

Jeremy Siegel on Why Stocks are Undervalued

By Dan Richards

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A video of this interview appears [here](#).

Jeremy Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania and a Senior Investment Strategy Advisor to Wisdom Tree Funds. His book “Stocks for the Long Run,” now in its fourth edition, is widely recognized as one of the best books on investing. It is available via the link above. A regular columnist for Yahoo Finance, he is frequently quoted in the financial press and is considered by many today’s preeminent market historian.



Dan Richards interviewed Siegel at his office at the Wharton School in Philadelphia on July 8.

Some would suggest that the last 10 years have undermined some of your findings about the long-term returns on stocks. How do you respond to that?

It's been a tough 10 years to say the least.

You have to remember that when we look back over the first decade of the 21st century, we will look back and see that we started that decade at the top of the technology bubble where I and many other people said that technology stocks were overvalued, as were many other stocks.

We had two incredible decades of stock returns prior to 2000. Never before had we had double-digit gains in two consecutive decades prior to that. In my analysis that brought us 50% to 60% above the trend line.

My research shows that there is reversion to the mean, which means that eventually that trend line is going to dominate – the trend line is eventually going to bring the market back. Unfortunately, often it brings it back with a vengeance. It actually goes below the line, which we have just experienced with the bear market.

My analysis suggests that the market is about 25% and maybe even 30% undervalued by long-term trends. But basically what we have done over the last 10 years is gone from a very overvalued market to an undervalued market – which is not unprecedented.



How do you arrive at that 25% to 30% undervaluation today?

Basically, there are two methodologies. One is looking at the long-term trends of after-inflation stock returns. I've done a lot of econometric analysis. My analysis confirms that there is reversion to the mean, which means that whenever you are outside a boundary you tend to go back. When I draw that line over 200+ years of return data, I find we are about 25% to 30% under trend.

But trend lines are only one aspect of it. There has got to be a valuation behind that. That is very much what supports the position that stocks are undervalued. When I look at earnings going forward on the S&P 500, for instance projections for 2010 and 2011, we are looking at either 13-times earnings this year or 11-times next year's earnings. In this interest rate environment, that is unprecedented and, again, demonstrates around a 25% or 30% undervaluation in the market.

So the norm would be historically more like 15- or 16-times earnings?

Absolutely. The very-long-term norm of price-earnings ratios is 15. That also adds single digit P/E ratios that occur whenever you have double-digit inflation. We couldn't be further away from double-digit inflation than we are today with very low single-digit inflation. Once you are into that low single-digit inflation, P/E ratios of 16 and 17 are more common, and we are well below that level, even below 15.

I have heard three concerns articulated. One is a concern about a double-dip recession, and whether those earnings will materialize. There are also concerns that we may face a lower economic growth rate as governments reduce debt. Finally, I want to talk about the valuation metric that Robert Shiller of Yale uses.

So let's talk first about the concerns that the US may be heading into another recession and will potentially drag the rest of the world with it.

I rate the probability of a double-dip recession well under 20%. But it's not impossible. Nothing is impossible.

What I see is a slowdown. I see growth going from 3 1/2%, 4%, even 4 1/2% down for a quarter, maybe two quarters, to 2 1/2% to 3%.

Of the forecasters that I look at, none of them have negative growth rates for GDP. In fact, none of them that I respect, and I look at a lot of them, are even below 2%. To have a double-dip you really have to have at least one quarter of negative GDP growth. So when I look at all the data and all the forecasters, I am very convinced that we will not have a double-dip. This is a slowdown, which I think by the end of the year will move into a reacceleration of 4% growth.

The earnings forecasts that you talked about, what kind of economic growth rate do those assume?

There are two types of forecasts. One is a bottom-up forecast, which is the analysts looking at individual firms. Those are the numbers that I quoted. Then there are the macro economists that do a top-down forecast. Almost always those top-down numbers are lower than the bottom-up ones. The bottom-up analysts tend to be a little bit more optimistic.

The truth is actually somewhere in between those figures, and is actually closer to the bottom-up figures when you're coming out of a recession. So even if I take the more pessimistic numbers of the top-down forecasters, who are forecasting fairly slow economic growth, I'm seeing 14- or 15-times ratios. Again, this is very, very reasonable, and even is low, very low given these interest rates.

Okay, let me raise another issue.

Toronto just hosted the G20, which agreed that developed economies should prioritize deficit and debt reduction. There is a bit of a difference in view. Countries like Germany and England are putting more priority on debt reduction, the US a little less so.

There have been suggestions that if there are significant cutbacks in government spending to reduce debt, that could reduce economic growth by 1% a year. So two questions, one — how concerned are you about that? How likely is that in your view? And secondly, what impact would that have on stock valuations?

