are constructed based on market capitalization don't represent a reality of actual portfolio construction. I have yet to meet a



money manager who determines his portfolio weights based on the market capitalization of companies in his portfolio.

What makes his message intellectually discordant is that Mr. Siegel has been promoting an index fund company (and I believe he is on the company's board too)--WisdomTree. WisdomTree's sole purpose is the creation of index funds not based on market capitalization but on fundamentals (i.e. price to dividends and price to earnings).

Mr. Siegel in his op-ed said that a disproportionate amount of losses come from companies that represent a very small market capitalization in the index. He is right, but their capitalization is small now; it was not small a year and a half ago. These companies used to be enormous. They are small because of their losses. If you were to recalculate S&P earnings based on the weights of the index in September 2007, you will likely get an earnings number that is far below Siegel's suggested \$71.10.

Also, Siegel's claim that a small company taking huge losses distorts results of the index lacks intellectual rigor. An originally small (I mean not one of the ones that just dropped in price tremendously because of high losses) company usually has low sales and lower profits, thus it is much harder for it to generate large dollar losses as well. In other words, my mother-in-law's barber shop or Jones Apparel (the smallest company in S&P index) for that matter will never have enough losses to overshadow mega large caps in S&P.

Problems with Siegel's suggested method don't end there. Our understanding of historical valuations is based on S&P 500 P/E data going back to the early 1900s which is computed based on the current "flawed" (according to Siegel) way. Siegel's P/E, based on market cap weighting, loses comparative reference to the past and thus loses its meaning as we start comparing apples (his computation) to oranges (aggregate, S&P's computation). For a reasonable comparison with historical valuation levels, Mr. Siegel would need to apply his capitalization weighted method to past periods. At 12 times earnings, based on Siegel's calculations, the market may or may not be cheap once past P/Es are computed differently.

We know that \$28 in estimated 2008 earnings doesn't represent the true earnings power of the S&P 500, but nor does \$70. Of course, charge-offs tremendously distort reported earnings numbers, and no rational person looks at the 2008 \$28 as a base case. But let's be honest with ourselves, 2007 earnings of \$84 are only real to us today if we think that the global bubbles of 2007 will reoccur in the very near future.



Siegel may manipulate earnings until they conform to this thesis as much as he likes, but the true number lies somewhere well south of \$71 and thus, while some stocks are cheap today, the S&P 500 is not.

P.S. Jeremy Siegel's book, "Stocks For The Long Run," is well-written and provides a very good overview of the performance of different asset classes over last two centuries. But the book needs a different title, maybe something like "Stocks for the Really, Really, Really, Long Run." This way, it would not lure investors into a false sense of security when it comes to stocks. It preaches that stocks are always a buy, no matter what their valuations are, as they do better than other asset classes in the long-run, and that a 7% real rate of return is a birthright for stock investors no matter if the stock market is extremely cheap or ridiculously expensive.

This is very true if your time horizon is 30 years or you plan to live forever. It is also true if you can tolerate seeing your portfolio go nowhere for a decade or longer. Unfortunately, most of us don't have this time horizon. We need to send kids to school, pay for weddings, boats, and other stuff. I don't know anyone who has the patience to see their portfolio of stocks do nothing for decades.

Despite stocks being a great investment for the really, really long-run, they have periods when their returns are unspectacular. I call them range-bound markets and they take place after secular bull markets. The buy and hold (forget to sell approach) that Siegel's book lures to believe fails to produce acceptable returns during these type of markets as the last decade proved so far.

P.S. S. The picture (watercolor) is by my father Naum Katsenelson. More of his art is at www.katsenelson.com

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