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CURMUDGEON'S CORNER

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curmudgeon (cur mud geon)
noun [ker-muj-uhn]

A bad tempered, difficult, contentious, querulous, grouchy, cantankerous person

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From the desk of James Montier

Welcome to the first edition in our new series. In this series we will seek to explore issues of interest to our investors on matters ranging from the investment landscape to behavioural psychology and, on occasion, perhaps even dabbling in the dark arts of macroeconomics on relevance to investors. Your feedback is always welcome, and I can be contacted at jmontier@acr-invest.com. I hope you enjoy these musings, and I look forward to hearing your thoughts.

A word on the choice of the series name

Definition of a curmudgeon: A bad tempered, difficult, contentious, querulous, grouchy, cantankerous person.

According to my family at least, I often fulfill multiple elements in this definition. As I have often pointed out there is evidence to suggest that the clinically depressed are the individuals who see the world the way it really is - which is, of course, why they are depressed in the first place! The rest of us are usually happier but ultimately deluded.

I long ago decided that I would be happy and deluded whilst I was at home (apparently poorly based on my prior comment), and clinically depressed when I come to work. Given the general lack of critical thinking in our industry, I often find myself adopting a curmudgeonly perspective when I am working, so the idea of the Curmudgeon’s Corner was born.

Unhand me grey beard loon

For those unfamiliar with the works of the 18th-Century poet Samuel Taylor Coleridge, the title for this first missive is drawn from his phantasmagorical epic, "The Rime of the Ancient Mariner". This wonderful poem tells the tale of a seaman who is cursed for shooting an albatross, and then doomed to suffer alone - in the doldrums after Death and Life-in-Death claim the rest of his crew mates. Eventually, the mariner finds his moment of grace, when he finally sees beauty in water snakes and blesses them. He is freed from his curse and finally returns home. However, he is compelled by a spirit to endlessly retell his tale to chosen listeners, finding only brief moments of solace after sharing his terrible tale of suffering and sin.

As the mariner puts it:

I pass, like night, from land to land;

I have strange power of speech;

That moment that his face I see,

I know the man that must hear me:

To him my tale I teach.

I often feel a sense of kinship with the mariner, as I feel doomed to witness seemingly endless cycles of financial euphoria, and equally compelled to repeat warnings against them. I'm sure that much like the accosted wedding guest, many a market participant would love to yell "unhand me grey beard loon" at me.

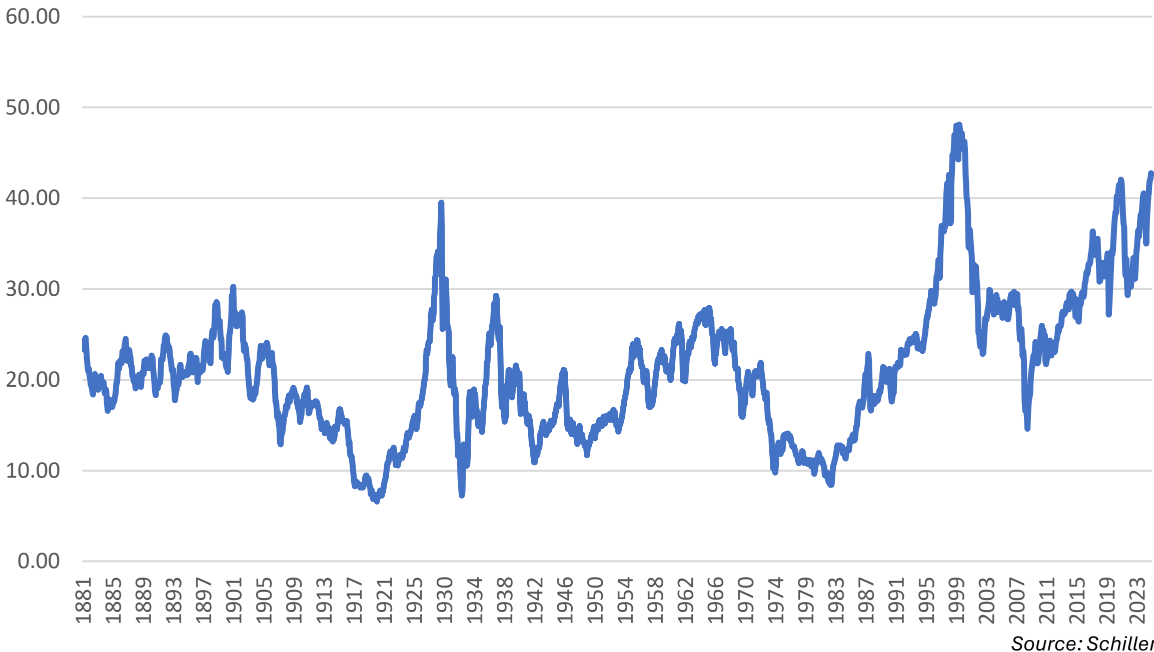
Mark Twain is reputed to have said that history doesn't repeat itself but it does rhyme, and this certainly seems to apply to the advent of financial bubbles. Alongside of the bubble itself (much more on this in future editions) comes the rise of the zealous high priests of justification.

