INSTITUTIONAL IMPERATIVE

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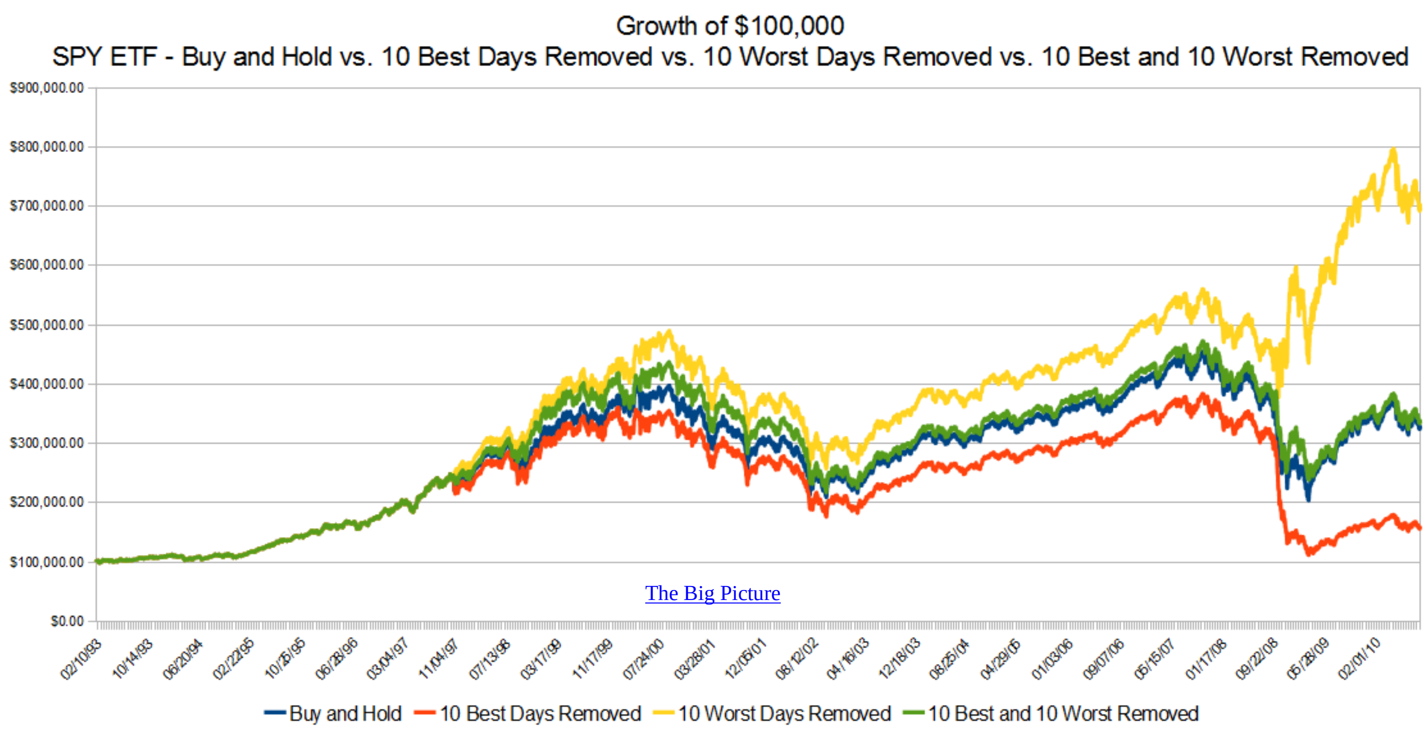
Wear your CAPE When Battling Markets.
An Allocation Strategy for the Enterprising Investor

“You can’t time the market” is one of the oldest saws on Wall Street. Research firms have produced many studies showing that the best 10 days of the market account for 50% of the buy-and-hold return. Missing those days year after year can destroy your long-term returns, making them look more like what you would have achieved in a money market account than by sticking with stocks.

