03/06/12: Is the Market Overvalued?

There's an important--if somewhat geeky--debate going on in investment circles about the true valuation of the stock market--specifically the S&P 500 index of large companies, and similar indices followed by the Wilshire and Russell organizations. The heart of the debate is surprisingly simple: are today's investors paying more than the historical average price for a dollar of corporate earnings, or less?

Why is this important? Because whenever you're paying higher than average prices, it's possible that your expected future return will be below average. If less, then you have a better hope of getting above-average returns. There are, of course, no guarantees, but in general professional investors prefer bargains to overpaying for a share of stock.

Why is there a debate at all? Don't we know the current market prices, and the earnings on those companies? The problem is that the current price/earnings ratio that you hear quoted can be calculated in a variety of ways. One is to take the aggregate price of the stocks in the S&P 500 index and divide them by last year's overall earnings. As an alternative, you could use today's stock prices and the earnings that analysts are projecting for the next 12 months. Or you could use "operating" earnings, which take out unusual write downs. Finally, since corporate earnings tend to jump around, you could perform the same calculation using the average earnings of the past ten years, which gives you what the industry calls the PE10 ratio.

In a recent presentation at the TD Ameritrade Advisor conference, which I attended, Dr. Jeremy Siegel, author of "Stocks for the Long Run," calculated the S&P 500 PE at 12.3, based on 2011 earnings per share of $97. The PE is a bit lower if you use forecasted earnings of $105. Siegel says that the S&P 500's PE ratio has averaged around 15 for the past 50 years. Therefore, you could argue that the index is selling at roughly a 20% discount. Then he blurred the picture a bit by noting that in years when interest rates are low, the average PE has been closer to 19. That would suggest that stocks are closer to 50% undervalued.

However, if you use the PE10 ratio, you get a different picture, and this is the heart of the debate. Siegel calculated the PE10 at 21.2--which would suggest that stocks are 30% overvalued.

What's right? Siegel told the audience of advisors that the PE10 might not be an accurate valuation measure when one or more of the ten earnings years it averages together is unusual in some way. Perhaps the most unusual year in recent memory is 2008, when earnings on the S&P index fell 80% from the previous year. Siegel says that when you look closely at the data, three companies were primarily

responsible for the overall earnings drop: Bank of America, Citibank and AIG, the epicenter of the financial crisis and subsequent bailout, wrote off a total of $450 billion. If you make a few simple adjustments, and account for the effect of companies buying back their own shares, Siegel reports a doubly-adjusted PE10 of 15.

Which suggests that the market today is fairly valued.

This is enough to make the average person's head spin, but it also helps you maintain a bit of skepticism whenever you see a talking head on TV telling you, with calm assurance, that the stock market is over- or undervalued. At the end of his presentation, Siegel pointed out that many stocks that pay dividends are paying out more, per year, than 10-year Treasury bonds. This may be the only valuation measure that matters: an astute investor can designate a part of the portfolio to collect dividends that beat government bonds, and if stock prices go up you get a bonus.

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