As JK Galbraith wrote in his wonderful Brief History of Financial Euphoria:

There are those who are persuaded that some new price-enhancing circumstances are in control, and they expect the market to stay up and go up, perhaps indefinitely. It is adjusting to a new situation, a new world of greatly, even infinitely increasing returns and resulting values.

Whilst we simple value orientated folks stare at charts such as exhibit 1 and shake our heads in wonder as measures of valuation seem to proceed unbounded, and talk in hushed tones of bubbles and the madness and delusions of crowds, the true believers never cease to create new and novel reasons for disregarding history and proclaiming births of a new era, and siren calls of the market's undervaluation.

Exhibit 1: Schiller TR CAPE



Source: Schiller

For instance, in early October 1929, Irving Fisher, professor at Yale proclaimed that stocks had reached a "permanently high plateau" with their meteoric rise justified by "realized and prospective increases in earnings", even going as far as to say he expected "to see the stock market a good deal higher than it is today, within a few months".

Or Joseph Stagg Lawrence (an economist at Princeton University) who opined "The consensus of judgement of the millions who valuations function on that admirable market, the Stock Exchange, is that stocks are not at present overvalued…Where is that group of men with the all-embracing wisdom which will entitle them to veto the judgement of this intelligent multitude?" (Eerily words echoed very closely by Alan Greenspan some 70 years later).

In 1989, with the Nikkei 225 sitting on a PE of around 70x (market level just short of 40,000) Nomura (the largest brokerage house in Japan at the time) issued a report claiming the Nikkei would reach 80,000 by 1995. At the time potential justifications such as latent land values and cross shareholdings (both beautifully circular arguments) were regularly cited as justifying sky-high valuations. For instance, in March 1988 Nikkei Business magazine quoted a survey which quoted the PEs of Hitachi at 60.1, Dai-Ichi Kangyo Bank at 75.6 and Toyota Motor at 25.6x. The survey then factored out all the shares held in cross-holding and calculated new PEs: Hitachi at 27.5x, Dai-Ichi Kangyo at 11.7x and Toyota at 3.4x!

Fast forward to the dot.com bubble of 1999/2000 and amid attempts to justify the market's valuation on the basis of eyeballs and clicks, we find Dow 36,000 by Glassman and Hassett (the latter of whom is a senior official in the Trump administration and was even being mentioned as a possible Chair of the Federal Reserve - you just can't make stuff like this up!).

