

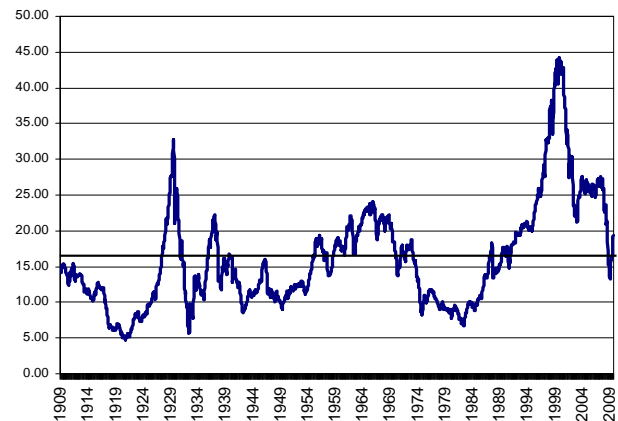
Benjamin Graham writes the parable of Mr. Market in his book *The Intelligent Investor*. “Imagine that in some private business you own a small share that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or sell you an additional interest on that basis.” Sometimes the offers seem logical. But often “Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.”

To work with Mr. Market, investors need a sense of the underlying value of a company or stock index – a value that changes over time but not as rapidly or wildly as stock prices. The underlying value could relate to the price of the tangible and intangible elements needed to buy an existing company or rebuild it from scratch. That’s close to Tobin’s Q (you can look it up on Wikipedia: [http://en.wikipedia.org/wiki/Tobin%27s\\_q](http://en.wikipedia.org/wiki/Tobin%27s_q)). More easily, the underlying value of a stock or index is based on estimates of future cash flows an investor can hope to receive, discounted to present value. A proxy for the value of cash flows is a price-earnings ratio.

There are several P-Es available. On a web site, the P-E is the current price divided by the most recent 12 months’ earnings per share. Some prefer to use a P-E based on estimates of the next 12 months’ earnings. Yale economist Robert Shiller and English economist/money manager Andrew Smithers dislike the two popular forms of P-E based on 12 month periods. In his recent book, *Wall Street Revalued*, Smithers argues that those forms of P-E hold no value for investors. He dismisses such factors as “broker economics” – statistics flung about by sales people rather than analysts.

In the following chart, the blue line represents the price-earnings ratio for the S&P 500 index of large U.S. companies. This P-E is based on Shiller’s 10-year average earnings for companies in the index, to help adjust for sudden booms and crashes. The straight black line just above 15 represents the 100-year average P-E using this method. That long-term average comes out to 16.1.

Shiller 10-yr Adjusted S&P 500 P-E



The good news is that even after a 60%-plus rally in the S&P 500 index since the recent March bottom, the adjusted P-E for the index is about 20 – 25% above the 100 year average and only a little above the 50-year average P-E of 19.4. That is not nosebleed territory, though stocks no longer are the bargain they were a year ago. Smithers argues that “it was only on rare occasions that it was clearly sensible for long-term investors, who were natural holders of equities, to sell. Indeed, the clear case for doing so appears to have occurred only twice in modern times, when the market had risen to about twice fair value, which occurred in the run ups to the peaks of 1929 and 2000.” Yet he warns those very close to or already in retirement to tighten up on that “sell” signal. Mr. Market may be warming up to another bout of over-enthusiasm.