The Habits of Great Investors: CAPE Fear

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"Bull markets climb a wall of worry."

- Ancient Wall Street Proverb

Hello, great investors. I hope everyone had a wonderful summer. With Labor Day behind us, it's time to focus on the markets. Today, I want to discuss a hot topic: stock market valuations. The S&P 500 is hitting new highs, closing around 6,600 on September 11th, a historic milestone that's generating exciting headlines. However, bull markets often climb a wall of worry, and these highs are accompanied by significant anxiety among investors, who fear the market may be overvalued.

Valuation metrics and historical perspective

The media frequently highlights high valuations, with articles like one from *The Wall Street Journal* claiming U.S. stocks are pricier than during the dot-com era, implying an imminent crash. The S&P 500's price-to-earnings ratio is currently about 22.5, compared to 25 during the dot-com bubble and a long-term average of 17. The CAPE ratio, a long-term valuation measure, is at 40, higher than historical peaks like 1929 or 2007. Yet, valuations are a poor market timing tool. For example, the 2008 crash occurred when the P/E ratio was only 15, below average, yet the market fell 56%. Since 1990, the CAPE ratio has been above average 95% of the time, but the market has grown from 330 to 6,600, showing that high valuations don't always predict declines.

Concentration of valuations and economic shifts

Today's high valuations are concentrated in the top 10 S&P 500 stocks, which make up 40% of the index and trade at 29 times earnings, while the other 490 stocks trade at 21 times, closer to historical averages. This reflects the dominance of innovative, less capital-intensive tech companies, especially in AI. The economy has shifted from capital-heavy industries like railroads and manufacturing to efficient tech firms with higher profit margins — 5.6% in the 1990s, 10.3% in the 2020s. This structural change may justify higher valuations.

Interest rates and valuation context

Valuations must also be considered in the context of interest rates. The S&P 500's earnings yield is 4.6%, compared to the 10-year Treasury bond's 4.02%, making stocks relatively attractive. During the dot-com bubble, the earnings yield was 4% while Treasury yields were 6.2%, making stocks less competitive. Low interest rates today increase the value of future earnings, supporting higher valuations.

Mean reversion and the new normal

The idea of mean reversion — where valuations return to historical averages — is questionable. Peter Bernstein's *Against the Gods* suggests the mean itself can shift. Since 1990, the CAPE ratio's average is 28.3, 60% higher than the 150-year average of 17.6, indicating a new normal driven by a tech-led economy. While valuations are elevated, this may reflect fundamental changes rather than an impending crash. The S&P 500's growth from 1,527 in 2000 to 6,600 today, despite the dot-com bust, shows the power of long-term innovation.

Final thoughts

In conclusion, valuations are not a reliable tool for market timing. Exiting the market during high-valuation periods would have meant missing significant returns over the past 40 years. While bubbles like the dot-com era led to corrections, long-term growth has been driven by new technologies and economic efficiencies. As we stand on the cusp of advancements like AI, I wouldn't bet against continued innovation. Please share your comments or questions, and if you know someone who could benefit from this perspective, encourage them to subscribe.

Thanks, and enjoy the fall.