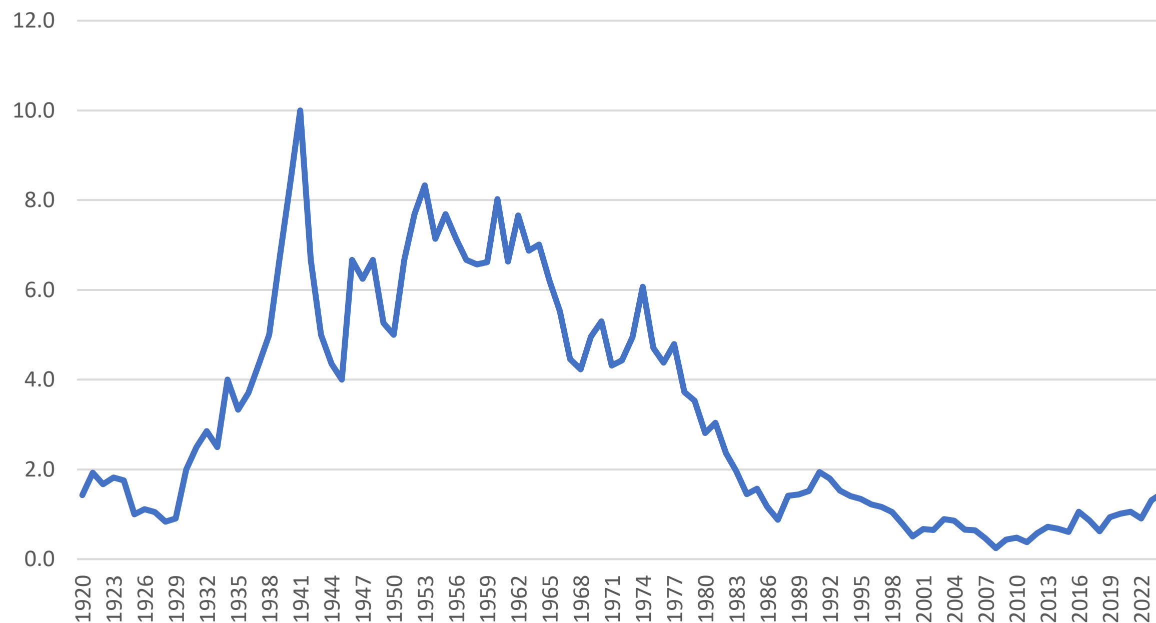
The basic (and immensely flawed) premise of Glassman and Hasset was that stocks were no riskier than bonds if held for sufficiently long time periods, and thus the equity risk premium (the required return of stocks above bonds) should be zero. Given this, the justified PE on the market was actually way higher than the PE observed, and thus the Dow should have quadrupled from its level of 9,000 to 36,000 in short order.

There is so much wrong with this "analysis" it is hard to know where to start. Personally, I am very skeptical of the entire concept of the ex-ante equity risk premium (ERP) as a useful construct for valuation - a subject I have written on elsewhere. However, even if I put this aside, the idea that the ERP should be zero seems like utter nonsense. We are comparing cash flows from liabilities backed by the printing presses of the US of A (bonds), with the uncertain cash flows generated by incorporated companies (equities).

It is a classic example of finance's favourite mistake, assuming risk can be measured by a number (a clear violation of one of my seven immutable laws).[1] In this case, Glassman and Hassett used the standard deviation - a purely statistical measure of risk to drive their fallacious arguments. In fairness, I guess they were correct in as much as the Dow did indeed pass 36,000 - just some 20 years after they published their analysis, and for reasons that had absolutely nothing to do with a zero ERP.

Even if we accepted the standard deviation as the correct unit of risk and accepted that stocks are no riskier than bonds in the long term, we would still have been faced with the reality of a seemingly ever shrinking time horizon for investment (as measured by the average holding period for stocks on the NYSE). So far from becoming rational acceptors of permanently lower long term returns (because the ERP has gone to zero), investors were increasingly behaving like hyped up day traders.

Exhibit 2: Average holding period for a stock on the NYSE (years)



Source: NYSE

[1] *I developed a set of principles that together form what I have called "The Seven Immutable Laws of Investing." They are as follows: 1. Always insist on a margin of safety 2. This time is never different 3. Be patient and wait for the fat pitch 4. Be contrarian 5. Risk is the permanent loss of capital, never a number 6. Be leery of leverage 7. Never invest in something you don't understand.*

I could write an entire paper on the flaws of Dow 36,000 but aside from historical interest what use would it serve? Rather I offer it up as a reminder of the intellectual hoops that some are willing to leap through in order to avoid the conclusion that the market is expensive.

