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SEVEN QUESTIONS

By IAN MCDONALD

Bursting the (Latest) Bubble

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Clifford Asness, an investment researcher and managing principal at a New York hedge fund, would like to burst your bubble. Literally.

His thesis: Stocks are troublingly expensive today. So investors should either expect muted gains over the next decade or another boom-bust cycle, where shaky stock prices rattle investors but make little progress -- like the past five years. In his bleakest scenario, U.S. stocks could actually lose to bonds over a 20-year stretch for the first time in history.

There's reason to heed his warnings. Mr. Asness and his colleagues at AQR Capital Management LLC use quantitative models to scour global markets for undervalued assets that are starting to come back to life. The approach worked well in the recent bear market. A person familiar with the firm's returns say it outperformed in that period, though it underperformed the broader indexes last year.

Mr. Asness is also an avid researcher, publishing papers and serving on the editorial boards of the Journal of Portfolio Management and the Financial Analysts Journal, among others. In 2000 he shared the Graham and Dodd Excellence Award for investment research with co-authors Bob Krail and John Liew.

Why is he so glum and where should investors stash their money in coming years? We got some answers.

1. What do you make of stock valuations today, and what do they say about where stock prices might be going?

In late 1999 and early 2000 I wrote a sarcastic screed called "Bubble Logic" when stock prices were a provable insanity. While we're not near those wacky levels, stock valuations are back to being very high.

ABOUT IAN MCDONALD

Ian McDonald covers the mutual-fund industry for the Online Journal, writing the Fund Fiend and Seven Questions columns, in addition to general reporting on the industry . Prior to joining the Journal in 2002, Ian was a mutual-fund reporter and columnist at TheStreet.com. He also worked as a marketer in the fund business for several years in Boston. Ian was named to The Journalist and Financial Reporter's list of 30 Top Journalists Under 30 in 2001, and won the New York State Society of CPAs Award for Excellence in Financial Journalism in 2000.

Ian passed the exams for the Series 7 and Series 6 licenses, required of financial professionals, and is a candidate for the Chartered Financial Analyst designation. A native of Brewster, Massachusetts, Ian earned a BA degree in English from Bates College in Lewiston, Maine.

To examine valuations, we don't look at Wall Street's favorite measures, like "forecast[ed] 2004 operating earnings." We don't like them because we don't have data back in time far enough to do a relevant comparison, and the street's earnings forecasts historically are overoptimistic. Also, "operating earnings" [which do not adhere to generally accepted accounting principles] are usually a fancy word for lies.

A measure I do like is the S&P 500's price divided by a long-term . . . version of real earnings [for stocks in the S&P 500 over the past ten years], a measure generally attributed to Yale Professor Robert Shiller. Using this, we see a [price-to-earnings multiple] for the S&P 500 that's back above 27. Its average over 1926-2002 is about 15.

What does history tell us to expect? When trading at over 19, the average real total return on the S&P 500 over the following 10 years is minus-0.2% per year. That's, on average, losing a small amount of money after inflation for a decade.

2. Couldn't a strong market continue in 2004 thanks to low rates and continued economic stimulus in an election year?

It easily could continue. Everyone has difficulty trying to call when craziness among investors will break. But we think the combination of overvaluation, high insider selling, investor complacency, rising interest rates and quickly rising commodity prices will counterbalance positive momentum in the market and turn things ugly this year.

We could be wrong. Valuations are a very strong predictor of long-term stock returns, but they're poor predictors of short-term performance, as is everything else. For instance, valuations first got this high back in 1996-1997, and we know what happened next -- [sharp equity gains in 1998, 1999, and early 2000]. So, while I think it's safe to say that now is a dangerous time for long-term investors in stocks, it's always a dangerous time to speculate stocks will fall in the short run.

It's the long-term that your typical 401(k) investor should be thinking about, not just this year. Prognosticators should be more honest. When a strategist or money managers says stocks could go higher this year because of low interest rates and low inflation, it's true, but it's also a sales job. Those same facts tell you that the five- to ten-year outlook for stocks is ugly and that stocks might lose to bonds over that stretch. Too often that kind of thing is left out of predictions.

