ADVISOR PERSPECTIVES

Rebuilding Confidence in Stocks

By Dan Richards
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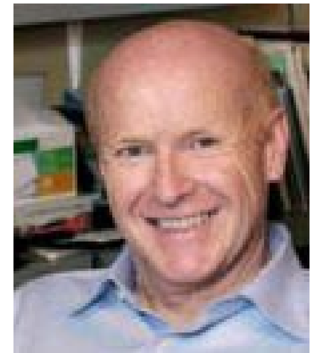

These days, there's a cloud of uncertainty over markets, with questions about economic growth, government deficits, the timing and impact of interest rates increases, unemployment levels and the housing market.

The result is that many investors have money in cash earning next to nothing. That's fine if someone only needs a 1% or 2% return to hit their long term goals – but for many investors, their current allocations mean it will be impossible to achieve their long-term goals.

This environment is when advisors can bring value, by providing perspective on both sides of the debate about the value that stocks provide at today's levels.

Expert views on stock valuations

Early March featured the one-year anniversary of last year's stock market lows and the 10-year anniversary of the tech bubble high of early 2000.

In honor of those anniversaries, the Wall Street Journal ran a feature story with the leading proponents of the undervalued and overvalued cases – Wharton's Jeremy Siegel, author of *Stocks for the Long Run* and Yale's Robert Shiller, who wrote *Irrational Exuberance.*

Here's a link to that article.

On July 8 and 9, I travelled to Philadelphia and New Haven and spent an hour each with Jeremy Siegel and Robert Shiller, who coincidentally are long-time friends who regularly vacation together on the Jersey Shore.

Notably, both went on record in early 2000 to say that tech stocks were overvalued and at unsustainable levels – but since then have diverged on their assessments of stock market valuations.

Last week and the week before, we featured transcripts of these two interviews. Links to those are at the end of this article.

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The case for stocks as expensive

Robert Shiller begins by looking at corporate earnings adjusted for inflation over the past ten years – looking back ten years eliminates short-term distortions in any given year.

Over the past 150 years, stocks have traded at an average multiple of 15-times their average trailing ten-year earnings. Below this level they're cheap and have tended to do well in the following period; above this level, they're expensive and have underperformed in the years that follow.

Today, stocks trade at over 20-times ten-year earnings. While not close to the peak level of 46-times earnings in 2000, this is still historically expensive – and suggests returns in the period ahead below 9% before inflation and 6% after inflation.

Shiller's P/E model has been accurate in predicting future returns over long time horizons (at least 10 years); it is notoriously inaccurate at predicting short-term (e.g., one-year) returns.

In January, I spent 90 minutes with Shiller over lunch, having fortuitously bumped into him at the Atlanta airport. At that time, he made the comment that even when stocks were at 20-times average ten-year earnings, investors could still do respectably in the following period.

Today, he is more pessimistic. He's concerned that eroding confidence by American consumers and businesses could lead to a downward spiral of reduced spending, which in and of itself could trigger a double-dip recession.

And he concluded our conversation by saying that while he expects returns in stocks to be positive, he doesn't think they'll be stellar – he's uncertain whether investors will be better off in stocks or in bonds over the next ten years.

The argument for stocks as cheap

Jeremy Siegel uses a different method to value stocks and reaches a different conclusion – his analysis suggests that, compared to long-term averages, stocks are undervalued by 25% to 30%.

The biggest difference between his approach and Shiller's is that his is forward-looking, focusing on consensus earnings forecasts for this year and next. Among his criticisms of Shiller's methodology is that mega-writeoffs, such as the $80 billion writedown by AIG, will distort the earnings base from which backward-looking calculations are conducted for years to come.

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Siegel has looked at U.S. stock market valuations over a 200-year period. During that time, the average stock multiple of earnings has been 15-times – that compares with a multiple of consensus earnings forecasts of 13-times for this year and 11-times for next year.

The impact of low interest rates

Siegel's average of 15-times earnings includes periods of double-digit inflation, when multiples are typically depressed. Excluding those periods of double-digit inflation, the average multiple that the market paid for earnings was 17-times.