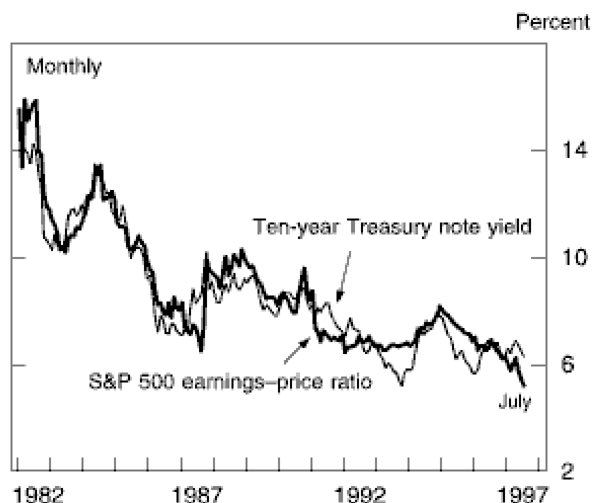
But the main purpose of this missive is to explore a more recent offering from the "It's okay, the market is really cheap" (read: it's different this time) crowd. On this occasion it takes the form of a paper from Hudson Bay Capital with the none too subtle title of "No, stocks aren't in a valuation bubble - not even close" penned by one Jason Cutter.

The interested reader is welcome to dive into the paper and explore its arguments at their leisure. However, from my perspective, the paper relies on a zombie-like resurrection of a valuation "methodology" that I thought had died long ago. Sadly, apparently I was mistaken.

The Hudson Bay paper essentially attempts to reconstitute the so-called Fed model (albeit with the addition of a "sentiment spread" which like much of modern economics is really a catch all data dependent term). If the earnings yield is above the bond yield, the sentiment spread is defined as a pessimistic environment; if the reverse situation holds, it is described as an optimistic environment. However, without some ex-ante measure of which environment we are in, this simply collapses to when it works, it works, and when it doesn't, it doesn't!

Those with pachydermal-like memories may recall that the Fed model compared bond yields and earnings yields (the inverse of the PE) (see exhibit 3). This approach has its origins in a Fed document offered up as part of a Humphrey Hawkins Testimony by Alan Greenspan in 1997. In the distant past, I and many others[2] (see for example Cliff Asness's masterful demolition) - have railed against this approach for many and varied reasons.

Exhibit 3: The Fed Model as it originally appeared



Source: The Federal Reserve

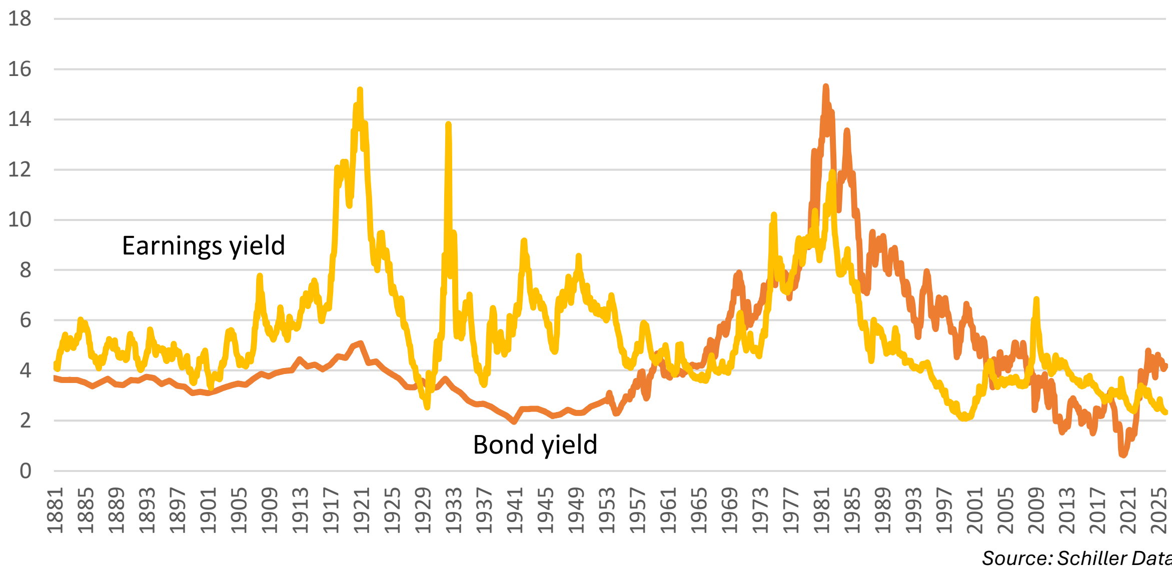
From my perspective, the basic theoretical error is one of comparing a real yield (the equity yield) with a nominal one. To make this explicit, consider an equity worth as the discounted future cash flows associated with the business. All the cash flows going out into the future are nominal (that is to say they incorporate inflation); the discount rate (assuming it is in form of a bond yield plus an equity risk premium) in the denominator also includes an inflation expectation. Since both the numerator and the denominator contain inflation, the resultant figure is actually real (i.e. accounts for inflation).

