Market Math Made Simple

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by David Scranton

Have you ever bought a pair of pants for your child or grandchild that were too big? It's a common occurrence, and when it happens you basically have two options: One, you can throw the pants in the wash and try to shrink them. Or two, you can just sit back knowing that child or grandchild will eventually grow into them. In essence, this same phenomenon applies when the price of stocks get overinflated in relationship to annual corporate profits, and if you can learn to recognize when it's happening, that knowledge can go a long way toward helping you make smart, safe savings and investment decisions.

I first observed this phenomenon back in 1998. What I was seeing, and what was starting to worry me, was that the overall price of stocks in the market was becoming overinflated – like a baggy pair of pants – relative to actual corporate profits. I understood from my knowledge of market history and my grasp of the basic financial ratios that one of two things had to happen to correct this growing imbalance: that overall stock prices had to shrink by 75 percent, resulting in a Dow Jones Industrial average below 3,000, or we had to slip into a significant and prolonged period of market volatility while we waited for corporate profits to grow into these baggy price levels.

As for the shrinking scenario, I knew the odds were slim. This just does not happen very often, so basically what I realized in 1998 was that we were sitting on the cusp of a brand new 20-plus year secular bear market. I wasn't sure exactly when it would officially start, but I knew it would be soon. I knew this based partly on my understanding of stock market biorhythms and past secular market cycles, but also because I had an understanding of a basic stock market formula: price to earnings ratios.

Every stock has a price to earnings ratio, and so does the entire stock market. The formula is simple: price per share divided by earnings per share. By comparing these two things in one stock, and then measuring the ratio alongside that of another stock, you can often get an idea of which stock is a better buy. As a very general rule of thumb, the stock with the lower price to earnings ratio is the more attractive because it is considered undervalued, and remember the goal is always to "buy low."

For instance, let's say you have a stock selling at 30 dollars per share in a company whose corporate earnings are one dollar per share. Then you have a stock selling at 50 dollars a share in a company whose corporate earnings are 5 dollars a share. Which one is the bargain? Well, it's the second one with the higher priced stock. That's because 5 divided into 50 is 10, while one divided into 30 is 30. Ten is lower than 30, and, thus, that's a lower price to earnings ratio. Now, it's important to remember that in the real world there's a lot more to consider than P/E ratios when choosing which stock to buy, but it's definitely something you want to have an understanding of.

Reliable Indicator

Again, both individual stocks and the market overall have a P/E ratio, and if you keep track of the overall ratio it can give you a good indication of when stock market levels are generally too high and ready for a drop. This is exactly what I observed in the late 90s when I recognized that our current secular bear market was about to begin. At that time, the average P/E ratios had exceeded 30, which meant that each dollar invested was buying just three cents of earnings, or annual profits. To put that in perspective, you would have been earning about 3 percent on your investments when – during that same period – you could have taken some of that same money and bought an FDIC insured CD with no risk and earned 5 percent.

Now, what does history tell us about P/E ratios when we look at long-term secular market cycles of the past. As a matter of fact, whenever we've come to the end of a secular bull market cycle – be it in the late 1920s, the mid-60s or the late 90s – P/E ratios have typically been near or above 30. So, history tells us, 30 is the warning sign. It's just like if you have a swimming pool: you know there's a certain number on your pool filter that tells you when it's time to backwash. Ignore that number and the pressure keeps building, and eventually your filter may conk out.

Why 30? Because at that point the imbalance in the price-to-earnings formula is bordering on ridiculous. That's exactly how things looked in the late 90s when so many people were still buy-and-hold happy despite this crazy imbalance. Here's an analogy: Suppose you decided to buy an ice cream parlor and the owner wanted a cool $3 million for it, and you knew the business consistently earned $100,000 annually. That's a P/E ratio of 30, and it means it would take you 30 years to recoup your investment and, potentially, hopefully, start turning a profit. Now suppose I remind you again about that FDIC insured CD you might have invested in instead, or told you that you could have bought government bonds and earned more in less time without having to dig into a single carton of Rocky Road?

Speculative Bubbles

Now, to look at the opposite end of the P/E spectrum, typically, toward the end of a secular bear market, price to earnings ratios slip below 10, very often into the 6 to 8 range. Historically that's a key signal that the next secular bull market cycle of steady growth is about to begin. So, why do secular bear markets like the one we're in right now typically last 20 years or more? Because that's how long it takes for P/E ratios to make that drop from 30 to the 6 to 8 range, which, again, generally happens in one of two ways: Either stock market levels suddenly drop by 75 percent (which hardly ever happens) or corporate earnings slowly quadruple and grow into the inflated stock prices, just like a child might grow into an oversized pair of pants. And what do I mean by "slowly" quadruple? How long does that take? That's right, usually 20 years or more, and with the market fluctuating wildly the whole time.

So, clearly P/E ratios can serve as a good indicator of where we stand in a secular market cycle, but are there other indicators? Indeed there are, and one is based on the fact that most people don't get serious about saving and investing for retirement until their late 40s or early 50s. With average life expectancies in the early 80s, that means, as a rule, most people are serious about their retirement investments, for about the last 35 years of life – the same length of time it takes a combined secular bull-bear market cycle, or one market biorhythm, to run its course. Coincidence? I don't believe so.

Do you remember your parents giving you advice based on bad decisions or mistakes that they had made? Of course you do. Did you ever take their advice? Of course you didn't. Unfortunately, human nature dictates to a large extent that we learn through our own mistakes. This applies to investing mistakes as well. The common mistake each generation repeats is that of letting greed take over during good times and creating speculative asset bubbles by driving stock prices to highs not supported by economic fundamentals. Every generation has to have, it seems, this period of greed where asset prices get overblown until everything comes crashing down.

Two Options

So, practically speaking, what are your options as we continue to wait for corporate earnings to grow in to overinflated stock prices, and for this generation's speculative asset bubble to burst – which history tells us could take up to another 10 years? Well, for starters, it's essential to recognize that "buy and hold" doesn't work in a secular bear market. It works great in secular bull market, but in a secular bear market it just puts you on a long rollercoaster ride that ends in zero net portfolio growth. Beyond that, you can take one of two roads:

1. Use a tactical allocation strategy in which you have a manager make wholesale moves in and out of the market to take advantage of the cyclical bull and bear markets within the long-term secular bear market cycle. This is risky, expensive in terms of management fees, and generally not likely to work very well in a secular bear market.
2. Stay out of the stock market altogether in a secular bear market, and invest for income instead of growth. The simple fact is, when you cross your fingers and toes hoping for capital appreciation, or growth, it sometimes turns into

depreciation or shrinkage. Conversely, investing for interest or dividends is more of a "bird in the hand" approach.

Getting started is as easy as contacting a qualified financial advisor who specializes in the universe of non-stock market, income generating alternatives. This is income you can spend if you're retired, or that you can reinvest in order to grow your portfolio organically, or "the old-fashioned way," with far less worry over damaging losses that could impact your life and sideline your retirement plans.

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