ADVISOR PERSPECTIVES

Jeremy Siegel - Why I Changed My Mind about Index Funds

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, has been cited as one of the top-10 all-time books on investing. It is available via the link above. A regular contributor to the Wall Street Journal and the Financial Times, he is frequently quoted in the financial press and is widely considered today's preeminent market historian.

Dan Richards interviewed Siegel at his office at the Wharton School in Philadelphia on June 9.

We're talking today about your research on the best way to select stocks and build portfolios. Before we get into that: When you published *Stocks for the Long Run* in 1994, what was your thinking then about the best way for investors to participate in the stock market?

According to my research, it was very clear and straightforward: Investors should use index funds. Capitalization weighted was the best solution, and I advocated it very strongly in my first edition of *Stocks for the Long Run*.

That was 1994, 17 years ago. How have your views evolved since then?

The biggest source of my change in views came as a result of the technology and internet bubble in the late 1990s and early 2000s. I saw technology stocks go virtually crazy, up way above any fundamental values. Clearly, if you were an indexed investor, you held them. You didn't sell them. You had to hold them in proportion to their market value, which was very substantial, and I felt that that may not be the best way for investors to actually invest in the market.

So that was the catalyst for starting to look at alternatives. How many different strategies did you consider?

Two principal strategies: One was investing in high-dividend stocks, and the other was to invest in low-price-earnings ratio stocks.

As you did your research and looked at those strategies, what conclusions did you arrive at?

I concluded that it was definitely better for investors to tilt their indexing toward either high-dividend and/or low-price-earnings ratio stocks.

How far back did you go in looking at the data to reach those conclusions?

I went back and exhaustively researched the S&P 500, which of course is now probably the most famous benchmark in the world — 500 of basically the largest U.S.-based stocks. It was formulated first in 1957, so it’s over half a century old. I looked at the higher dividend-paying, lower price-earnings-ratio stocks and saw whether staying in those stocks actually did outperform the market as represented by the S&P 500 index.

Going back to 1957, what specific returns would somebody have obtained with a strategy relative to the S&P as a whole?

I performed a very simple experiment. On the PE stocks, I sorted all the 500 stocks into groups of 100 stocks, or what we call quintiles. The first quintile was those with the lowest price-earnings ratio, and this was chosen at year-end in December and held throughout the remaining year. The second quintile was the next lowest price-earnings ratio. The third was the middle, and then all the way down to the fifth quintile, which was the highest price-earnings-ratio stocks.

There was no forecasting involved here. It was just taking the price relative to the last 12 months of earnings. I found that those hundred stocks with the lowest price-earnings ratios substantially outperformed the S&P 500 index and in fact did so by almost three percentage points per year. And that’s quite extraordinary over a period of more than 50 years. And it did so with lower risk than you would've had in the straight S&P 500 indexed portfolio. Now those things are not supposed to happen in finance. You’re not supposed to be able to find portfolios that give you higher returns with lower risk, but indeed these portfolios did deliver on that.

Looking back to the inception of the S&P in 1957, could you talk about how this strategy has performed during different periods since then?

It performed pretty consistently throughout the whole 50-plus years of my study. Of course, not every year. But it wasn't just concentrated on, for instance, the last 10 years, when we broke the tech bubble, or some other isolated period. The outperformance was in about two-thirds of the years and was spread pretty evenly. It did perform much better during the bear market, and you lost a little ground during the strongest part of the bull markets, but you got it back. And you know we've had quite a few bear markets since 1957. So it's not just something that has one period that gave you the results that you have here. It's really over a half a century of data.

I'd like to finish up by talking briefly about the whole topic of market valuations today. This is obviously a topic that draws intense debate. Given your research of almost 200 years of stock market valuations, what's your view on the opportunities that the U.S. stock market presents today?

It's an excellent opportunity. People ask me, "Jeremy, have you seen stocks cheaper than they are today?" I say yes. I've seen stocks and the U.S. market when we've had seven-times earnings to nine-time earnings, but the only time I've ever seen that is when we had double-digit inflation and double-digit interest rates.

I have never seen a market that had as low a PE ratio when interest rates have also been as low as they are today. PE ratios right now on the S&P 500 are in the 12-14 area on projected 2011 earnings, below the long-run average. This again is extraordinary given the, virtually the lowest interest rates we've had in a half-century or more. So today's market offers tremendous opportunities for the long-term investor.