The same state of affairs is not true of a bond. It pays a fixed amount (hence the term fixed income), and thus is not protected against the vagaries of inflation. Thus it is a nominal asset. Comparing nominal and real assets is like comparing apples and oranges. It simply makes no sense. Hence the entire edifice comes crashing down in a confused jumbled mess.

[2] *Asness (2003) Fight the Fed Model* https://www.aqr.com/Insights/Research/Journal-Article/Fight-the-Fed-Model

The defenders of the approach usually point to Exhibit 3 and simply say, "Look, it works". There is certainly a (n inverse) correlation between the bond yield and the earnings yield - but here is the rub - only in certain periods and in certain places. As my old statistics lecturers used to admonish, correlation doesn't equal causality. If we extend the historical sample and take even a cursory glance at Exhibit 4, the transitory nature of any relationship between bond yields and earnings yield is immediately revealed.

Exhibit 4: The long term Fed Model

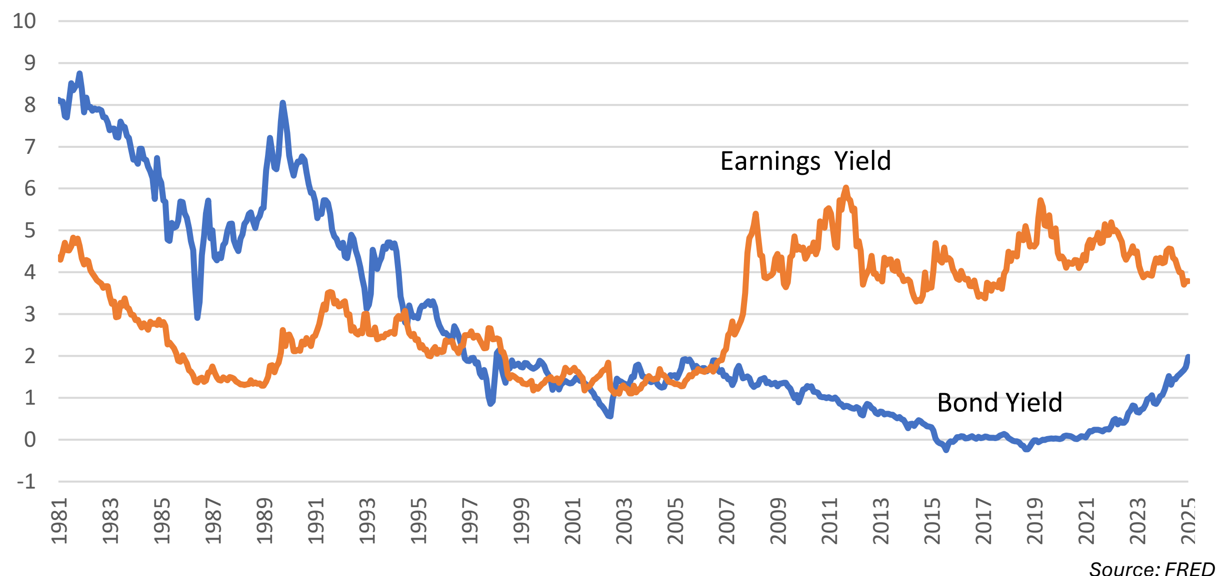


Source: Schiller Data

One of the ironies of this finding is that Hudson Bay Capital paper argues that investors are too readily accepting of the notion that the US stock market is overvalued. They suggest that this stems from three behavioural biases:- (i) myopia (a focus on the short term), (ii) recency bias (using only recent data), and (iii) anchoring (clinging onto irrelevant inputs). Yet their own paper displays all three biases writ large.

