Easterling, Ed – Unexpected Returns

Cypress House, 2005, [Equity Investing] Grade ★★★★

During the summer InvestingByTheBooks will review some older books that we never got around to writing about although we think they are important. Ed Easterling shows that by taking a step back and getting a better overview the investor gains an understanding of secular market cycles that most lack. The basic premise is that the valuation of markets matters and affects expected return during periods of both one and two decades ahead during which trends in PE-ratios give vastly different investment results.

Easterling who's the founder of Texan investment firm Crestmont Holdings and a popular writer of investment research at crestmontresearch.com, with a number of very long term historic time series shows how the equity market moves secular trends of 15 or 20 years during which it moves from low PE-ratios to high or vice versa. It might be true that in the very long run – say 50 or 100 years – the equity market has an annual return of for example 8 percent, but during a decade or two the average return is often far higher or lower than this. Decades starting with low valuations have much higher average returns than those starting with high valuations. Contrary to financial theory it is not necessarily so that taking higher risk by for example holding a higher proportion of equity to bonds gives higher expected returns. It simply depends on the starting valuation of both assets. According to the author the correlation between starting PE-ratio and the subsequent 20-year average annual return is -69 percent. Taking a higher risk could for an investment with a horizon of a decade or two have lower expected return than taking lower risk. Unfortunately, most investment advice focuses either on the average 100-year horizon or on the next 6 to 12 months and this seldom reflects investors' actual investment horizons.

Decades that start with high valuations are usually trending sideways despite large cyclical swings. Further, the author states that investors underestimate the long-term adverse compounding effects of sideways volatility and negative periods. Hence, Easterling argues that depending on which environment we are in at the moment we should act accordingly as investors. If valuations are low enough to give expectations of a secular bull market, then the investor should "sail along" with an equity buy-and-hold strategy. If a secular bear market is more likely then the investor should switch to "rowing" through various absolute return strategies, i.e. invest in hedge funds.

With enlightning color pictures and graphs it is shows that over very long time the movements of the equity market reflect the value of corporate cash flows. However, during decade-long periods there are huge deviations. The long-term trend in cash flows or earnings is actually remarkably stable. Instead, the secular trends in equity valuations depend on changing in PE-ratios. Easterling shows that these valuation trends do not depend on the average level of GDP-growth for a period. If something the correlation is the opposite from what is expected. The author finds a Y-shaped correlation between PE-ratios and inflation levels. When inflation is really high or there is severe deflation, PE-ratios are low and then there is a sweet spot when inflation is in low single digits when historic PE-ratios has been high.

In the middle part of the book Easterling launches what he calls Financial Physics – a way to predict future equity returns. The starting point is the trend in real GDP and then an estimate of inflation is added that both gives the nominal GDP and hence the EPS plus an estimate of the PE-ratio. Multiply the PE-ratio and the EPS to get the equity market returns. As future inflation is unknown and also as the correlation between inflation and PE-levels is low I would personally prefer to use some measure of reversal to the mean in PE-ratios.

Unexpected Returns makes it clear that the stock market has a faint but strikingly long memory that tilts probabilities in one way or the other thereby changing the returns landscape.

Mats Larsson, Aug 12, 2015