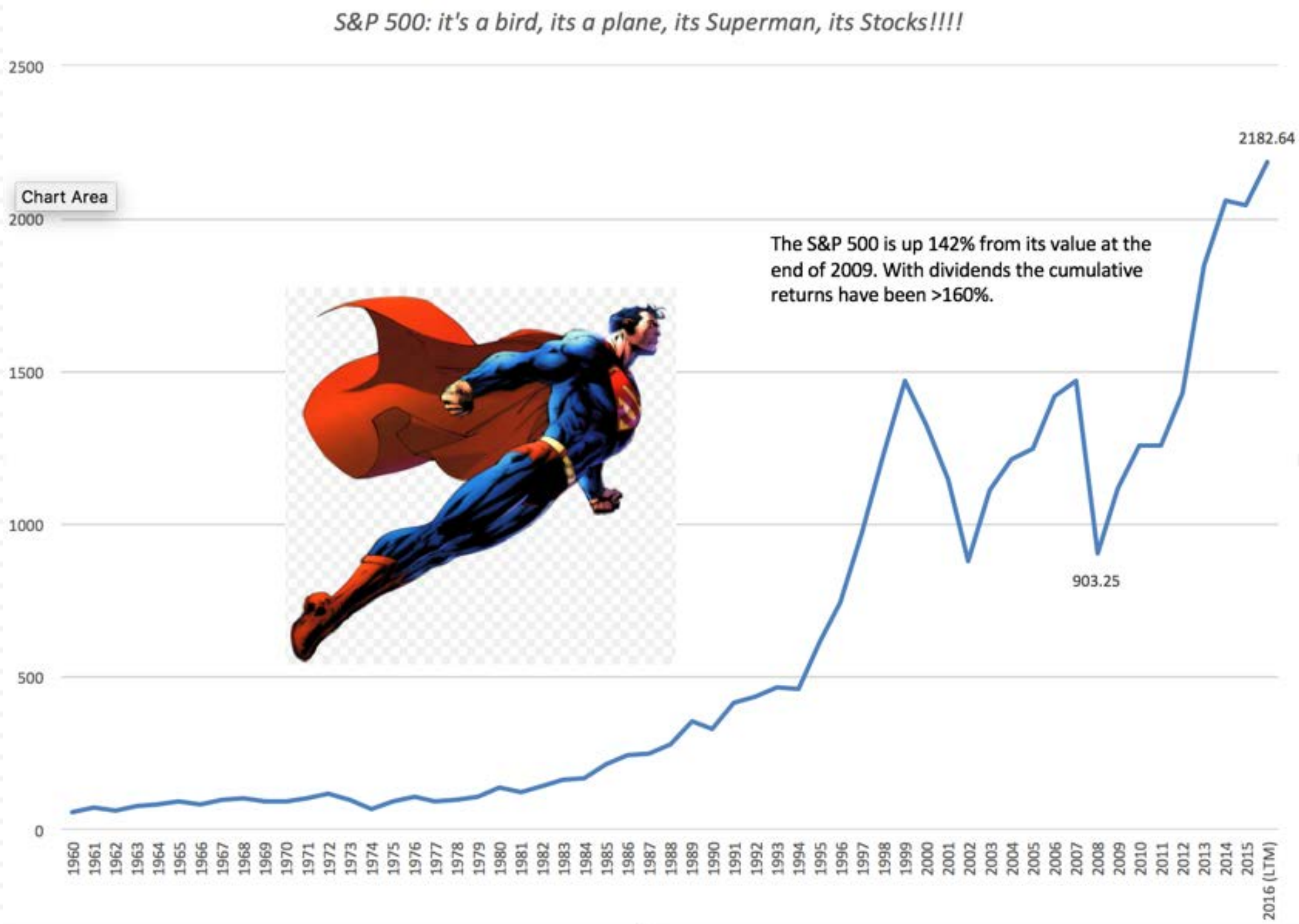
SUPERMAN AND STOCKS: IT'S NOT THE CAPE, IT'S THE KRYPTONITE!

It's a bird, it's a plane, its Superman

A wandering mind..

Up, up and away! Super stocks!



