

I Feel So Good, It Must Be Wrong

In seeking a sense of order and certainty to the world, it's only natural for most of us to associate good economic times with good investment returns. After all, think of the 1980s (It's morning in America!), or the 1990s (Don't stop thinking about tomorrow!).

But investment returns rarely match up well with comforting and widely held views of the world. In a recent article in the *Financial Analysts' Journal* (FAJ), William Bernstein tore apart the cheerful good-times-equals-good-returns hypothesis in an article titled "The Paradox of Wealth."

Bernstein is more than an ivory-tower thinker publishing obscure bits of analysis in peer-reviewed journals, although the FAJ is one of those peer-reviewed journals. Bernstein retired from practice as a physician because he had become fascinated with investments and with history. A practicing asset manager in Connecticut, Bernstein wrote "The Four Pillars of Investing Wisdom." He later penned a history of world trade, also a great read, titled "A Splendid Exchange: How Trade Shaped the World."

Reaching back a few thousand years through history, Bernstein notes in his FAJ article that as the quality of human existence improves and life expectancies increase, the amount of interest we demand on loans (or returns on equity we purchase) decreases. It's logical, in a way. If you are unsure of when you might next eat, you're less likely to agree to swap a cheeseburger today for the promise of two tomorrow.

Bernstein also looks at a favorite equity valuation tool of the world's worry-warts – the cyclically adjusted price earnings (CAPE) ratio used by Robert Shiller, who was awarded a share of the Nobel Prize for Economics earlier this year. The CAPE measures the current price of a stock or an index such as the S&P 500 against the earnings-per-share averaged over the most recent 10 years. Shiller is fond of pointing out in his *New York Times* column and elsewhere that the current S&P 500 index CAPE level of 24.8 is well above the measure's long-term average of 16.4, indicating that equities in the U.S. are overpriced. Bernstein notes that there is a clear upward trend in the CAPE over the past 115 years (which is as long as we have reliable S&P 500 index data). Using a statistical "best fit" regression, Bernstein shows the typical CAPE level rising from 13.6 in 1881 to 20.3 today. That might indicate that another stock crash is not necessarily imminent. But it also more gloomily predicts that long-term returns on U.S. stocks have diminished since the 19th century.

The good news? Bad news! Every now and then something terrible happens – a financial house of cards tumbles, a dysfunctional set of leaders shut the government down, a bubble in some large asset class such as technology stocks blows apart violently. The ensuing chaos, fear and loathing are symptoms of a period of great opportunity for investors. "At some point in the next few decades, investors will almost certainly have opportunities, given adequate fortitude and cash, to purchase securities at near historically low prices, but it seems likely that these windows will be more fleeting than in the past," Bernstein writes.

There is another way: Find investments to make in parts of the world that aren't quite as cozy as our own. Essentially, investors are paid more for bearing more risk. The deal is a

good one for those with the stomach and patience to wade and wait through lingering periods when various countries or regions suffer the violent process of burgeoning capitalism and the rise of a substantial middle class. The financial markets roiled for 40 years in the U.S. as we grew into a world economic power from 1880 through 1921. It will be interesting to see if China (or maybe Malaysia, or Indonesia, or Brazil, or Nigeria) will make and survive the same trip over the next decade or two. Whichever countries or regions do succeed in making that transition, those will be the places where the most eye-popping investment returns will come.