Given investors’ propensity to buy and sell at precisely the wrong moments, adding money when prices are highest and panicking or giving up when things look bleakest, it’s understandable that both advisors and academics would encourage a buy-and-hold strategy.

What’s less discussed by ever-bullish brokers, advisors, and other investment professionals, however, is that missing the worst 10 days more than doubles the buy-and-hold performance. (Missing both the best and worst 10 days gives you something similar to market performance.)

Exhibit 1

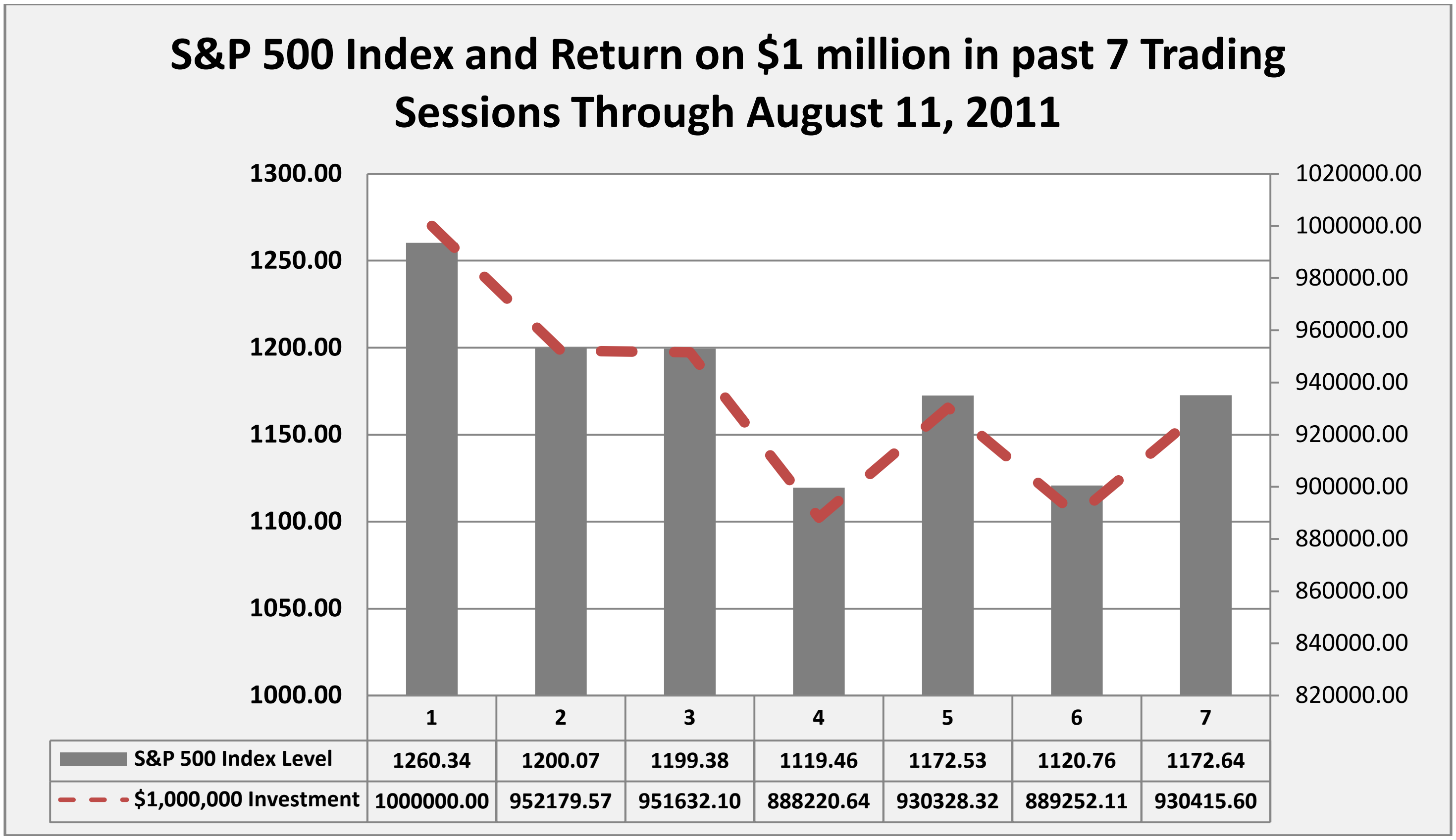


So is it possible to capture the best days and avoid the worst days of the market every year?