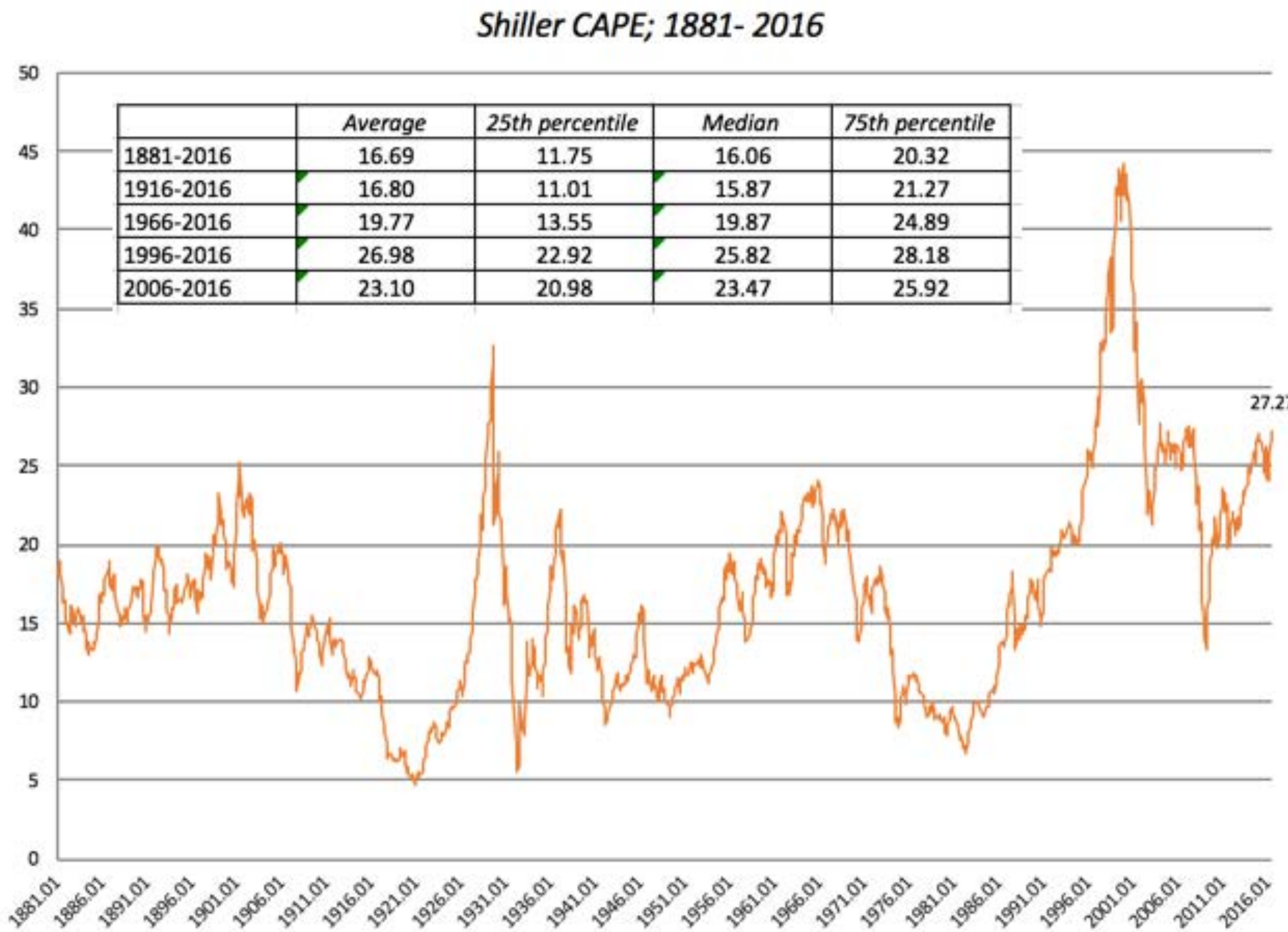
The Bubblers

1. **The Doomsday Bubbler**: Has been warning you about bubbles ever since you've known them.
2. **The Knee Jerk Bubbler**: Go into hibernation in bear markets but become increasingly agitated, the more they go up
3. **The Armchair Psychiatrist Bubbler**: Use psychological clues from their surroundings to make judgments about bubbles.
4. **The Conspiratorial Bubbler**: Bubbles are created by small group of evil people who plan to profit from them
5. **The Righteous Bubbler**: If investors are having too much fun (because stocks are going up), they have to be punished
6. **The Rational Bubbler**: Use market metrics that are both intuitive and widely used, note their divergence from historical norms and argue for a correction back to the average

The Rational Bubbler's Favorite Tool

- The CAPE ratio is the PE ratio for the market, adjusted for two factors:
  - Varying earnings over time, by averaging earnings over ten years.
  - Inflation, by inflation-adjusting past earnings.
- The ratio comes with impeccable credentials, since it was developed by Robert Shiller, who not only won a Nobel Prize but has called (if tentatively) the bursting of both the dot-com and housing bubblers.

