Stock Market Perspective: Better Price/Earnings Ratios?

The price-to-earnings (P/E) ratio likely is the most common valuation measure for stocks and stock indices. For example, a P/E of 20 indicates that each twenty dollars invested returns one dollar in earnings. Another way of looking at this is take the reciprocal of the P/E, which is often called the "earnings yield" to distinguish it from the more common dividend yield. In the example, the earnings yield is 5%.

Relatively high P/E ratios for individual stocks usually mean the market is optimistic about the companies' growth prospects. For a broad market index, a higher P/E may indicate that the market is "overvalued," and the converse is true for lower ratios.

While the price of a stock or index is well known, the value used for the earnings is not cut and dried. Most common is the one for the latest completed fiscal year or sometimes for the last four quarters. Such has the advantage of being "real," at least to the extent that accounting practices and rules capture the true performance of the company, and it is the most recent data. The major drawback is that earnings often fluctuate considerably from year-to-year, so they may not accurately reflect how well a company or the broad market is doing at the particular time. One way to deal with the problem is to make an estimate of the earnings for the year in progress and/or the next year or two. However, such estimates have been documented to be quite inaccurate. As the famous Danish physicist Niels Bohr (and likely others) reputedly said, "Prediction is very difficult, especially about the future."

One of the "improvements" to the P/E ratio suggests stocks are overvalued. The other disagrees. Will either be right?

An article in the April 9 *Wall Street Journal* discusses two approaches to improving the E in the P/E ratio with regard to evaluating whether the stock market is overvalued or not. One was developed by Yale professor Robert Shiller and has received quite a bit of publicity and is fairly widely accepted. The other, which is not as widely known, is due to David Bianco of Merrill Lynch (now owned by Bank of America) and has the "academic blessing" of Jeremy Siegel of the University of Pennsylvania's Wharton business school. It is worth noting that Shiller and Siegel are long-time friends, but that Bianco was Siegel's student at Wharton.

Schiller uses the average earnings for the last ten years adjusted for inflation for each company in the index to obtain his adjusted P/E ratio. Doing so avoids distortions from short-term profit fluctuations, which smoothes out the effects of the business cycle to some extent. For an individual company, using data over that period can be a problem if the nature of the firm's business has changed significantly over the ten years. However, this is not likely to be as an significant issue when analyzing a broad market index such as the S&P 500 although the changing nature of economic conditions can be obscured by the average.

Bianco says the ten-year look back is useful, but thinks it should be modified in three ways to remove what he thinks can be distortions. Quoting from the article:

"First, Mr. Bianco would adjust the way corporate earnings are calculated. Instead of the as-reported profits Mr. Shiller favors, he would use what analysts call operating earnings, which don't count some of the write-offs of the dot-com bust and the financial crisis. That change sharply boosts 10-year average earnings, making price/earnings ratios look less scary.

"Second, he would change the historical data to which today's numbers are compared. He prefers to compare today's numbers only to data since 1960 or 1980, a period during which P/E ratios have been higher than in the past, making current levels look less extreme. If long-term data are used, he wouldn't count the decade following 1914, on the grounds that corporate profits were distorted by World War I more than by any other modern event,

even the Great Depression. Throwing out that decade also makes past P/E ratios higher, so that today's look better.

"Finally, he would adjust earnings figures still higher, based on the fact that companies have been retaining a higher percentage of profits and paying lower dividends for decades. When companies retain and invest more profits, he says, earnings growth is faster and reported earnings don't fully reflect the ability of retained earnings to spur growth. He calls this the Equity Time Value Adjustment, or ETVA."

I have some qualms about a couple of these. One problem to me is that so-called operating earnings are sometimes massaged and may not reflect how a company is doing. Write-offs result from problems a company has experienced. Although they are supposed to be "one time" events, they reflect losses and have been known to continue. The ETVA notion strikes me as similar to using estimated future earnings in that is incorporating "earnings" that have not yet been realized. Moreover, if a higher percentage of profits have been retained "for decades," then I don't see why earnings growth currently is faster than would be indicated by using unadjusted earnings.

The graph, courtesy of the *Wall Street Journal*, shows the long term history of the two P/E ratios and compares them to their averages for 1960-20009. Shiller's P/E for the S&P 500 is currently 23, well above its average, which indicates the market is overvalued. On the other hand, Bianco's is 14.5, just below the average, indicating that stocks are fairly valued. However, the article says he is quite bullish and thinks stocks are a "bargain." However, the graph shows that by either measure, stocks are hardly a bargain. Both measures were much lower from the mid-1970s into the early to mid-1980s. As the incredible secular bull market from 1982-99 showed, stocks were truly bargains then. I don't think the current secular bear market will end and a new secular bull will be in place until we see P/E ratios, no mater how they are measured, at much lower levels than the current ones.

I have no opinion about which of the two is the better one. The article reminds me of an old joke. A corporate executive needed to hire a statistician to help with management. Three candidates were brought in to interview. The first was asked how much is two plus two and immediately answered four. That candidate was dismissed and the second one was asked the same question. Having some mathematical background, the candidate said that based on the Peano Postulates[1] the answer is four. The executive thought that was a little better, but wanted to see the third candidate. Upon hearing the question, that one whispered in the exec's ear "what do you want it to be?" That one got the job.

[1] A set of simple axioms from which our number system can be derived.