Additionally, if we look outside of the boundaries of the US and take a peek at the Fed Model in Japan, we can see no evidence of a relationship here.

Exhibit 5: The Japanese Fed Model



Source: FRED

So the Fed model is a flawed theoretical approach, which unsurprisingly isn't supported by the data. Relying upon such flawed "methodologies" to justify the undervaluation of the US market is truly clutching at straws.

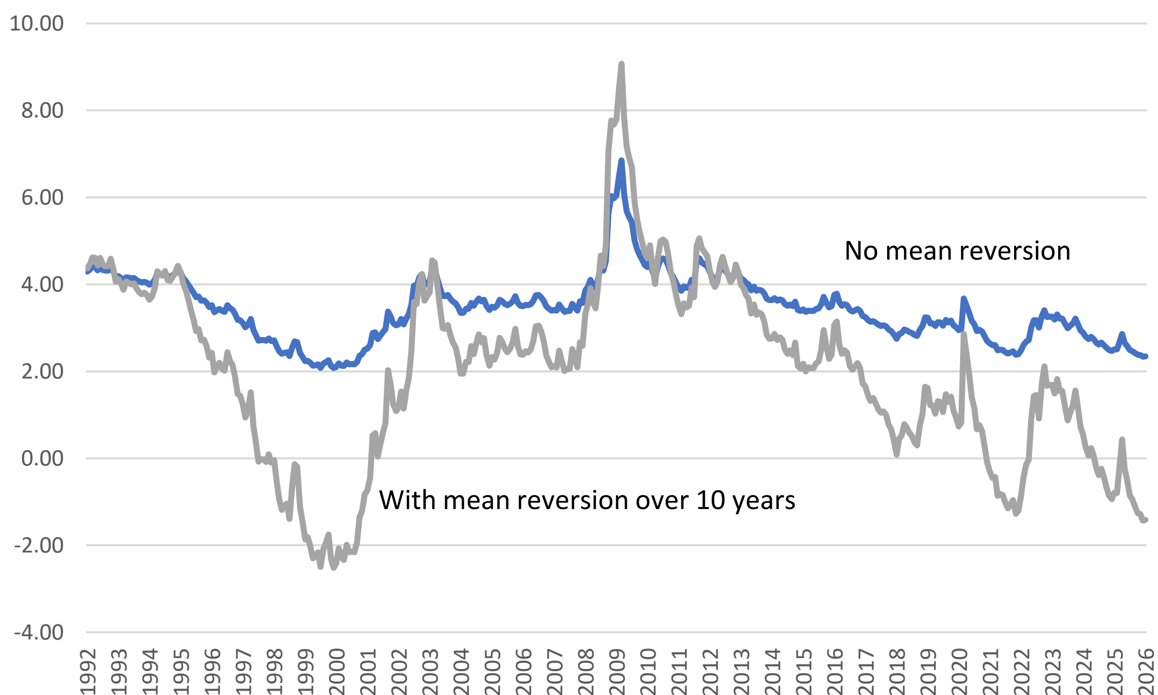
Forever Blowing Bubbles

To go from the statement that US stocks are overvalued to the statement that the US is in a bubble requires more evidence. Indeed, one of the perennial pushbacks from academic supporters of the efficient market hypothesis is how do you define a bubble? The prevailing wisdom seems to align with Greenspan's 1999 view that "Bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgement that hundreds of thousands of informed investors have it all wrong".

For me, a good practical working definition is when returns implied by valuations are heading in a different direction to the returns expected by investors. Indeed, Nick Tompras posited a similar description in his July 2018 commentary when he opined, "ACR proposes our own definition of a bubble: a price which implies a high probability of an unsatisfactory return".