It's called a fiscal drag. Most of the economists I look at think that in the United States we are talking about 1% to 1 1/2% fiscal drag from the fact that all those tax cuts are going to be removed.

This is my position: The big item is government spending. We need to reduce government spending, but in this environment I would also keep taxes low. The US is scheduled to have a big tax increase in 2011. I just read a J.P. Morgan report that says there are going to be 66 separate tax code increases next year.

We must defer all of those increases. That is very important. We need to reduce government spending. We should also stop taxes from going up. That may raise the deficit short-run, but once that growth comes back with lower government spending and more private sector spending, we are going to close that deficit going forward.

In terms of long-term corporate earnings, which obviously drive valuations, if you get that fiscal drag that you talk about, of 1% to 1 1/2%, are you still anticipating the kind of earnings that would support your valuation and analysis?

When we take a recession as severe as we've had — and it is as severe as the 1970s and 1980s — we have usually had bounce-backs of 5%, 6%, or 7%. One of the reasons is we were more a manufacturing economy and that bounces back faster than a service economy.

When people are saying 3% or 4%, they are taking into account a fiscal drag and the fact that we are more of a service-oriented economy and are not going to bounce back as fast. From history, this is a very conservative earnings forecast and a very conservative economic bounce-back.

Let's talk about the third overhang for those who are looking to be positive about stock prices, which is the work that Robert Shiller has done.

On March 9, you and he were profiled on the front page of the *Wall Street Journal* as long-time friends and colleagues who debated this issue. Shiller's analysis looks at 10 years of earnings, adjusted for inflation, and uses that as the basis to look at stock prices. The long-term average he calculates around 16. Today, using his numbers, we are at 19-times, which would suggest a little overvaluation. How do you respond to that?

I respect Bob a lot. I think he's one of the best economists we have, but here I do take issue. It's a backward look, and he uses the last 10 years. It is not forward-looking. That is the mean. And we had one of the greatest tankings of earnings because of the financial sector. I've written that AIG, which was .01% of the S&P 500, contributed \$90 billion of write-off losses that brought the earnings down over the entire average.

I actually thought S&P should have thrown out AIG. I still think it should. Those figures make a lot of difference. AIG and the financial crash number is going to be in for 10 years, because he takes a ten-year average. We know that stock prices are forward-looking. I want to look at forecasts, and I'll take optimistic and pessimistic forecasts.

Another very important point: His average goes all the way back 130 years. It is only a constant if earnings growth is constant. It also means that the dividend-payout ratio is constant.

But in the last 30 years of the data set — and Bob agrees on this point — payout ratios have gone down, earnings growth has gone up as retained earnings and buy-backs have become more important. As a result of the “steeper” earnings growth, you are going to get a distortion looking out over a period, during most of which the earnings growth was not very strong. If you do a correction for the change in earnings growth, you actually get an under-valuation, even with Bob's data.

So we have some contentions. He doesn't want to make a correction for the earnings growth differential over the last 20 or 30 years, because of the dividend payout ratio, and I can understand that. But I think that is a major factor that gives him a pessimistic cast to his earnings projections and his valuations.

Before we move on, how do you respond to someone who says, “Yes, AIG wrote off \$90 billion, and so that depressed the average earnings, but they had those windfall profits in the period leading up to that, so that inflated profits in the period prior to that”?

There was some inflation of financial sector profits before then. I'll absolutely give that to you. But what they wrote off, if you take a look at it, was far more than any of the profits they earned. Many of the other financials have been forced to do so. Some of it definitely was not earned back then, but some of it is just a write-off for firms that don't even exist.

I want to come back to something that you mentioned earlier, which is the impact of today's low interest rate environment on valuations.

I had the opportunity in January to sit down and spend 45 minutes with Robert Shiller in Atlanta, at the American Economic Association meeting. I asked him whether valuations should be adjusted based on low interest rates. He said he didn't think so. His view is that low interest rates, based on his experience and research, are not that material in terms of valuations. That's a different conclusion than the one that you draw.

I understand it. A lot of that is the data from the Great Depression, when interest rates and valuations were very low. However, my analysis, and that of most others, is that whenever interest rates get high – 7%, 8%, 9%, 10% or double-digit – it definitely depresses stock prices. You could say we are not there, but that's what gives the average 15. If you take out the double-digit inflation period in the United States over the last 50 years, you get 17 or 18 as the average current valuation number.

Even without that argument, do low interest rates stimulate stock valuations, just if you take out the double-digits which depressed P/E ratios to 7, 8, 9 when people could get 16% guaranteed for 10 years on Treasury bonds? No, you get a different average.

Secondly – Bob knows this as well – there are two aspects that go into the valuation of any asset. One is the earnings flow (the cash flows). Second is the discount rate, and that discount rate is based on the interest rates. So I would be very wary to say it doesn't have any effect. It's got to have an effect.