Market Valuation and Long-Term Results

It isn't possible to capture the best days and avoid the worst ones in a given calendar year. Day trading an S&P 500 ETF, for example, will likely not yield satisfactory results, and could very well lead to disaster. Exhibit 2 shows the S&P 500 Index levels and the return on a hypothetical $1million invested in the index for the six trading sessions through August 11, 2011. This single week may contain a few of the best *and* worst days of 2011 when the year is over, which shows that markets are radically unpredictable in the short term.

Exhibit 2



Instead of day-trading an ETF, one approach to beating the market over the longer haul is to concentrate on adjusting your exposure to the market less frantically based on a sound understanding of the market's price relative to its underlying value. This will necessarily entail fewer manipulations than trying literally to capture up days and avoid down days. Knowing which days the market will go up or down isn't possible, but making a general assessment of the market's price relative to its underlying valuation – estimating whether you have a reasonable margin of safety or not -- is.

Valuation Metrics

In the effort to value the entire market, investors often speak of the market's or the S&P 500 Index's price relative to trailing or prospective net or operating earnings.

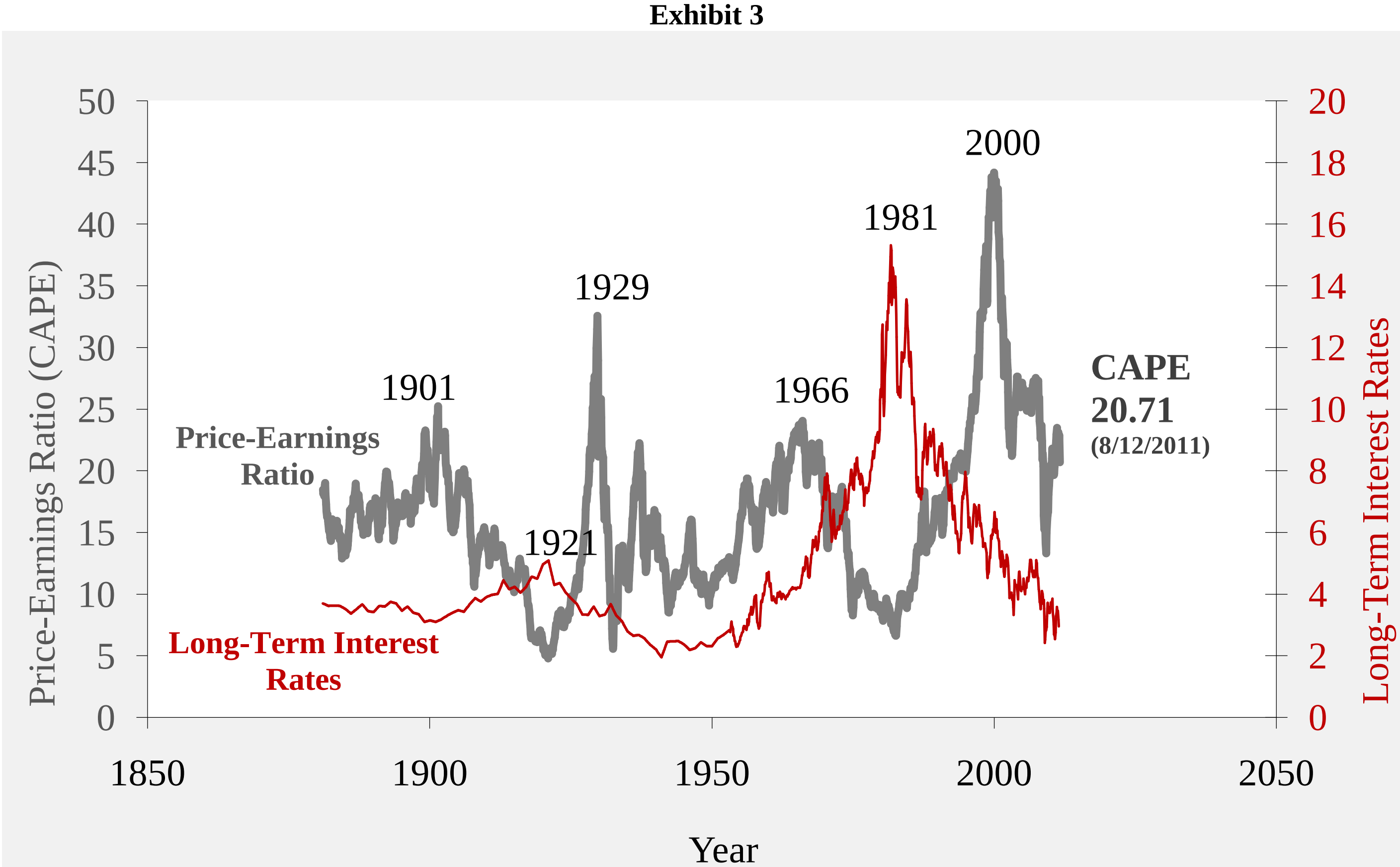
Both of these approaches have defects that hinder their utility when it come s to market valuation. Price relative to trailing one-year earnings is flawed because one-year's worth of earnings isn't always representative of the earnings power value of a company or an entire index. Forward one-year earnings estimates are even less reliable. In addition to the problem of accepting one year's worth of earnings as normalized earnings power value, many studies have demonstrated the poor performance of analysts' predictions of future revenue, margins, and earnings. (David Dreman provides one of the most comprehensive -- and most damning -- compilations of studies showing the inaccuracy of analyst projections in *Contrarian Investment Strategies*.)

