ADVISOR PERSPECTIVES

Jeremy Siegel on why Equities are "Dirt Cheap"

Robert Huebscher
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Jeremy Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania, and a Senior Investment Strategy Advisor to Wisdom Tree Funds. His book, *Stocks for the Long Run,* now in its fourth edition, is widely recognized as one of the best investment books. He is a regular columnist for Yahoo Finance, and is frequently quoted in the financial press.

We interviewed Professor Siegel on November 11, 2008

At the end of October, you wrote that stocks were "dirt cheap," based on your analysis which showed that the P/E of the Dow was 10.7 and the S&P was 11.7, as compared to historical averages of around 15. You said investors should expect a return of 20% over the next 12 months, and that a fair value of the S&P is 1,380 (based on earnings of $92/share and a P/E of 15). I'd like to ask about these last two assumptions - $92/share and a P/E of 15. Looking at Robert Shiller's data, using a 10-year average of earnings to determine a normalized P/E ratio, the average P/E over the last century has been closer to 18, and the current level is approximately 20. Can you explain your calculation?

I may be the lone optimist in this market.

One of the big reasons I get a lower P/E is because we have a growing economy and growing earnings. Shiller uses a historical average of earnings and I use the current value. When there is growth, the current value will always be higher than the historical average and lead to a lower P-E ratio.

Shiller and others, including Jeremy Grantham, assume that, over the last 130 years, the average growth of earnings per share (EPS), after inflation, has been constant. There is one big problem with that assumption - it is wrong. The growth of EPS is critically dependent on the dividend relative to earnings, or the dividend payout ratio. Lower payout ratios are accompanied by a higher growth rate of EPS, and vice versa. When companies use cash for purposes other than paying dividends, such as to buy back shares or to invest in their businesses, it leads to higher EPS growth.

Since 1981 the average dividend payout ratio has gone down substantially, and the rate of growth of EPS has gone up. So, there has been faster growing EPS since the 1980s. By the way, the relationship between EPS and payout ratio is independent of the growth in the economy or the GDP.

By making the assumption that EPS growth has been constant, Shiller and others are greatly underestimating trend earnings. From 1871 to 1981, EPS growth was between 1.4% and 1.5%; since then it has been between 3.7% and 4.5% depending of whether one uses reported or operating earnings.

That is a very fundamental problem with their analysis.

Regarding your EPS estimate of $92, it looks like the number for 2008 is likely to be in the mid-$50s. What is your outlook for corporate earnings? Are we likely to see more "surprises" on the upside or the downside?

Here are the historical quarterly earnings for the S&P 500 since 1991:

The red line is the regression trend line, and it indicates the current fair value of quarterly EPS, based on historical trends, is $23, which how I get an annual estimate of $92. This value of $23 is consistent with the higher growth rate since 1981, as I indicated earlier.

The green lines are one and two standard deviations from the mean red line. You can also clearly see the recessions in 1991 and 2001.

What is your outlook for the global economy – how long and how severe will the recession be? Will it get worse before it gets better?

There is no question the economy will get worse before it gets better. But remember that the stock market turns around six to eight months before the economy bottoms out. I expect the economy will be a disaster in the fourth quarter, and the first quarter of next year will also be very slow. We will see a bottom in the economy in the second quarter, although GDP growth may still be negative. By the third quarter GDP will be growing, and by the fourth quarter growth will be about 3%. 2010 should be strong.

How serious a threat is inflation? When do you expect to it to escalate, and how severe will it be? Should investors be structuring portfolios now with the expectation that inflation is on the horizon?

I do not see a threat from inflation. Commodity prices are down. Oil prices are low – WTI is at $58.30 today and Brent is at $54.92. Wages are down, lessening the likelihood of demand-driven inflation. The deficits that will result from increased government spending will substitute for a lack of private spending, and will not push the economy toward inflation. There is very little private debt being issued– corporations cannot borrow in this environment – and this gap will be replaced by government debt, which is what people want to hold.

The question of the day is whether the government should "bailout" the automobile industry. What are your thoughts?

No, the government should not bailout the automobile industry. That would be a bailout of the United Auto Workers (UAW) and the union's health programs. The auto makers should go the same route that the airline industry did, where virtually every major company went through bankruptcy. Bankruptcy is a great catalyst for corporations to undertake the right kind of reforms. The UAW needs to renegotiate their health benefits now, because they would be at great risk in a bankruptcy.

Is a massive stimulus package – as the new administration has advocated – the right way to revive the economy?

Yes, there will be massive spending on infrastructure and alternative fuels, along with tax cuts. This will provide the necessary job growth and will substitute for the lack of private consumption.

What is happening in China is very important, too. Will they continue to buy our government debt? Will they move toward an import- or export-oriented economy? It is better for us if they stay export-oriented, because we need their cheap goods.

I've read that you turned down an offer to serve as a Federal Reserve Governor. Would you like a role in the new administration?

I did turn down that offer, which was made in August. I saw there was no hope that Congress would act on and approve my appointment before the end of the previous session. Since all outstanding nominations must be resubmitted, I would have had to go through the process again in the next Congress. I have no idea whether I will be offered a role in the new administration.

What is your own asset allocation now? Are you 100% in stocks?

Basically, all my long term money is in a diversified portfolio of international equities. It is weighted toward dividend paying stocks, which are the ones I believe will outperform in the long run.