Sure, because 20 years from now \$1,000 of earnings, discounted at 8%, has a huge impact compared to discounting at 1% per 2%.

And right now you ask the question where are people going to put their money. In Treasury bonds or anything short-term the rate is virtually zero. That has got to affect how you are going to allocate your money.

I'd like to talk about some specific regions. You were just in Europe at Wharton's Global Business Conference. Probably one of the regions today where you hear the most doom-and-gloom is in Europe. What is your take on valuations and opportunities in the European marketplace?

The Eurozone got too big. I remember back in the early 1990s talking about how big the Eurozone would be, and we debated whether Italy would get in. We thought Spain or Portugal, on the fence. But Greece — are you kidding? Now come on. That's, like, way outside.

The problem is, too many countries wanted that rush of capital. Greece particularly manipulated statistics to join.

There are two very important principles for a currency union to work. One is you have to have a lot of labor mobility. Labor in the depressed areas must be able to migrate to areas that are more prosperous without any restrictions. Secondly, you have to have a strong central government fiscal authority. And as you know there isn't either of these.

The United States is a perfect currency union. We have the most mobile labor market in the world and our federal government taxes are 80% of our total taxes. In Europe it is exactly opposite. The Greek workers are not going to move to Germany. They don't speak the language and their culture is different. They became overpriced. Their labor costs became too high. This is a huge problem for Europe. I am not optimistic that the euro in its current form is going to last over the next few years.

I should note however that many European firms are geared to export where most of their revenues or a large chunk of them are coming from exports, so they do very well with a depressed euro.

Germany is an example of that, right?

Yes, and if you are going to be selling to the Mediterranean countries, you are going to have trouble if those are your markets. If your markets are abroad, you may do very well. But you have to be careful. Don't totally write off Europe. Europe has problems, but some firms are going to do well.

Let's talk about the other extreme, where there is a fair amount of optimism. That is emerging markets, China, India of course, but there is also Brazil, Turkey, Indonesia. What is your take on valuations there and the kind of returns that investors can expect in those markets compared to developed economies?

Over the last three or four years I have been very enthusiastic about the emerging markets. I look at their valuations today, and virtually everyone is under 20. For countries that are growing as fast as they are — they are not going to grow as fast as China, we know, or even 6% or 7%, which India has managed over the last four or five

years – to have 15, 16, 17 valuations. Indonesia and these other countries they are buys. As a group I think they are going to be winners going forward.

We've talked about a couple of regions. I want to talk about the financial sector. We've had a conversation about financials. Today in the Wall Street Journal there is an article that suggests that based on price-to-book ratios, financials have entered into the value realm as stocks. What is your view on financials as a category today?

I'm enthusiastic about financials. I think they have been priced to write-off a much larger percent of their assets than are going to be written off. In other words, mortgages that are priced 20 cents on the dollar are going to get 50 cents. Commercial loans that are now going at 35 cents might get 70 cents or maybe will remain good.

Just as there was way too much optimism before on what those loans are worth, there's too much pessimism right now. And right now it's the only game in town. The banks have \$1 trillion of excess reserves in the United States on which they are getting 25 basis points. If they see any bargains, if they get any degree of confidence in terms of the borrower, their spreads are going to be extremely high and that is going to make for good profits. So I see them at the value end again. On a book ratio and even on an earnings ratio, they are going to be a standout performer in the next 6 to 12 months.

I want to talk about your view of the impact of the Internet. It has transformed the way many of us to business and operate our daily lives. What is your take on the impact of the Internet on stock profitability and stock prices going forward?

One of the biggest outcomes of the Internet is going to be the acceleration of research, discovery, invention, innovation, or whatever you want to call it. I see my colleagues working on problems with fellow workers in China and India, everywhere around the world, which would not have been possible 10, 15, or 20 years ago. When brains get together, they can do innovation. There's going to be an acceleration of innovation and productivity growth.

At the same time, we also know when information is freely available there is a lot of price competition. That was apparent at the very beginning of the Internet boom, when you could find out who has the cheapest prices. But firms have been able to navigate around some of those issues. The biggest force going forward is we are going to see new products, inventions, and innovations. Those people on the edge are going to be able to get the revenues. I think it's net positive for economic growth and positive for corporations.

We talked at the beginning about what's happened over the last 10 years. It's been a disappointing period for investors largely because their entry price was just too high. What kind of lessons would you say investors should draw from what has happened over the last 10 or 20 years in terms of the stock market?

Valuation counts a lot. You can't say you'll eventually be bailed out no matter what price you go in at. You have got to pay attention to the price. It may be true if you wait long enough you will be bailed out, but that's not what investing is about. Just take a look at historical valuations and where we stand now. If you are buying at or below long-term valuations, there's no reason why won't get the long-term returns which have been so outstanding in stocks. Don't forget valuations. I think that's the main message.