The Cyclically-Adjusted P/E or CAPE

The problems of ascertaining earnings power value of a business from one year of earnings (trailing or projected) and the difficulty of projecting future earnings led Benjamin Graham to recommend relying on past 10-years' earnings of a company to smooth out business cycles and determine the company's earnings power value. Similarly, Graham thought this metric could be applied to the market as s whole to ascertain if it was expensive or cheap. Indeed the concept of taking the current price of a stock or the market as a whole and relating to past average earnings is sometimes called the "Graham & Dodd P/E." Graham argued that a sound investment policy would avoid purchasing equities that had an average Price/10-year average earnings of no greater than 16.

More recently Yale economist Robert Shiller, inspired by Graham, has produced the cyclically adjusted P/E (called "CAPE") for the S&P 500 Index on his website www.robertshiller.com. The chart, through August 11, 2011, is shown in Exhibit 3. Interestingly enough, Shiller found that the average CAPE of the market over the past century or so has been around 16, confirming Graham's assertion that any security over 16 was likely overpriced.

Exhibit 3



CAPE has proved to be a robust metric for gauging the value of the market. The first thing to notice about the chart is that it displays clear sell signals in 1929, 1966, and 2000, when CAPE reached relative peak levels of nearly 35, 25, and 45, respectively.

Additional evidence supporting CAPE is that it has a strong record predicting 10-year future returns. Exhibit 4 shows the average future cumulative 10 year returns depending on a CAPE of between 18 and 22 at time of purchase from 1050 to 2010. Exhibit 5 shows 10-year future annualized returns depending on CAPE at time of purchase from 1871 to 2010.