The Basis for the Story

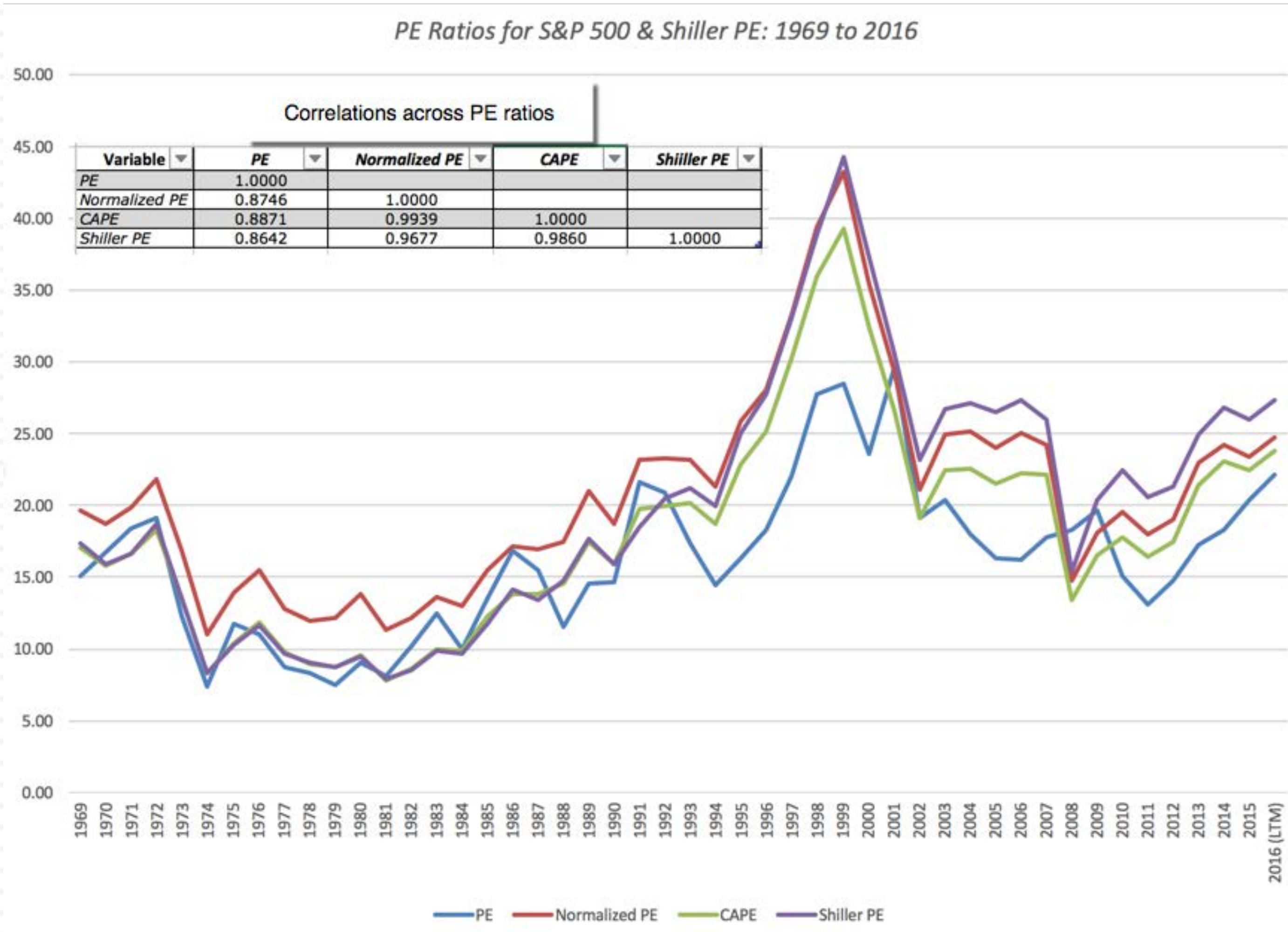


	Average	*25th percentile*	*Median*	*75th percentile*
1881-2016	16.69	11.75	16.06	20.32
1916-2016	16.80	11.01	15.87	21.27
1966-2016	19.77	13.55	19.87	24.89
1996-2016	26.98	22.92	25.82	28.18
2006-2016	23.10	20.98	23.47	25.92

