



Letters to the Editor – Stiglitz and Shiller PEs

February 9, 2010

The following letters are in response to our article, [Stiglitz: U.S. Economy Will Falter without More Stimulus](#), which appeared last week:

Dear Editor,

I appreciate the different views and opinions that your forum presents. In this case, Professor Stiglitz's ideas are bugnuts. He proposes sending MORE tax-payer dollars to the states that have been the most reckless with their budgets - states with massive, bloated public retiree pensions and the like. No thanks, professor. It's nothing personal, but I sincerely do NOT want my tax dollars going towards an \$80,000-a-year pension for a retired sheriff or department of motor vehicles manager. Of course, being a good socialist econ professor at the People's University of Columbia, I would expect nothing less from this Keynesian goof-ball.

Kevin Wells
Wells Financial Group LLC
Walnut Creek, CA

Dear Editor,

In regard to the causes of the financial crisis, Stiglitz claims there is "plenty of blame to go around..." If so, why does he fail to mention of the dual roles of the repeal of Glass-Steagall and our elected officials who put the pressure on the banks to lend the money in the first place? (Thank you Maxine Waters [D-CA] and Barney Frank [D-MA])

Don't kid yourself: history proves central planning does not work, and our economy will not return to a true growth trajectory until the government stimulus is out of the system.

Sincerely,

Geoff Peterson
Lakeshore Insurance Services
Stockton, CA



The following is in response to Keith Goddard's article, [Return Distributions and the Shiller P/E Ratio](#), which appeared last week:

Dear Editor,

This article and the one by Joe Tomlinson make lots of sense. Their historical studies are instructive. The Shiller P/E is crucial ingredient in their financial brew.

So, what's the Shiller P/E now? How is that number calculated? Is it a forward P/E on estimated earnings? On based on reported earnings? Are write-off included? Can you explain the P/E calculation method?

What do you when the P/E on 10-year earnings is not at an extreme level? The average of 128 annual 10-year P/Es is 16.45. The average P/E was 25.65 for 2008. That was among the highest ever. For 2009 (not sure when it was calculated) the ratio was 16.16, a little less than average. There's nothing yet for 2010. It appears that projections on his hypothesis with 2008 or 2009 PE's would not have been useful for predicting an appropriate allocation to equities for the terrific returns of 2009.

Nevertheless, my focus is on 2010 and later. So, what number should be used, when and how is it calculated, and, most importantly, is the information appealing as a historical happenstance or as a useful guide for the future?

Michael B. Weissman
Merrill Lynch
Pittsburgh, PA

Keith Goddard replies:

Michael,

Professor Shiller maintains a web site with his P/E values [here](#).

The Shiller P/E uses average inflation-adjusted earnings over the previous 10 years as the "E" in the ratio. It is designed to smooth out the short-term influence of business cycles on the earnings measure used to quantify the valuation of the market index. There is another tab in the spreadsheet included in Dr. Shiller's website that shows the underlying data behind the graph. There you will find the month-end P/E for every month going back to the late 1800s. The latest reading as of mid-January 2010 was 20.79.

I would never encourage anyone to use the Shiller P/E as a short-term trading tool, because valuation cycles tend to be VERY long-term in nature. For



example, the Shiller P/E remained below its long-term average of 16.4 for 17 consecutive years from 1973 through 1990, then stayed above 16.4 for the next 17-years from 1991 to 2008. The more important point is that the distribution of most likely outcomes becomes increasingly favorable the lower the Shiller P/E ratio at the start of the measurement period, and vice versa, provided an investor is willing to think in terms of three-to-five-year holding periods.

This line of thinking could have helped an investor, in real time, over the past several years, by indicating a very unfavorable risk-reward profile throughout the “lost-decade” period from the late 1990s through 2007, while highlighting a brief window from November 2008 through March 2009 when the Shiller P/E dipped below its long-term mean for the first time since 1991. Stock market exposure accumulated during that five-month window may indeed show decent three-to-five-year returns...time will tell.

My firm uses this kind of input to tilt the aggressiveness of our portfolios upward or downward over time, without making all-or-nothing “bets” about the short-term direction of the market. This [fact sheet](#) describes our process in brief.

Thanks for your interest in the article, and best of luck to you and your investments!

Keith C. Goddard, CFA
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