Smithers, Andrew & Wright, Stephen – Valuing Wall Street

McGraw-Hill, 2000, [Equity Investing] Grade ★★★★★

Two books came out early 2000, right at the peak of the TMT-bubble, and in combination they changed the way I viewed the equity market. The first one was Irrational Exuberance by Professor Robert Shiller and the second was Valuing Wall Street by Smithers & Wright. Not only did they point out that we were in a bubble – I had figured that one out myself even though the scale was hard to fathom – but they also presented two different methods to value the stock market that actually, from historical records, could be shown to say quite a lot about the future long term return of equities. Smithers & Wright further pointed to a number of other valuation measures that they could prove had nothing to say about the future return of the stock market.

The measure Shiller presented was prior to his book often called Graham and Dodd-PE, but is now simply called Shiller-PE or CAPE (cyclically adjusted PE). The simple concept is to divide current share price with the average of the prior ten years EPS. In UK Stephen Wright, professor in economics at London University, and economist Andrew Smithers of his own consultancy firm Smithers & Co took Nobel laureate James Tobin's concept Tobin's Q and renamed it q. Both measures pointed to a coming decade where the returns from equities had a high probability of being very close to zero. Jeremy Grantham of GMO has called these two books the most well timed 1-2 punch in financial history.

A decade later the post script indeed shows that equity returns the ten years after publication of the books was very close to zero. In the mean-time the world has had to endure two out of the three worst equity bear markets in history. Shiller-PE is today a reasonably well used measure, q is still not and all the other valuation measures that add nothing to a prediction of stock market performance still dominate Wall Street research.

The stock market has a fair value witch is close to the long term historic average of the market's q. The market can be shown to fluctuate around this fair value in long cycles. When the current pricing is too far from fair value the central feature of the stock market is mean reversion. The academic concept of a stock market where prices exhibit a so called random walk is thus wrong. The logic of q is that the value of an asset is what it would cost to replace it. Hence the value of the stock market is the cost that it would take to replace all the physical and financial assets minus the corporate liabilities, what Smithers & Wright calls net worth. Q is then simply the current accumulated market price of all the companies in the stock market divided by their net worth. It's a measure somewhat related to price-to-book.

The bulk of the book is dedicated to the construction q and to show that the measure has the ability to predict long term equity returns, but a substantial amount of text also analyses alternatives to value the stock market. Smithers & Wright point out that to be of any use a tool for valuing the stock market must be measurable, mean reverting, make economic sense and it must tell you something about future returns. In general the more stable the fundamental that the current price is measured against, the better. Few of the competing measures that the book analyses score on more than one of the above criteria's and especially what is called "the FED-model" and it's cousin the implicit equity premium get a well-deserved beating.

This might be the most important book on stock market valuation ever. The notion that expected return over decades varies according to starting valuation was innovative at the time and it is still not well appreciated. The writing is academic but still very engaged in pointing out the insanity of the market prices of the time and also in showing what works and what doesn't.

Mats Larsson, December 17, 2011