The Case against CAPE

1. The Shiller CAPE is not that informative, since it moves for the most part with other pricing multiples.
2. Its predictive power is weak in the short term, with conventional PE besting it. It is stronger in the long term (5 years) but that may help little in asset allocation and investing.
3. Investing is relative and just because the CAPE is high, relative to past history, does not mean that you should not be buying stocks.
4. It's the cash flow, not earnings, that drives stock prices.

1. It’s not that informative



Variable	PE	Normalized PE	CAPE	Shiller PE
PE	1.0000			
Normalized PE	0.8746	1.0000		
CAPE	0.8871	0.9939	1.0000	
Shiller PE	0.8642	0.9677	0.9860	1.0000

2. It's not that predictive

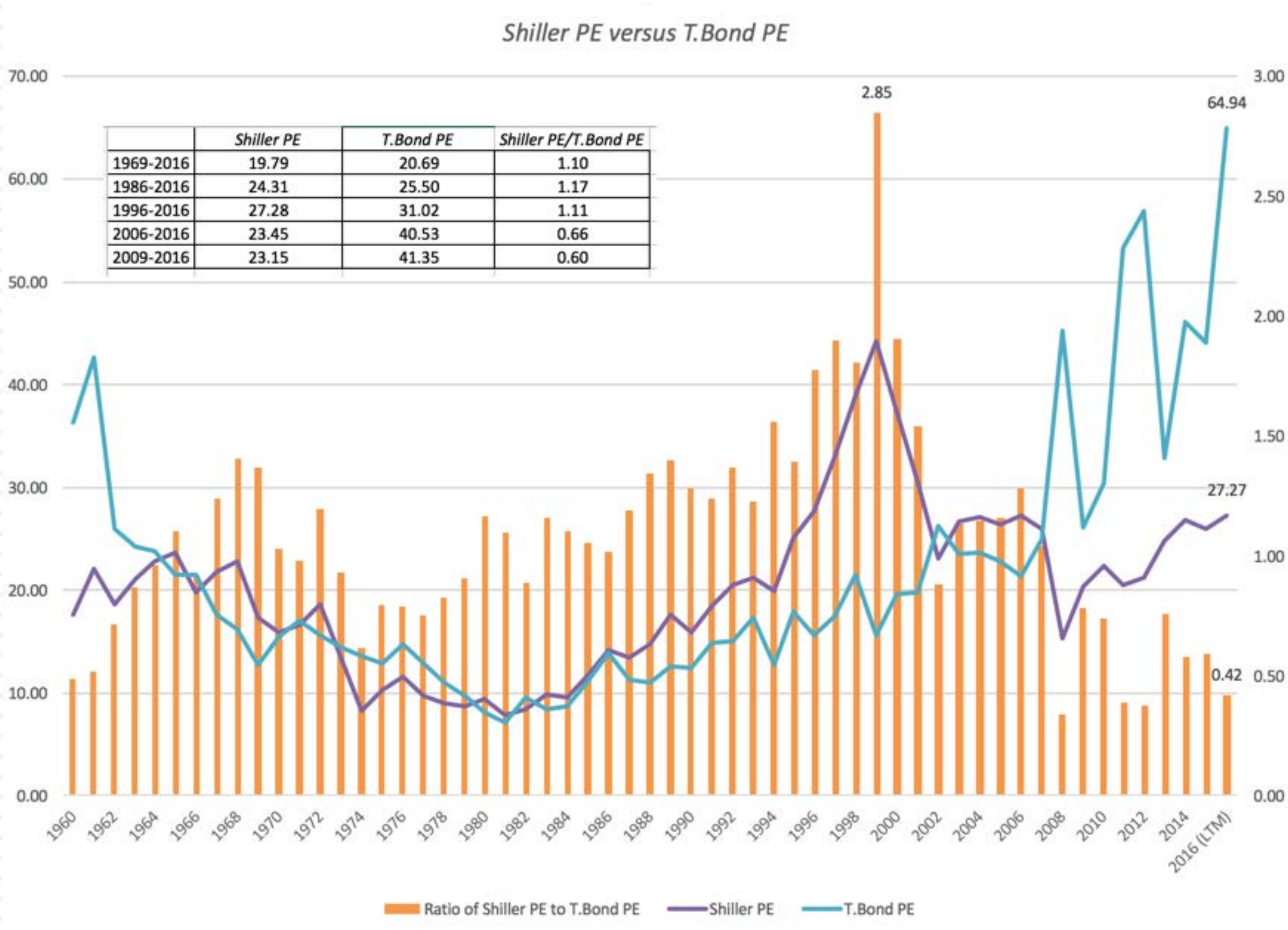
	PE	Shiller PE	Shiller PE/T.Bond PE	Price Dividends	Earnings Yield	Stock Return next year	Stock return next 5 years
PE	1.0000						
Shiller PE	0.8545	1.0000					
Shiller PE/T.Bond PE		0.5093	1.0000				
Price/Dividends	0.7829	0.9327	0.4522	1.0000			
Earnings Yield	-0.9182	-0.7814	-0.2877	-0.6802	1.0000		
Stock Return next year	**-0.3185**	-0.2711	-0.1759	-0.2751	0.2946	1.0000	
Stock Return next 5 years	-0.4884	**-0.5939**	-0.3387	-0.5544	0.4480	0.4955	1.0000