Exhibit 4

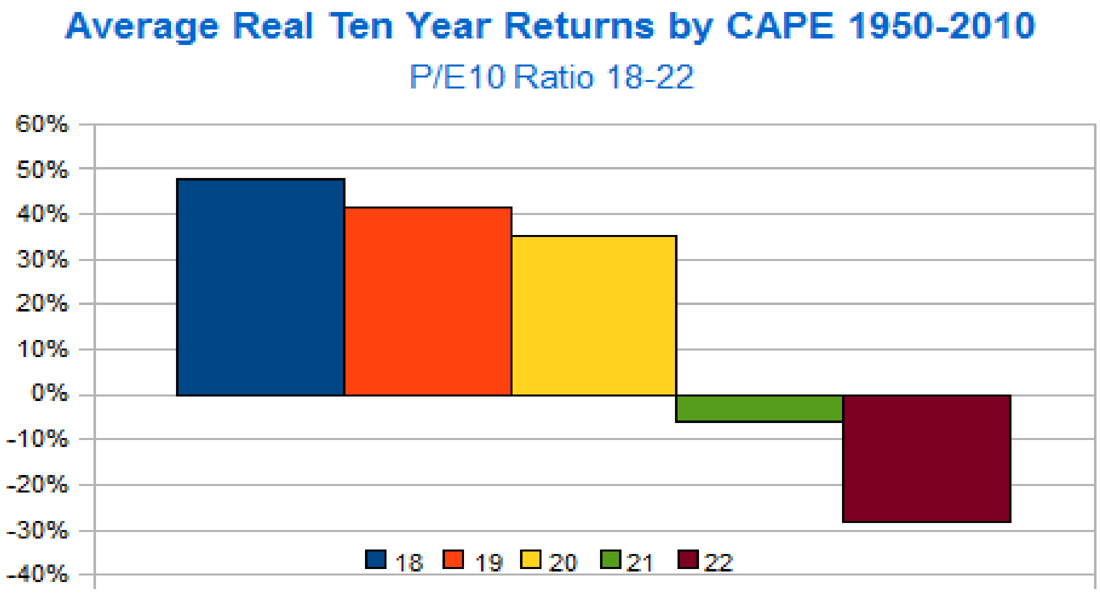


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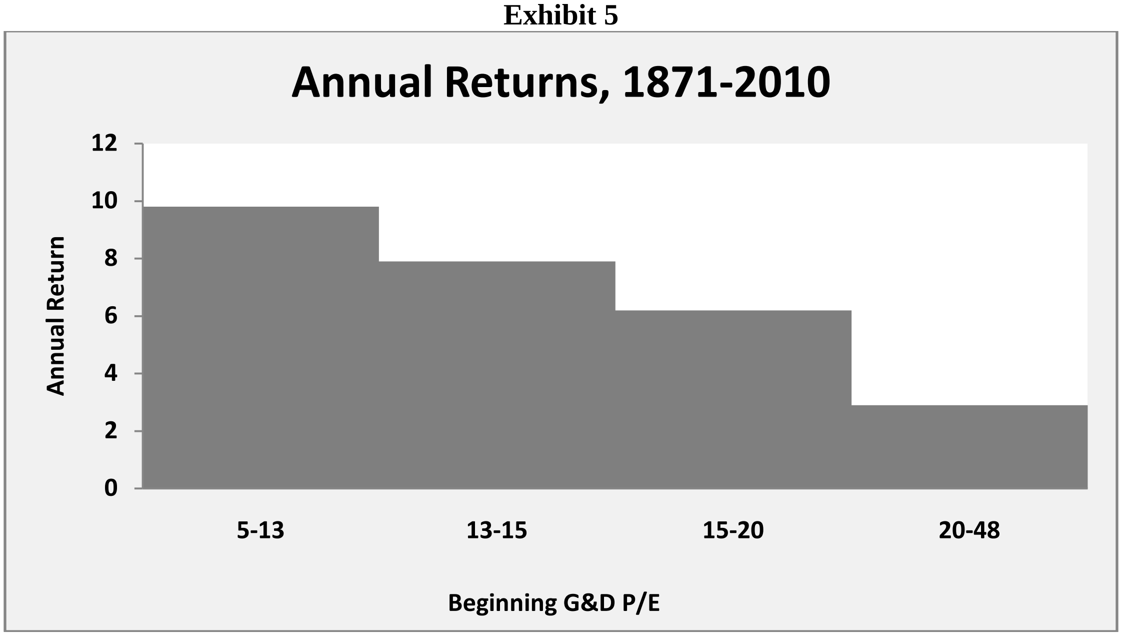
Exhibit 5



