

Can Wall Street Continue Its High-Wire Act?  
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With the Dow pushing 9000, investors are asking with increasing nervousness whether the market is overvalued. I don't think it's possible for even the Almighty to know whether a market is "over" or "under" valued. But there are two useful questions we can ask about today's valuations: First, given the current expectations of investors, is it likely that many will be disappointed by the growth in earnings and the returns from the stock market during the next decade? Second, if such disappointments are likely, do today's valuation levels imply a significant degree of risk at precisely the time when stock market risk premiums -- the excess returns that investors require to hold risky common stocks rather than perfectly safe government securities -- appear to be compressed? I believe the answer to both of these questions is yes.

It's not hard to see why most Wall Streeters are so bullish now. Corporate earnings in the U.S. have been expanding in recent years at double-digit rates. Many investors have simply assumed that such growth can continue through the foreseeable future. Even those who anticipate more modest single-digit growth rates are implicitly accepting the view that American business has entered a new era of productivity growth in which the business cycle and inflation are relics of the past.

Perhaps the dawn of the new millennium does indeed coincide with a new era in American economic performance. But a few facts are worth keeping in mind. Virtually all the resurgence of corporate profitability during the 1990s reflects a cyclical expansion of profits as we have moved to "full" employment and a decline in net interest expense resulting from lower interest rates and from paying down leveraged debt. With profit margins and the share of profits in gross domestic product way up, it will be difficult to keep up the recent sharp pace of earnings growth, especially with tight labor markets and the increasing competitiveness of the world's economies. And while we may well be entering a new era of productivity growth, official government statistics have yet to show clear confirmation of any change.

We should also remember that some of our extraordinary economic performance is merely fortuitous. The world economy has been unusually

unsynchronized. Europe has double-digit unemployment, Japan has yet to recover from a prolonged slump, and some Asian economies appear to be basket cases. We cannot always count on excess capacity in the rest of the world to help send commodity prices and import prices downward. Were it not for these world factors helping to keep prices in check, the Federal Reserve might well have been ready to spoil the party.

Looking ahead, there are certainly many scenarios under which corporate earnings might prove disappointing. It is even more likely that some expectations regarding future stock returns will be disappointed. During the past 15 years, average annual total returns from equities have exceeded 18%, well above the 11% returns characteristic of the past 75 years. Some investors have simply extrapolated these recent returns in forming their expectations of the future. Indeed, mutual fund investors in recent surveys were even more optimistic, expecting the stock market to return between 25% and 30% per year over the coming years. Many investors have "learned" that the stock market only goes up, that dips are buying opportunities rather than causes of worry.

In truth, the generous returns we have enjoyed since the early 1980s have resulted from an economy expanding from double-digit unemployment to "full" employment and from price/earnings ratios rising from less than eight to almost 24. But the economy now is close to capacity, and it is hardly likely that P/E ratios will triple again. There is a powerful tendency in the stock market for returns to revert to the long-run mean. And there is a strong likelihood that the expectations of many investors will prove far too optimistic.

If such disappointments are in the offing, do today's valuation levels suggest considerable risk? Historically, equities have returned 5.8 percentage points more than long-term government bonds. Many investors today believe, as James K. Glassman and Kevin A. Hassett argued recently on this page, that the stock market carries little long-term risk and the "correct" risk premium may be close to zero. It is only with small risk premiums that today's market levels can be justified. But the stock market may contain far more risk than investors have bargained for.

Almost every valuation measure suggests that common stocks today sell well above their past average and at the top of their historical range. The price-earnings ratio for the Standard & Poor's 500 is currently close to 24, more than 50% above its 30-year average multiple of less than 15. The dividend yield for the market is only 1.5%, well below its 4% average. Even if we add buybacks to the cash dividend, the augmented yield of about 2% is well below average.

At least in the past, investors have earned higher long-run rates of

return following periods when they could buy stocks at low P/E and high dividend yields. Conversely, future long-run returns have been lower following periods when yields were low and P/E high. Similarly, ratios of price to book value, price to cash flow, and price to sales all signal that the stock market is richly valued. In addition, stocks are selling at an all-time high relative to the replacement value of corporate assets and to gross domestic product.

It is possible to argue that many of these traditional benchmarks are less relevant today than in the past. After all, they all have been signaling danger for some time now, even as stocks have continued to rise. The point, however, is not to use them for forecasting or even to argue that stocks are overvalued. But if there are disappointments, what these measures show is that the stock market could fall 40% from today's levels and still exhibit ratios that equaled the averages of the past. This suggests that stocks today have more risk than usual at precisely the time when risk premiums appear to be quite low. To put it in terms used by Benjamin Graham and David Dodd, authors of the 1934 classic "Security Analysis," stock valuations today do not provide any substantial "margin of safety."

It is wise to remember that markets are always surprising us. Only 10 years ago we were told that Japanese management techniques were the most effective in the world, and Japanese stocks soared to unprecedented P/E ratios as the Nikkei stock index came close to the 40000 level. The U.S. was widely seen as losing its manufacturing edge, and U.S. stock prices were low. Today the Nikkei stands at 16000, and Japan's economy has languished throughout the 1990s. The U.S., by contrast, is now described as a supertanker economy. We weren't so bad in the 1980s, and we probably aren't so good today. We should be very wary of a complacent belief that our present noninflationary growth is permanent.

We should also be wary of uncritical acceptance of one of the other supposed pillars that will continue to buttress stock prices. It is said that the baby boomers, now in their asset accumulation stage, will continue to pour money into equities for years to come. To be sure, households have recently increased the proportion of their assets in equities. But the increased flow of money into mutual fund equities through retirement plans has been accompanied by a reduction in directly held equities. Overall savings rates in the U.S. economy are low. And experience indicates that individuals can quickly change their allocations if sentiment changes. Today's passion for U.S. stocks may not last forever.

U.S. stocks may not be overvalued, but they are richly valued and risky, and they are likely to produce considerably lower returns than in the

recent past. This is not a call to sell stocks; no one can consistently time the market. But it does suggest that new money might appropriately be placed in other assets. The best policy for investors is to reduce risk by diversifying broadly -- especially into assets that tend to have a low correlation with U.S. stocks.

Over the past 10 years, an investor could do no better than to put his entire portfolio in large-capitalization U.S. stocks. Ten years from now, I believe investors will be very glad that they diversified their portfolios into small-cap U.S. stocks, real estate, foreign stocks (including those from the battered-down emerging markets) and even bonds. Diversification does not guarantee the best returns, but it does ensure that you will have some participation in the best markets, and it should certainly allow you to sleep better at night by reducing risk.

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