EQUITIES

Theoretical Foundations II

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Historically, high price-to-earnings ratios (P/Es) have led to low returns in the stock market, and low P/Es have led to high returns. So, with today's market at historically high P/Es, there is a real need for rescue. This discussion examines three possible ways in which the market might be saved from decline: high and sustained real earnings growth (which is highly unlikely), low interest rates (which help only in the short term) and investor acceptance of lower future rates of return.

The last possibility boils down to a choice between low long-term returns forever and very low (crash-type) returns followed by more historically normal returns. The research presented here found some support for the prescription that investors should accept a 6%–7% nominal stock return, but evidence indicates that investors do not actually think they face such low returns.

Wall Street's growth expectations are ridiculously optimistic, but investors seem to still believe them. We examined a strategy based on these expectations, a portfolio for a 20-year period that was long high-growth stocks and short low-growth stocks. For a long time, the beta was mildly positive, but for the past few years, it has been massively positive.

The data say that every rally for the past several years has occurred because the high-expected-growth stocks were crushing the low-expected-growth stocks. And every market sell-off has been a result of the opposite occurring. Does this pattern indicate rational acceptance of the low equity risk premium or the buying of lottery tickets?

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