If earnings forecasts for next year are accurate, then returning to that long-term average of 15-times earnings would result in stocks increasing by 35%; rising to the historical low-inflation valuation norm of 17-times would see stocks rise by 50%.

The long-term trend line

Siegel has plotted a long-term rising trend line in profit levels and stock market prices going back 200 years. When stock prices get above that trend line, as they did in 2000, typically underperformance follows – and often prices drop below the trend line.

Siegel points out that when stock market prices are below the trend line, as they are today, the lesson of history is that a period of outperformance follows – although he cautions that just as stocks can stay above the historical valuations norms for long periods of time, they can also stay below them, and investors have to be prepared to be patient.

Addressing the "new normal" of lower growth

We also discussed some of the arguments by Bill Gross at PIMCO and others about a "new normal" of slower economic growth, due to deleveraging, re-regulation and a reduction in the pace of globalization.

Siegel's response was that these are legitimate concerns, but that they ignore the impact of innovation and especially the effect of the internet. Siegel points to the internet as a transformative tool in accelerating the pace of innovation, as scientists and researchers around the world are able to work together in real time.

And he went on to say that this will inevitably lead to faster economic growth.

Communicating your views to clients

In an industry where opinion often drowns out reason, Robert Shiller and Jeremy Siegel stand out for their careful, fact-based approaches.

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Which view advisors and investors favor will largely depend on their going-in biases – those who are currently negative will look to Shiller's approach, those who are more optimistic will side with Siegel.

The good news is that these two views lay out clear parameters for the upside and downside case for stocks – and provide the foundation for a reasoned discussion about the direction of stocks in the period ahead.

In my conversations with investors, most want to deal with advisors who are generally positive but at the same time provide a balanced perspective, so don't fall into the perma-bull "don't worry be happy" camp.

That's why you can't dismiss the issues that global economies and stock markets are facing.

And with many clients, you can't rely on just your own opinion or your firm's research – in times like these, it's helpful to provide support from trusted, third-party sources.

Be careful about only telling one side of the story –by demonstrating that you've looked at the full gamut of views, your ultimate recommendation has more power.

If you're recommending clients stay fully invested, it's important to show clients you've examined the negative case.

And if you're cautious and recommending cash, it's helpful to demonstrate that you're not ignoring the optimistic voices.

By sharing the arguments on both sides of the debate with clients, you position yourself as someone who considers all the facts before reaching conclusions and making recommendations.

The interviews with Shiller and Siegel allow advisors to present both sides of the argument to clients – and to use these as a jumping-off point for a conversation. If you're going to use one of these interviews with clients to support your case, you might want to send clients not just the one you agree with, but both interviews – and then talk about the contrary case that you presented.

This entails a longer, more detailed conversation – but it's this kind of conversation that helps clients stick to their plan when the market goes against whichever stance you've taken.

Two routes back into the market

A final comment on helping clients get back into the market:

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After your discussion with clients, you may agree that it makes sense to increase their stock allocations. At that point, you can go in one of two directions.

One is to immediately move to the target allocation. The advantage of making the full move now is that clients will benefit from any run-up in stocks and you won't have to contend with hesitation to complete the commitment in six or twelve months.

The downside is that if markets suffer a short-term setback, you risk heightened anxiety from your client and potentially losing the client entirely.

The other route is to phase that move in stages, with perhaps a third now, a third in six months and the final portion in a year.

For many clients the decision to put in a third now and phase in the rest is a more comfortable process than investing the total amount right now.

Further, by suggesting that you phase-in the commitment, you reduce the risk of clients wondering whether your advice is influenced by the desire to earn higher compensation from funds that are invested in the market rather than sitting in cash.

To watch videos of some of the interviews with Jeremy Siegel, click here. Here is the transcript of those interviews.

And these videos summarize Robert Shiller's views on the market. Here is the transcript of those interviews.

Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to www.clientinsights.ca.

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