James Montier

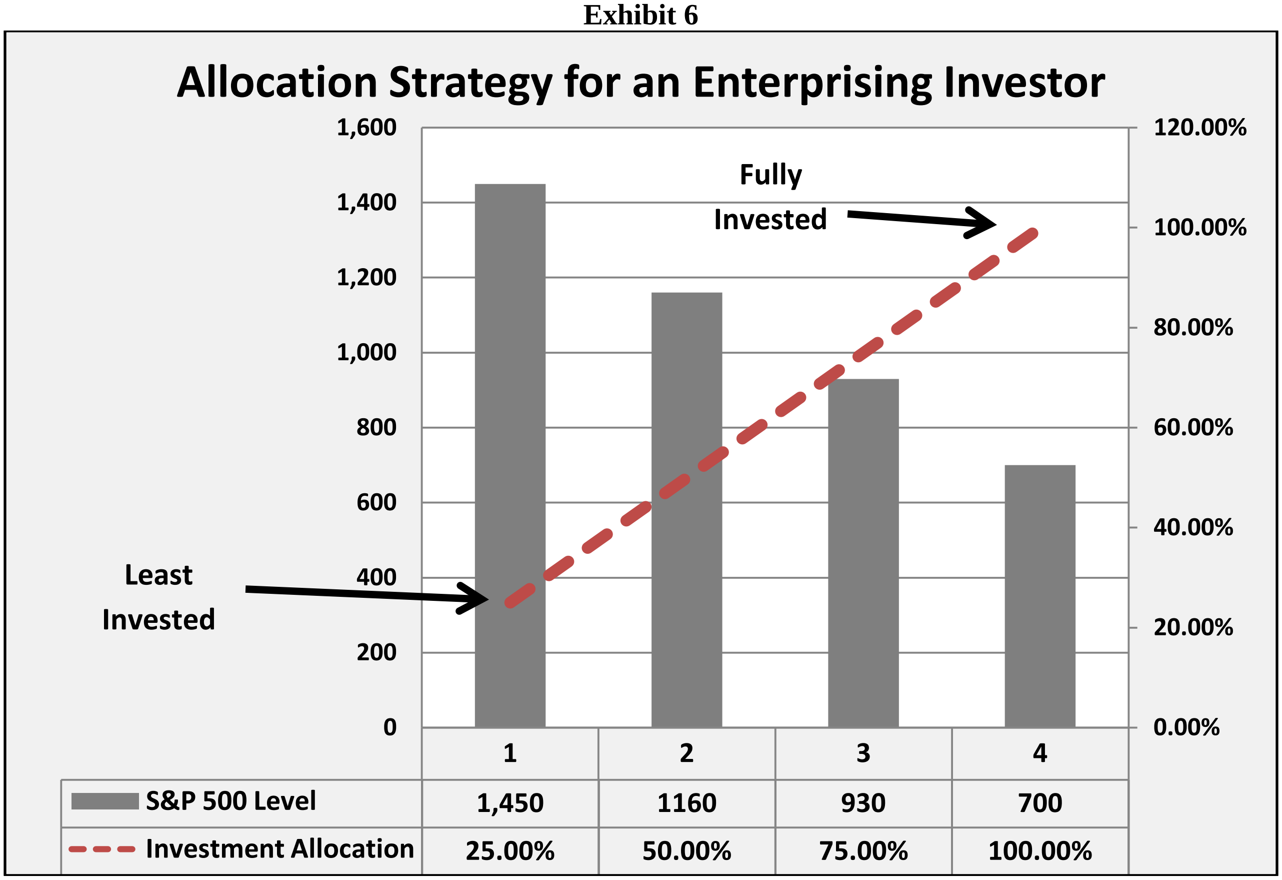
Not surprisingly, buying at lower prices tends to produce higher long-term returns, while buying at higher prices tends to produce lower long-term returns.

