
NEW SHILLER CAPE-LIKE MODEL OFFERS SUBDUED OUTLOOK

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Last week's *Behind the Markets* podcast featured a conversation with Thomas Phillips, adjunct professor in the Department of Finance and Risk Engineering at NYU's Tandon School of Engineering, and Adam Kabor, a director of investments at NYU's Investment Office.

They are co-authors of a paper that caught our attention earlier this year called "*Ultra-Simple Shiller's CAPE: How One Year's Data Can Predict Equity Market Returns Better Than Ten.*"

Professor Jeremy Siegel has published on how earnings distortions in [GAAP](#) earnings can lead to misguided and overly pessimistic conclusions from the original Shiller [CAPE](#) model framework.

One feature of the [cyclically adjusted price-to-earnings](#) measure Shiller created was to use a 10-year average of earnings to smooth the business cycle, along with an [inflation](#) adjustment, to arrive at a more normalized earnings measurement.

The paper by Kabor and Phillips tries a novel approach to smooth earnings by dropping the worst quarter in a given year and normalizing (multiplying by four-thirds) the remaining three quarters as one way to get cyclically adjusted earnings that do not rely on looking back at 10 years of earnings.

Kabor and Phillips point out that during the financial crisis in 2009, the majority of losses were in one quarter, and in 2020's downturn, the first quarter was far below the other three quarters and gives a more realistic adjustment for normalized earnings during this pandemic.

In addition to smoothing earnings using this one-year approach, their model also incorporates a [price-to-sales ratio](#) data point in addition to a [price-to-earnings](#) gauge. Given the trends over the last 20 years of profit margins moving higher and earnings growing faster than [GDP](#), the price-to-sales component of the model gives a more pessimistic reading for the future.

The net outlook from the model is for returns to be around 1.5%, with a 3% outlook implied from the earnings metric and negative returns implied by the price-to-sales component.

There was some discussion about whether the forces of market competition will ultimately pressure profit margins for some of the [large-cap](#) technology names like Facebook and Amazon. Phillips concluded that this CAPE model [valuation](#) work would be supportive for [value](#) strategies over [growth](#) strategies going forward, given the dispersion in valuation multiples.

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: Adam Kabor & Thomas Philips

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DEFINITIONS

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Cyclically Adjusted Price to Earnings (CAPE) Ratio : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

Inflation : Characterized by rising price levels.

Price-to-sales (P/S) ratio : share price divided by per share revenue.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.