In Exhibit 6, I show two versions of returns implied by valuations. One is based on the CAPE reverting to its long run average, the other assumes that the best guide to valuations is today's valuation and assumes that investors have accepted lower returns going forward than they have demanded in the past. Irrespective of which series you choose to focus upon, the direction of implied returns is clear - post COVID, both series have been trending lower (obviously the mirror image of the valuation expansion we saw in Exhibit 1).

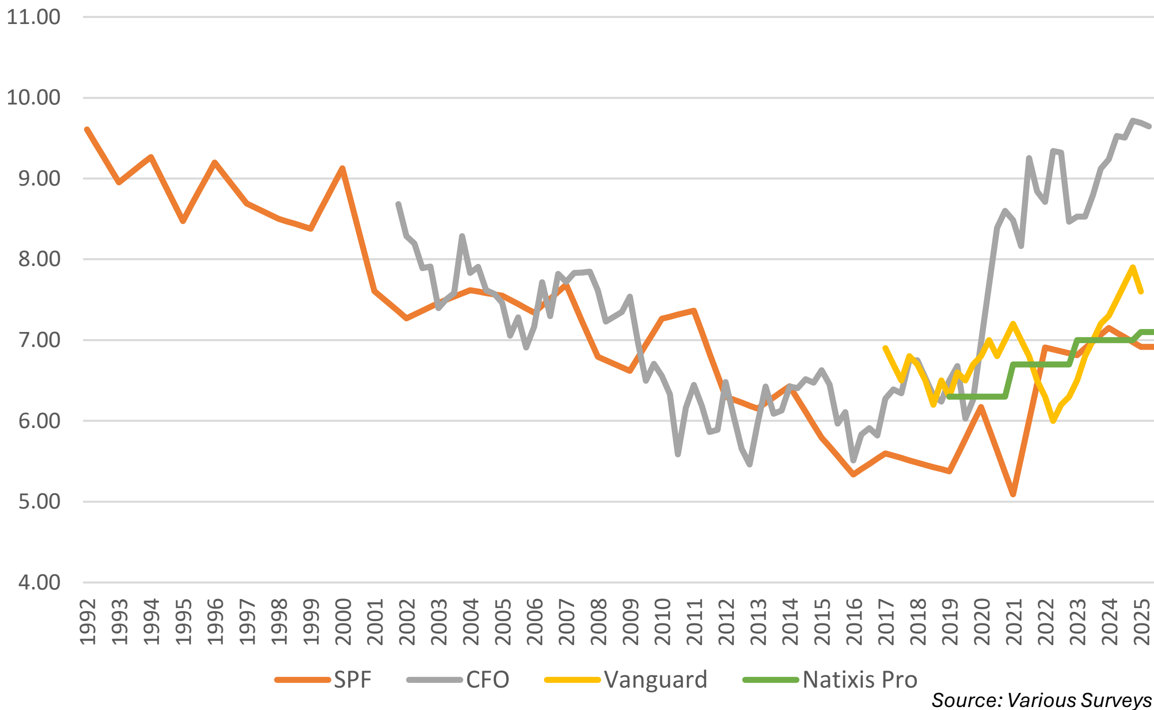
Exhibit 6: Returns implied by valuations (Real expected returns over 10 years)



Source: ACR Alpine Capital Research

In contrast, Exhibit 7 shows the long-term return expectations from various groups of investors. The difference between the two exhibits couldn't be more stark. Whilst valuation implied returns have been falling, the returns expected by investors have been increasing! When these two series are heading in different directions, we have prima facia evidence of a bubble.

Exhibit 7: Return expectations from investors (real)



Source: Various Surveys

To bring this full circle, back to the poems of Samuel Taylor Coleridge, we can highlight this as a financial equivalent of what Coleridge termed the "willing suspension of disbelief". Coleridge used to argue that this was necessary for readers to fully immerse themselves in his wilder poems (The Rime of the Ancient Mariner and Kubla Khan). Those lulled by the siren attempts to justify the US market as cheap strike me as prime examples of victims willingly suspending their disbelief - a path that has never yet ended well.

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