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A gift from risky markets

Michael Nairne, Serious Money

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Italy stocks are at fire-sale prices.

This holiday season, gloomy economic prospects and mercurial markets are actually bringing investors a gift in the form of increasingly attractive stock valuations. Unfortunately, cheaper stocks, like fruitcake, are the kind of present rarely appreciated by the recipient. Weary of the never-ending barrage of melancholic financial news, most investors miss the opportunity wrapped in lower prices — higher potential long-term returns.

Finance academics have recognized for several decades that when stock prices swing too far from fundamental value as measured by earnings or dividends, there is a tendency for prices to revert to more normal levels. This reversion is not a short-term phenomenon; it occurs gradually over a number of years.

Practically speaking, this means pricey markets tend to be followed by lengthy periods of poor stock returns while cheap markets tend to be followed by better returns.

History is illustrative. Investors who stayed with equities through the tortuous recessions of the 1970s and early 1980s when stock prices stagnated were more than amply rewarded by the double-digit returns of the subsequent great bull market. Conversely, investors who poured into the extraordinarily expensive market spawned by the tech boom of the 1990s have faced a lost decade — the S&P 500 has returned only 0.5% a year since 2000, a period in which the U.S. economy has grown by well over 50%.

From 1825 to 1999, there have been seven stock-valuation cycles in the U.S., each characterized by a lengthy span of moribund or even declining stock prices that followed on the heels of a period of ascending prices. It typically takes well over a decade of stagnant prices to bring valuations down to attractive levels from the bullish extremes reached during the ascendant phase. Investors' dreams born in bull markets ebb away ever so slowly.

Today, the U.S. is just over a decade into an eighth phase of stagnant prices.

Although stock prices are languishing at a level first seen in 1998, valuations have improved dramatically. Measured by Professor Robert Shiller's cyclically adjusted, real price-earnings ratio (CAPE) — a ratio that has shown to have predictive power over longer time spans — valuations have fallen by more than half, from a ridiculously expensive 44 times earnings in December 1999 to around 20 times earnings today.

Don't get me wrong. U.S. stock prices aren't at bargain-basement levels. The average CAPE ratio since 1950 has been 18.7, so prices today are still above average. Still, today's valuations offer the potential of long-term annual returns of 6% to 7%, far ahead of the 2%-to-3% yield offered by bonds.

The bargains are elsewhere in the globe. European and Asian stocks are nearly a third cheaper than U.S. equities. Pension Consulting Alliance has calculated the CAPE ratio of the international stocks in the MSCI EAFE index at 13.7, a level not seen since the early 1980s and the dark days in 2009.

Wegel & Co., a Swiss private bank, has a similar view. It rates Canada and the U.S. as the second- and third-most expensive stock markets among major developed countries. The Asian markets of Singapore and Japan are cheaper. Germany, the Netherlands, the U.K., Norway and France, all still AAA rated by credit agencies, are even more inexpensive while Italy, Spain and Austria are at fire-sale prices. Overall, Wegel & Co. forecasts the expected long-term, real return from stocks from developed nations globally to be a rewarding 7.3% annually.

Emerging markets are also inexpensive. HSBC recently reported that emerging markets are trading at a 20% discount to their past five-year average valuation based on forward 12-month price-to-earnings ratios.

So, this holiday season investors can find a little good cheer in improving stock valuations and the resulting potential for higher long-term returns.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.