Shiller, Robert J. – Irrational Exuberance

Broadway Books, 2000, [Finance] Grade ★★★★★

During the 1990's the cheeky Swedish TV-character Gert Fylking, dressed in an awful pink tracksuit had the habit of shouting "Finally!" when the Nobel Prize committee announced another obscure literature prize winner to the waiting possy of pretentious culture journalists. This year I fully agree with Gert when it comes to the Nobel Prize in Economics, finally Bob Shiller gets the award. On the financial market Shiller is mostly know for the valuation multiple Shiller-PE and the Case-Shiller real estate index. However he's a towering figure when it comes to financial theory that's brought forward the still underappreciated notion that longer term average future returns vary with the starting valuation.

Shiller was a pioneer in showing that asset prices weren't random. As early as in the 70's he could show that asset prices were more volatile in the short term than was motivated by their fundamentals. This implies that prices are mean reverting and hence that above-average returns in average are followed by below-average results. In direct conflict with the academically dominating Modern Portfolio Theory this pointed to predictability in asset returns. In practical terms it was possible to formulate profitable strategies based on valuation multiples as long as the denominator is relatively stable (dividends, trend earnings etc.). Pressing further, Shiller explained this predictability with psychological factors such as herding and fads and by this became one of the early key proponents of Behavioural Finance.

Irrational Exuberance that was published early 2000 at the peak of the TMT-bubble was one of two remarkable books that by way of pointing to the markets valuation warned of the bubble and predicted that the stock market world show negative or very low returns the coming decade. The other book was Andrew Smithers' and Stephen Wright's *Valuing Wall Street*. The name of Shiller's book was immortalised by Alan Greenspan who borrowed the expression from one of Shiller's presentations and used it in one of his speeches. Greenspan didn't have the same impeccable timing as Shiller though.

The opening chapter presents the Shiller-PE that the author readily admits to have borrowed from Ben Graham and David Dodd. The multiple is constructed by dividing current price with the average of the prior ten years of real EPS. He shows a clear correlation between the level of the PE-ratio and the coming ten years stock market return. At the time of publication the ratio was at the highest level in the last 120 years which lead Shiller - at the height of the optimism - to conclude that: "Long term investors would be well advised to stay out of the market". Today we know how spot on he was.

The bulk of the book discusses structural, cultural and psychological factors behind the on-going TMT-bubble. For an academic this part of the book (and the rest also for that matter) is surprisingly easily written. It's fluent and seamless. The topics will not surprise anyone who was in the market at that time: it's about the change of zeitgeist when it comes to admiration of monetary success and the belief in a "new economy"; self-enforcing loops between asset prices and investor confidence, an explosion in media coverage of the stock market giving coverage to an ever growing amount of stories, the changing of financial multiples to justify prices, increasing amounts of fraud, the proliferation of day traders, psychological herding etc. etc. The book ends with a more philosophical discussion regarding the extent to which it is morally just to try to protect people in a free society from the psychological mistakes they make by their free will.

The releases of *Irrational Exuberance* and *Valuing Wall Street* have been called the "*most well timed 1 – 2 punch in financial history*". The amazing thing is that in early 2008 Shiller repeated the feat by publishing *The Subprime Solution* discussing a bubble in the US real estate market. I hope his Nobel speech reveals the topic of his forthcoming book. Finally!

Mats Larsson, October 20, 2013