Yes, stocks might return 20% in the next year, but they will probably average 5% to 6% annually over the next five or ten years because of their high valuations. When stocks are expensive, they're not a good deal for long-term, buy-and-hold investors. If the teacher socking money into his retirement account doesn't accept that, he's in trouble. People need to be told that, so they'll expect lower returns, save more and work a little longer.

3. Can you make a case that the equity bubble hasn't popped yet?

A bubble basically just means that most investors are wrong and really overly optimistic. I don't think we're in a provable bubble anymore if investors are willing to accept that they'll earn about 2% more on stocks than bonds in coming years. But if investors go back to expecting 10% to 15% returns every year, we're in trouble. …

Stocks going up from here means we are back to the bubble. Yes, the economy is improving, but so what? [Stock] prices are too high, and further increases, no matter what current news we mistakenly think justifies them, are running on pure air.

I'm pretty skeptical that investors have really accepted a lower risk premium and we can all go calmly forward with permanently high stock prices and very low stock returns.

This is only guesswork, but look at the following: Internet stocks are back to moronic levels, all the old hucksters who managed to avoid jail, or didn't retire to "spend more time with their families" are back on CNBC, tech company CEOs and venture capital salesmen are still arguing vehemently . . . that executive options are not an expense, and my extended family are again all asking me if it's time to get back in.

We've all seen this movie before.

4. So what kind of returns should investors expect from stock and bond investments?

Start with bonds. Government bonds are yielding about 4.5%. I think history tells you to assume bond yields will about equal their return [that is, don't plan on price appreciation, just interest payments]. For equities, authorities like [Wharton professor] Jeremy Siegel would tell you stocks' earnings yield is a good proxy for expected returns. It's not precise, but historically it's been a good guess. That tells you to expect about a 4% yield above inflation, which you'd expect to be about 2% [or a 6% return on stocks].

That assumes that stock valuations don't change. The good news is that you can expect a positive return from stocks and a two [percentage-point] edge over bonds. The bad news is that this kind of return will be below average [historically] and that they don't have much of a cushion over bonds. There's a nontrivial possibility that even over the long term, investors who own stocks could lose to investors who own bonds. People get drawn to stocks because they've never lost to bonds over a 20-year period, but now we've bid stocks into prices where they could lose to bonds.

I'm a fan of Jeremy Siegel and the "Stocks for the Long Run" argument, but it's self-defeating. If everyone believes it, stocks get bid up to a level where that's just not true anymore.

5. So, what do you like?

We are in a low-expected-return world. There's too much capital chasing too few assets, and there's not a place in the world now that looks exceptionally "cheap." So, my first advice is not to do too much. When expected returns everywhere are lower than normal, take less risk than normal. The opposite strategy, to take more risk in order to hit your old return targets, is a recipe for disaster.

Specifically, we do think non-U.S. stocks, particularly Asian developed markets and emerging markets as a whole, look a fair amount better to long-term investors than U.S. stocks, based on valuations. We think bonds aren't cheap, but are not the disaster some think, as their "real yields," or yields minus expected inflation, are only mildly lower than normal.

Our hedge funds are implementing these positions, but we're also focusing on a host of other things, including discrepancies between yield-curve shapes and mispricings among fairly similar stocks, as well as classic convergence strategies like merger and convertible arbitrage. Right now there is just nothing super compelling, but we do think a portfolio of many things can still do well.

6. If we gathered all of the nation's 95 million mutual fund investors in a room, what would you say to them?

I'd say keep your costs low. In a low-expected-return environment, costs as a portion of equity returns are higher, so you have to pay more attention to them than ever.

I'd also say diversify savagely…. Only investing in U.S. securities isn't a neutral position. You have to have an active, strong opinion that the U.S. will outperform the rest of the world to do that. If you don't have that opinion, you have to spread your money around the world.

I'd also say make sure you rebalance your portfolio. Rebalancing is one of the few free lunches out there. You're generally selling things that have gone up the most and buying things that have gone down the most. There's a valuation tilt there. Someone who doesn't rebalance is a tacit momentum investor.

Finally, save as much as you can and look at your account less. Spend more time with your kids because you don't have to watch CNBC every day.

7. Given the research scandal and the current fund-trading scandal, would you say Wall Street will be a fairer, cleaner place over the next five years than it was over the past five years?

I think there's a good chance of that. You might have other problems down the road, but at least not the same problems.

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