BEWARE REGRESSION TO THE MEAN

Thomas J. Feeney

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Throughout the twentieth century to date, some statistical conclusions are clear. The Dow Jones Industrial Average has sold at an average of 14 times the cumulative earnings of its component companies. Those companies have yielded a dividend of about 4.5%. And those companies, have, on average, sold at a bit more than one and one-half times their book values. These ratios have applied over decades that have included war and peace, bull and bear markets, rampant optimism and pervasive gloom, boom times, recessions and a depression. The time they cover exceeds the span of our lives. Curiously, when smoothed for short-term variations, the ratios look remarkably similar from the first half of the century to the second. When one reads the market commentary of the times, there were always persuasive voices raised to convince investors that "It's different this time" to justify what, in retrospect, was excessive bullishness or bearishness We know today that, while the particulars were obviously different in every one of those earlier instances, the market conclusions ultimately were always the same. The ratios of market value always reverted to their means.

If we apply the twentieth century's average price-to-earnings, price-to-dividend and price-to-book ratios to today's levels of earnings, dividends and book values, we find that each suggests a Dow Industrials level around 2,000. Near 3,000, the Dow is about 50% above this century's norm. While the markets have occasionally spiked up to levels even more overvalued for very brief periods of time, they have always fallen precipitously from such rarified air. It is also instructive to note that the market's value ratios have, logically enough, spent as much time below their twentieth century averages as above them. They have retreated just as far below the norm in a few instances as they have climbed above it.

Those who argue today for a heavily equity-oriented approach see the economy emerging from a mild recession this quarter or next and expect visible growth in the economy and corporate earnings for an extended period ahead. At least implicitly, they argue that these historically high-value ratios are justifiable because we will experience considerable growth in the years ahead. Let's examine the growth argument.

As a country we have grown with only minor interruptions since our founding. We will certainly grow in coming decades as well. The question is not whether we will grow, but rather how much we will grow and what price we will assign to that growth. At today's prices we are evidencing a willingness to spend 50% more for a dollar of earnings, dividends and book value than we have, on average, throughout the nearly completed twentieth century. This is a century in which we have experienced the introduction and growth of automobile and airplane travel, instant audio and video mass communications, information processing by computer and the development of numerous lifesustaining medicines and procedures. All of that progress has resulted in a compounded growth in the Dow Jones Industrial Average of about 5 1/2% per year. Combined with an average dividend of 4.5% per year, this century's equity investor has reaped an annualized total return of about 10%. To justify today's historically overvalued levels, much less to make a case for higher stock prices, we need growth at an even faster rate in the future than we have experienced so far this century. Is it likely that an ever more mature society will grow faster than a younger society, one closer to emerging status? That's hardly the norm.

Can we grow our way to a justification of today's value ratios? Of course, anything is possible, but it makes sense to examine existing precedent. While we are not at all-time levels of overvaluation on any of the three measures mentioned earlier, we have only three historical precedents in which the three reached their current levels of overvaluation simultaneously. While the precise levels of overvaluation and the duration of the periods of overvaluation differed in each instance, the only three similar combinations of overvaluation in these measures preceded the sharp stock market declines that began in 1929, 1937 and 1973. The mildest of those was the 45% decline in the Dow Jones Industrials through 1973 and 1974. We have never in this century grown out of such an overvalued condition without a serious stock market setback.

Will it be "different this time?" Frankly, arguing against nearly a century of market precedent is difficult in any case regardless of current particulars. An examination of today's economic environment lends little support to the argument. Even the government, the cheerleader of last resort, is damning the expected recovery with faint praise. They, and most private economists, are forecasting a subpar recovery.

This projected recovery is to occur with consumers, corporations and government saddled with the greatest absolute and relative debt in U.S. history. We have as a country moved in the 1980's from being the world's greatest ever creditor to our present status as the world's greatest ever debtor. As a consequence, the government is unable to provide the kind and degree of stimulus normally available to help the economy from recession. And as a result of the rampant borrow-to-buy mentality of the 1980's the consumer, whose wallet is most influential in changing recessions to growth periods, is finding too little money available to spend. The strapped consumer, having saved in recent years at the lowest rate in a half century, has far less available than in past recessions.

This hardly looks like a financial structure set to spawn a period of sustained growth at a more robust than normal rate. It looks strikingly like what most economists are characterizing it to be -- a setting for slower than normal economic growth.

Where's the case for value measures 50% above the historic norm? In fact, most are finding it difficult to make the case even for trend-line growth. The lesson of our entire investment history is that these value measures will revert to their means. Unless earnings, dividends and book values skyrocket upward (and they never have in this century when their ratios have been substantially overvalued), these value measures will have to remain at precarious heights for years to come. There is a huge price gap below this market just to reach historically normal levels. Upward price progress from here would come only from investors' willingness to endure even greater overvaluation. Realization of just normal value relationships looms as a market disaster, not to mention the potentially more devastating consequences from a worsening of the current economic condition.

All that said, these measures, especially book value, are notoriously poor short-term market forecasters. That leads to the almost overwhelming temptation to try to squeeze a little more return from stocks in this cycle. Once again history argues against the temptation. Although markets have gone higher temporarily after these measures have reached such levels, the investor who in the past stepped aside from these value levels has never been unrewarded. Markets have always retreated to levels, even if some years later, at which the conservative investor could reinvest in the equity markets without having sacrificed return. In most instances, not only was great volatility avoided, but substantial price erosion was prevented as well.

Realistically the only rationales for staying heavily in equities at this level are 1) that you will be able to time the ultimate top or 2) that "It'll be different this time" and history won't apply. The probabilities argue convincingly against both.