Smithers, Andrew –Wall Street Revalued

John Wiley & Sons, 2009, [Equity Investing] Grade ★★★★

Economist Andrew Smithers is the founder of Smithers & Co that gives advice on asset allocation to many of the largest asset managers globally. Smithers real claim to fame is however as the co-author of the extremely well timed book Valuing Wall Street. In this book he, right at the climax of the stock market bubble in 2000, presented the measure q and showed that the stock market not only could be valued with a tool that gave sufficiently accurate predictions of future returns, but also pointed out that the stock market at the time was hugely overvalued and as a consequence could be expected to give quite mediocre returns the coming decade. This Smithers third book is to some extent a follow up and extension to Valuing Wall Street.

Smithers was in the aftermath of the financial crisis of 2008 understandably frustrated that central bankers and especially those at the FED hadn't caught up with the idea that markets can be valued and that this is a useful practice also for them. Prior to the crisis, Alan Greenspan and Ben Bernanke persisted in their opinion that markets were to a large extent efficient and even if they weren't, asset bubbles couldn't be predicted.

The central thesis of Smithers book Valuing Wall Street was that assets can be valued and if the prices are far from their fair value mean reversion is to be expected, i.e. asset bubbles can be predicted and if the FED had done just that much of the crisis of 2008 could have been avoided. Smithers see the accommodating interest rate environment during the last decade as the root cause of the financial crisis. "When too much liquidity is being created, the results will show in consumer or asset prices", in this case real estate prices.

According to Smithers the three features FED and other central bankers should monitor are the equity market, the housing market and the price of liquidity as they have the largest effects on the real economy. Smithers presents a number of ways to value the stock market but as long as there is good data, q (the tool that was presented in Valuing Wall Street) and CAPE (presented in the equally well timed book Irrational Exuberance by Robert Shiller in 2000) are the preferred methods. Over the long run house prices will be related to income and a good way to monitor real estate is to look at the relation of house values versus disposable income. When this relation is far away from its historic trend line warnings flags should be waved. What Smithers calls the price of liquidity relates to risks in financial assets and unreasonable returns for holding illiquid assets due to conditions created by lax credit conditions. Ways to monitor this factor are for example Debt-to-GDP, spreads between different types of debt and money supply measures.

This is in many ways a two tiered book. One part is the discussion on asset valuations and the responsibility of central banks to monitor these. Smithers also proposes a few means that central banks can use to try to remedy bubbles in asset values. The other is a number of chapters that work as a supplement to Valuing Wall Street. The topics include overstatement of profits as explanation of the fact that the average q of the market is not 1, justification of the fact that intangibles are excluded from the assets in calculating q, the change in the US stock market valuations pre and post 1950's etc. There's nothing wrong with these topics and Smithers is often brilliant but the two tiered shape of the book is unfortunate – it doesn't constitute a seamless text.

Too few really grasp the fact that expected returns over the next decade vary widely according to the starting valuation of an asset and the discussion whether central banks should have utilized this to avoid the 2008 crisis is an important one. Too bad Smithers had to include the rest.

Mats Larsson, December 18, 2011