A more direct test

End Value of $100 invested at end of 1927

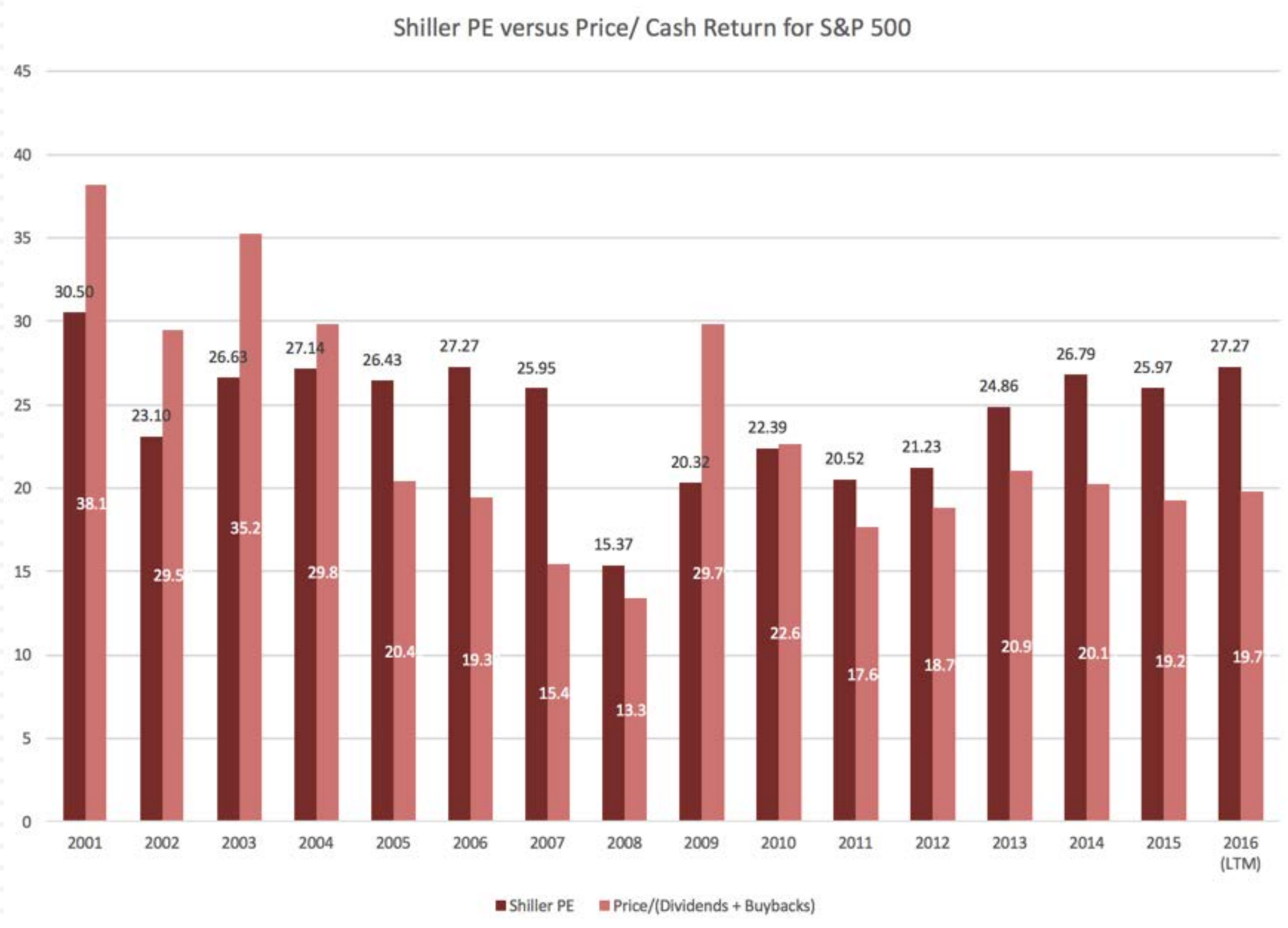
	% invested in equities			
CAPE over valued cut off	0%	25%	50%	75%
10%	$21,371	$49,125	$101,448	$189,332
25%	$59,992	$101,656	$160,083	$234,694
50%	$137,943	$179,065	$224,536	$272,432
With no market timing, you invest 100% in equities. A $100 invested in equities in 1927 would have been worth $320,173 in August 2016.				

