

# EXECUTIVE SUMMARY



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## **Jeremy Siegel: Even in a Bearish Market, Bullish on Stock**



In an open discussion with executives in the Securities Industry Institute, Wharton professor Jeremy Siegel examined investment strategies in the current market. Siegel, author of the landmark books *Stocks for the Long Run* and *The Future of Investors*, drew upon historical records in making sense of the current downturn.

Based on Siegel's analysis of data from 1802 to the present, stocks have outperformed every other major asset class — including treasury bills, bonds, and gold — over the entire period, including important sub-periods. A dollar of gold in 1802, for example, would be worth just \$2.45 in December 2007 after adjusting for inflation. In contrast \$1 invested in stocks would have grown to more than three-quarters of a million dollars. Stocks have delivered 6.8 percent return per year after adjusting for inflation. "It is remarkable how consistent this has been across all long-term periods," says Siegel, who also teaches in the [Investment Strategies and Portfolio Management](#) program for investment professionals and individual investors. "Equities are about the last asset class that you can buy at or near its long-term historical value."

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**—Jeremy Siegel, Russell E. Palmer Professor of Finance**

The gap between stock and bond performance has been widening. While bonds have delivered 3.5 percent returns above inflation over two centuries, returns are going down. Since the end of World War II, bonds have delivered only a 1.7 percent real return per year. Currently Treasury Inflation-Protected Securities (TIPS) have a real return of about 1 percent. Of course, for experienced investors who can recognize values outside the triple-A bond market, there may be opportunities. "Safe bonds are of no value today. They are one of the worst values," Siegel says.

### **Long-Term Stability, Short-Term Instability**

"People ask me: What do you tell people in troubled times? I say look at the chart," he says pointing to the jagged path of stock prices over two centuries. Although the path zigs and zags, the general direction is always up. "The wiggles up and down are the great bull and bear markets, but over two centuries they all wash out and give you this return of about 6.8 percent after inflation. No other asset class shows more long-term stability than stocks — yet no other asset class shows more short-term instability."

Some fear that the development of global markets, the meltdown of the residential real estate market, rising oil prices, and other changes might present a "perfect storm" that defies historical returns. But Siegel said there is nothing in the current environment to indicate we have reached such a point.

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He notes that a reliable leading indicator of company stock prices is their price-earnings (P-E) ratios. The inverse of the P-E ratio gives a pretty good indication of real stock returns. Historically, the P-E ratio has been about 15, and  $1/15$  works out to about 6.7 percent, roughly the historical real return on stocks.

Returns thus depend on valuation, and valuations are holding. Using P-E ratios based on a range of estimates for 2008 earnings leads to projected after-inflation stock returns of 5.55 percent to 7.6 percent. The middle estimate of about 6.2 percent is close to the historical average. "That is not bad," Siegel says.

Siegel notes that what we are seeing now doesn't appear to be much different from other previous downturns. "People ask; Have you ever seen anything like this before? Oh, yeah. Many times."

## Is History a Good Predictor?

As Siegel was preparing for the Securities Industry Institute in March of 2000, he became concerned about the astronomical valuations of tech stocks. He received a call from an editor at the *Wall Street Journal* a week before the SII program and discussed his observations. The editor asked him to write an editorial, which appeared the second week in March. Siegel also told viewers of CNN's *Moneyline* on March 10 that there was a crash coming, although the timing was uncertain. It turned out that this date was the peak of the Nasdaq market.

The subprime mortgage crisis has obviously had a negative impact. But Siegel points out that there are good underlying assets to these mortgages—houses. These assets are worth far more than in earlier crises such as the Internet bubble or the collapse of telecommunications companies in 2001 and 2002. Telecom companies worked up a trillion dollars in debt laying fiber and making other investments, which was worth just 10 cents on a dollar when the market collapsed. Many tech companies had little more than flashy business plans when the bubble burst.

Real estate is different. Perhaps 20 percent of mortgages might be worth 70 cents on the dollar. "There are good houses out there. They will be occupied and this slump is lowering the price for first-time buyers."

Siegel also notes that while the high price of oil may be a concern in the short term, the price increases will also encourage alternatives and conservation. "I don't think it is going to be a long-run drag on the economy. History has shown we have been able to find alternative technologies."

"History is very suggestive here," he says. "If you have five events in a row, of course that doesn't guarantee that the sixth event will happen in the same way. There are always slight differences in the crises you go through. That is what brings fear into people's minds. Your mind can conjure up many worse scenarios, but when you look back at history, they are not that different at all."

## Efficient versus Noisy Markets

Where you invest today depends upon your view of the market. Siegel notes that there are two competing hypotheses about how markets work. The "Efficient Market Hypothesis" says that stock prices reflect the underlying value of the enterprise. In contrast, the "Noisy Market Hypothesis" - a term

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coined by Professor Siegel—contends that the market price fluctuates more than can be justified by the underlying value of the enterprise. Siegel says that if you believe the Noisy Market Hypothesis, you should not invest in capitalization-weighted indices, in which each stock affects the index in proportion to its market value. These indices are optimal based on the Efficient Market Hypothesis. "Efficient markets assume an infinite supply of arbitrage," Siegel says, referring to the ability to buy and sell at different prices in different markets. "But if arbitrage is limited, then stock prices are subject to temporary shocks that are not related to fundamental value, which cause mispricings." If you believe there is noise in the market, you should choose a fundamentally-weighted index, where the weights of the individual stocks are based on metrics such as dividends or earnings rather than market capitalization.

One puzzle in the current market downturn is the relationship between market declines and corporate writedowns in the financial sector. While total writedowns worldwide are \$160 billion, financial stock values have dropped by about \$3 trillion worldwide over the past three months. A temporary write-down should affect stocks dollar for dollar, which would mean a drop of only about \$160 billion. But a permanent loss of income would be expected to have an effect on stock prices that is about 15 times greater. This seems to indicate that "those trading in stocks in Wall Street, banking, and financial sectors believe they will have lost \$200 billion in yearly income every year in the future," he says. This may indicate a "mistake between permanent and temporary impairment of profit flows" that causes investors to undervalue the financial sector.

It wouldn't be the first time that conventional wisdom was wrong. As Siegel says, "The story of our capital markets is standing against the herd, both on upside and on the downside."



*P Jill Ashley visited Professor Jeremy Siegel, to discuss the "Noisy Market Hypothesis," October 2007 at Wharton School of Business, University of Pennsylvania, Philadelphia.*

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