Richard Bernstein Advisors

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RBA Quick Insights

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Time to hang up your CAPE?

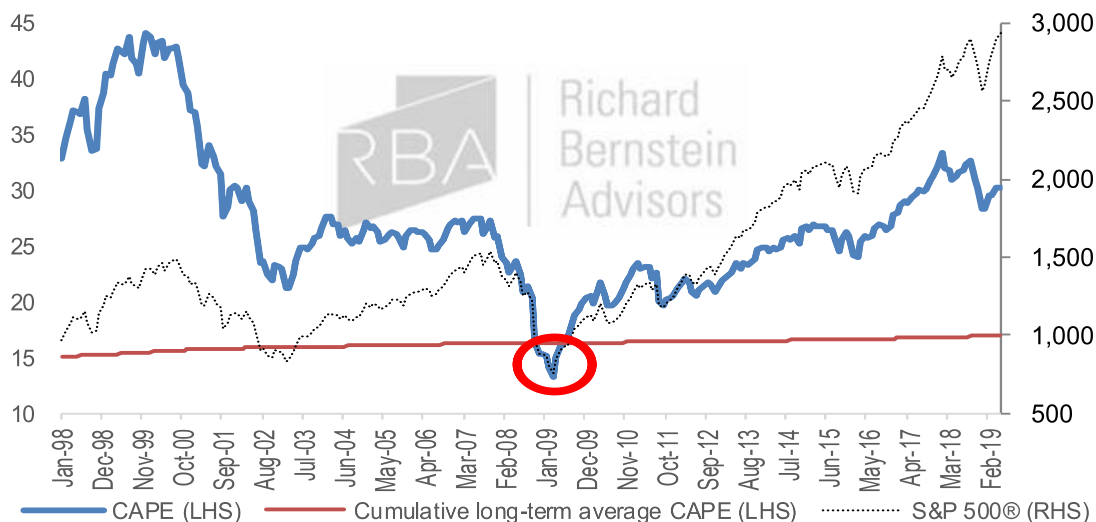
The cyclically adjusted P/E ratio (CAPE) — also known as the Shiller PE — was first published in 1998[1] and has since become one of the most widely followed valuation metrics, particularly for those arguing that the stock market is expensive. When assessing the usefulness of any indicator, it seems prudent to ask two questions:

Does it make sense? Conceptually, the idea of averaging 10 years of earnings (adjusting for inflation) does makes sense, but the indicator's methodology fails to account for secular shifts in non-cyclical drivers of growth (e.g. demographics, innovation, capital allocation). In our view, the model's implicit 30% haircut to last year's earnings seems more like a recessionary scenario than a cyclical adjustment.

Does it work? Since it was first published, there have only been seven months in which the indicator has implied that US stocks were "cheap" (below the historical average). So, while this was indeed a good time to buy (2008-2009), if you had sold when the indicator said the market was "expensive" (above average), the you would have missed out on most of the 200%+ market returns since 1998.

Bottom line: Being bearish on stocks because of the CAPE reminds us of the saying about the broken clock being right twice a day (don't forget that valuation is also a terrible timing indicator). Being more cautious on stocks because investor sentiment is improving despite a weakening profit outlook and tightening liquidity…that seems more reasonable to us.

Shiller cyclically adjusted PE ratio since 1998



Source: Richard Bernstein Advisors LLC, Robert Shiller

[1] *Campbell, J. and R. Shiller. 1998. "Valuation Ratios and the Long-Run Stock Market Outlook." The Journal of Portfolio Management, Vol. 24, No. 2: 11–26*

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