3. Investing is relative



	Shiller PE	T.Bond PE	Shiller PE/T.Bond PE
1969-2016	19.79	20.69	1.10
1986-2016	24.31	25.50	1.17
1996-2016	27.28	31.02	1.11
2006-2016	23.45	40.53	0.66
2009-2016	23.15	41.35	0.60

It’s the cash, not the earnings..



Time to be bullish!

- Using another metric, say cash flow or the ratio of stock PE to T.Bond PE, to decide that stocks are under priced is just as dangerous as using CAPE to conclude that stocks are over priced.
- No single pricing metric can time the market. If it did, we would all be successful market timers.

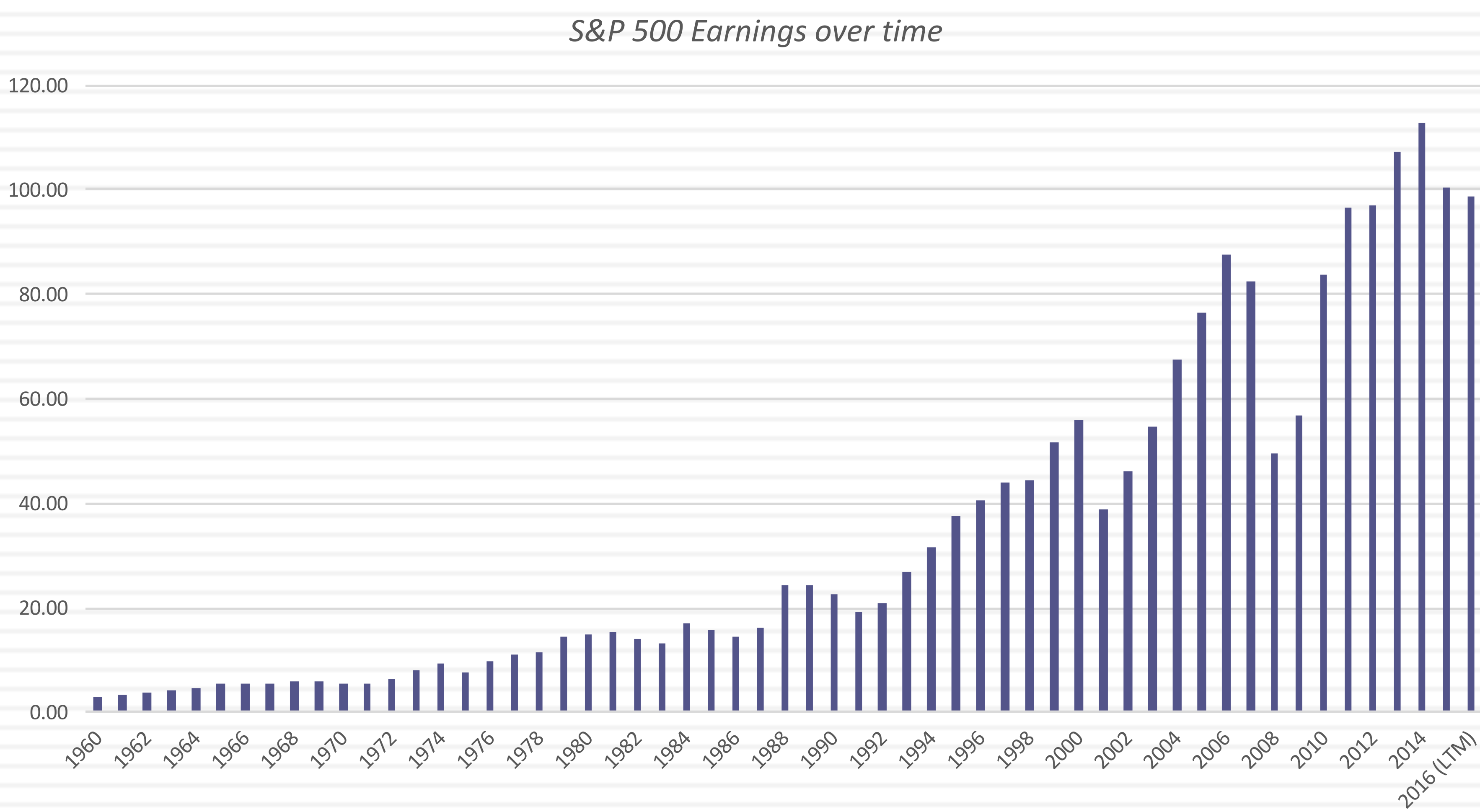
So, what's the market's kryptonite?

