Forbe's Magazine's Portfolio Strategy columnist and Fisher Investments chief executive KEN FISHER says the assumption that price/earnings ratios can predict returns and risk in the markets is unfounded

Time to stop clinging to this age-old myth

What is the biggest myth that investors cling to religiously? It's that the market's price/earnings ratio (P/E) somehow partially predicts returns and risk. No. Doesn't. Isn't supposed to. We will get to that. But the current fear of high market P/Es is still fear and therefore bullish.

First, why do we believe in P/Es? Well, it appeals to age-old human senses of nature, fairness, value and simplicity – as with basic economics such as: "If meat was cheap, we should want more than if not." Feels fair and right. It augments our desire to blame failure on incompetence, as in, "no wonder he went broke; paid too much, the idiot."

It offers ethics, like "be OK, don't overpay". We feel pride when it works as if we "earned" something whereas we associate high-priced buying with gambling, hence not "earning" it. We also fear heights because our genes derive from aeons of ancestors who survived nature that way – P/E is, of course, a heights framework.

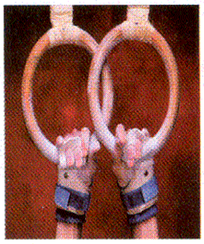
But it is wrong. Were it so simple the FTSE 100 wouldn't have dropped 52% in 1974 starting from a very low P/E. Or have risen 49% in 1968 from a high P/E. It is wrong for three simple reasons. First, it can't pass rigorous statistical analysis. Next, there are no good data. Third, finance theory denies it.

The several best and longest P/E data series come from the US and are all terribly dirty data. Amazingly, few folk know that. Using dirty data is classically garbage in, garbage out – like relying on a faulty speedometer in your car. Most accepted are those for the S&P 500, which are constructed with "pro forma" earnings, skewering them from reality. Incredibly, before 1958, the earnings aren't even based on the S&P 500 stocks but an evolving universe of about 90 stocks with a huge overweight to railroads and utilities that then unduly stabilised the data.

Other common US series, such as the early Cowles Commission series, have similar flaws. How is that easy to know? They all say 1932 was a low P/E year. Anyone with common sense knows there were no US earnings in 1932 – not even close – which is readily verified via Internal Revenue Service data, showing massive losses. Hence no P/E.

This year, in the *Journal of Business*, two respected academics, Jack W Wilson and Charles P Jones, attempted to scrub the data with adjustments they saw necessary. But it remains all guesstimates. There are no good data. UK earnings series may be shorter, but they are no less flawed – and elsewhere it gets worse.

And even if those data were good, they lack the hoped-for predictability. In autumn 2000, the *Journal of Portfolio Management*'s Meir Statman and I showed statistically that the normally accepted data are no better than random in predicting returns based on earnings (or dividends). Worse, if you create a toggle rule like "buy when the market's P/E is below 15 and sell when above 15", it fails to beat a simple buy and hold strategy.



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That remains true for 16, 17, 18 or any other P/E level and whether you pick holding periods of one, two, three or five years. P/Es just don't cut it. Yes, the UK history, on average, slightly favours low P/E years – but it isn't statistically "robust" because the advantage flows 100% from only two years: 1975 and 1977.

Finance theory says the inverse of P/E, called the earnings yield, should compete in the long term against long-term interest rates. But that pricing always comes from supply and demand and, short-term preferences for earnings or fixed income can drive these fields apart (this is known as the equity risk premium). Hence the 1990s' returns boomed with low earnings yields the whole time.

Current high P/E market fears indicate fear is abundant, which is bullish longer term. So, buy beaten up, quality stocks with potential upside surprises. From the US, try the utility AES, retailer The Gap, insurance leader Hartford Financial Services, consumer finance specialist Household International, bank Mellon Financial, scandal-plagued but leading broker Merrill Lynch, supermarket Safeway or semiconductor stalwart Texas Instruments.

Outside the US try the utility Endesa, cruise-liner Carnival, supermarket Royal Ahold, car leader Toyota Motor or UK-based Reuters. More on these next month. BM

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