Asset Allocation

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An Old Friend: The Stock Market's Shiller P/E

November 1, 2012

The S&P 500 Shiller P/E, a particularly useful measure of the valuation of the entire U.S. stock market, was 22.2 on September 30, 2012. While that is not close to historic excesses — it is almost exactly half of its peak value during the 1999–2000 stock market bubble and about two-thirds its height in late 1929 — it is high versus history generally. In fact, it's higher than it has been 80% of the time since 1926.

Based on the past, the 2012 level of Shiller P/E — the ratio of stock prices to an inflation-adjusted 10-year rolling average of corporate earnings — suggested that the average annual real stock market return over the next decade would not exceed 1%. At similar levels in the past, the worst case horrendous: –4.4%. The best case is very good — about 8.3% annually — though it is less wonderful than the much better best cases from lower starting Shiller P/E's.

This type of analysis is not much help to market timers, but it can help to set reasonable expectations. If your long-term plan calls for a stock market return of 10% nominal (or, with today's inflation, about 7% to 8% real), you are basically rooting for the absolute best case in history to play out again, and rooting for something drastically above the average.

This could happen, but unless you are comfortable with forecasting some giant positive market surprise, we believe you should plan for lower average returns. You could, for example, save more or spend less, or change your portfolio structure.

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