1. The Treasury Alternative: If the T.Bond rate surges suddenly, and the stock environment remains unchanged, your decision can flip.
2. The Earnings Hangover: If earnings, which have dropped last year and this, continue to drop, your judgment on stocks could quickly shift.
3. The Cash Flow Sustainability: If companies reduce the cash that they return to investors, especially by curbing buybacks, the cash story can quickly turn negative.

1. The ”All Powerful” Central Bank

- The fear: One reason that stocks look attractive right now is because interest rates are low in many currencies. If you believe, like many seem to, that central bankers are omnipotent and can raise rates on a whim, your nightmare scenario is a Federal Open Market Committee meeting that “pushes” long term treasury bond rates to 4% (over night).
- The counter: Central banks don’t set government bond rates and it is debatable how much power they have to even influence them. If rates are to rise, it will have to be because inflation and/or real growth rise, which will also play out as higher growth for earnings in stocks.

2. The Earnings Hangover



3. Cash Flow Sustainability

Year	Earnings	Dividends	Dividends + Buybacks	Dividend Payout	Cash Payout
2001	38.85	15.74	30.08	40.52%	77.43%
2002	46.04	16.08	29.83	34.93%	64.78%
2003	54.69	17.88	31.58	32.69%	57.74%
2004	67.68	19.407	40.60	28.67%	59.99%
2005	76.45	22.38	61.17	29.27%	80.01%
2006	87.72	25.05	73.16	28.56%	83.40%
2007	82.54	27.73	95.36	33.60%	115.53%
2008	49.51	28.05	67.52	56.66%	136.37%
2009	56.86	22.31	37.43	39.24%	65.82%
2010	83.77	23.12	55.53	27.60%	66.28%
2011	96.44	26.02	71.28	26.98%	73.91%
2012	96.82	30.44	75.90	31.44%	78.39%
2013	107.3	36.28	88.13	33.81%	82.13%
2014	113.01	39.44	101.98	34.90%	90.24%
2015	100.48	43.16	106.10	42.95%	105.59%
2016 (LTM)	98.61	43.88	110.62	44.50%	112.18%

The Market Timing Mirage

- There will be another market correction. When it happens, the bubblers will come out of the woodwork claiming to have seen this coming.
- Before we anoint these bubblers as market timers, take a closer look at their predictions and what following those predictions would have meant to you, if you had followed them all the way through.
- For most market timing, what you lose by staying out of the market because you saw calamity coming year after year will be greater than what you gain from the next downturn.