More recently, CAPE nearly hit 25 in 2007, also flashing a warning signal. Then, in early 2009, CAPE reached the low-teens, encouraging value-oriented investors to purchase stocks at reduced prices, even if it wasn't indicating that stocks were astoundingly cheap.

Although nobody disputes the wisdom or common sense of buying at cheap prices and selling at high prices, most investors find it difficult to buy when fear is gripping the markets, and sell when euphoria is abundant. Investors insist on following short-term trends even when it's financially harmful probably because there is a certain psychological comfort in doing what everyone else is. Recently, some behavioral finance studies produced evidence that the social aspects of human nature make it difficult for investors to oppose their peers in their trading habits. It seems to be less painful to be wrong and lose money, while being part of the crowd, than to be correct and produce a positive return, while being alone.

CAPE, though an imperfect valuation metric, can give an investor the courage to fight the instinct to be part of a manic or depressive trend; it can help an investor buy and sell appropriately – or at least avoid adding to overpriced securities and selling underpriced ones -- based on fundamental valuation. In Ben Graham's parlance, it can help an investor exploit Mr. Market rather than follow or mimic him in his manias and depressions.

Exhibit 6



Using CAPE to Your Advantage

So how should an enterprising investor use CAPE? As Exhibit 6 shows, an enterprising investor can choose to have elevated stock exposure when CAPE is low and lower stock exposure when CAPE is high.

The S&P 500 levels in Exhibit 6 from 1 through 4 correspond to CAPE levels of 25, 20, 16 (the historical average, at which this system recommends 75% investment), and 12. Investors can tweak or modify these as they see fit. But it's important to keep in mind that owning stocks at above a 25 CAPE level has rarely produced satisfactory 10-year returns, and owning them below 12 as rarely produced unsatisfactory 10-year returns.

As of this writing, the S&P 500 Index is at 1178.81 and CAPE at nearly 21, which implies that an investor should be 50% invested according to our methodology.

Some Pitfalls of the Approach

The method doesn't work 100% of the time. At times buying at a high CAPE will be rewarded and buying at a low CAPE won't be over the next few years. For this reason an enterprising investor, who has a long-term (multiyear) horizon, should consider always having 25% of his assets invested in stocks. Investors in this strategy can also take solace from having a low probability of impairing their capital permanently (suffering a permanent loss), even if others may appear to be producing better returns for a period of time. The strategy's main drawback is not keeping up with a surging market.

Accordingly, the method would have been particularly difficult to follow throughout the 1990s. CAPE began that decade at around the historical average (16), proceeded to exceed 20 by 1992, and virtually never fell below 25 from early 1996 through the middle of 2002. Many investors would have found it excruciating to have only 25% exposure to stocks while CAPE surged from 25 to nearly 45 (the highest it's ever been in a century) over a four-year period (1996-early 2000).

To mitigate problems like this, investors may consult valuation-based asset class forecasts that have proven reliable in the past, such as GMO's, in order to find other underpriced asset classes. In 1999, for example, REITs and small-cap stocks looked extraordinarily cheap on basic valuation metrics, even as large-cap stocks reached nosebleed prices. Having some exposure to other undervalued asset classes or parts of the stock market besides the S&P 500 Index components would have helped. However, again it is important to remember that REITs and small-caps didn't close their price-value gaps quickly; it took a number of years. CAPE and other similar asset class valuation metrics are appropriate for projecting multiyear returns, not immediate returns. For example, outsized exposure to REITs from 2000 through 2005, though not in 2000 alone, would have made up nicely for avoiding or having minimum exposure to large-caps during that period.

Investors may also take some solace in that there is a low probability of CAPE reaching 45 again anytime soon, though one can't rule it out completely.

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