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## 75 Years After The Crash

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It was an age of exuberance. Throughout the 1920s a long bull market took stock prices to peaks never before seen. From 1920 to 1929 stocks more than quadrupled in value. Many investors became convinced that stocks were a sure thing and borrowed heavily to invest more money in the market. Margin accounts permitted \$100 invested to purchase \$1,000 in stocks, as banks rushed to loan to investors. Even banks invested their depositor's funds into the stock market. Nothing could seem to go wrong, and the sky was the limit.

The US stock market boomed together with the economy and peaked in September 1929. On September 3, 1929, the Dow Jones Industrial Average (or DJIA, a stock index) reached 381, compared to 100 in 1926. The price-earnings ratio (P/E) ratio of the Standard and Poors' 500 index was 32.6 at the end of September 1929, up sharply from a low P/E ratio of 4.8 at the end of 1920.

Of course, the sky was not the limit, and the stock market crashed in October 1929, with frantic selling on Black Thursday October 24, Black Monday October 28, and Black Tuesday October 29. The DJIA fell to 145 in November, down 62% from the highs. It didn't stop there. By June 1932, nearly three years after the initial shocks, the DJIA reached its low at 34, down 91% from its high.

While many economists continue to debate the cause of the Great Depression, and the cause of the 1929-1932 stock market declines, in retrospect we can see that the stock market had reached historically high levels of valuation. From 1926 through 2003 we saw an average price-earnings ratio for the S&P 500 of only 14.5 (using data provided by Professor Robert J. Shiller). The 1929 valuation peak of 34 were more than twice this average level.

The lessons learned from 1929-1932 were, of course, forgotten. In December 1965, for example, the P/E Ratio of the S&P 500 index reached a quite high 24. From December 1965 through July 1982, the average annual return for the S&P 500 index was only 5.1%, and the index failed to beat inflation, which was 6.9% over the same period.

Since 1982 we have seen another stock boom. Let's look at some interesting figures. The answers to the following questions are (not in order): 7.4; 15.4; 19.9; 21.0; and 32.0. Remember, a P/E Ratio higher than 14.5 generally indicates an "overvalued" stock market, while a P/E Ratio substantially lower than 14.5 generally indicates an "undervalued" stock market. Match the answers to these questions:

- A. What was the P/E Ratio of the S&P 500 index on July 31, 1982, at the beginning of the bull market of 1979-2000?
- B. What was the P/E Ratio of the S&P 500 index on August 31, 1987, just before the late 1987 stock market downturn?
- C. What was the P/E Ratio of the S&P 500 index on November 30, 1987, after the 1987 stock market downturn?
- D. What was the P/E Ratio of the S&P 500 index near the recent height of the stock market, on March 31, 2000?
- E. What was the P/E Ratio of the S&P 500 index on Sept. 30, 2004?

(Answers on next page.)

If you answered the following, you were correct. A. 7.4. B. 21.0. C. 15.4. D. 32.1. E. 19.9.  
(Source: www.barra.com, using index values which include negative earnings.)

Surprised? By traditional measures of stock market valuation, including price/earnings ratios and price/book ratios, it appears that U.S. large company stocks were approximately 30% overvalued on Sept. 30, 2004, relative to historic norms. Does this mean the investor should flee U.S. stocks? Not at all. Knowing the recent valuation levels of U.S. stocks does not give us the ability to predict the future. Academic research has not been able to demonstrate any statistically significant relationship between high or low stock market valuation levels and what happens to stock market prices in the next year or two years. (Some research indicates, however, a correlation between high or low valuation levels and average annual returns over a subsequent 10-year or 15-year period, but that's the subject of another article.)

1929 teaches us that the stock market should not be a game for speculators. Rather, investing in stocks is truly a long-term endeavor, and should be undertaken using a disciplined approach stressing broad diversification (both among individual stocks and among asset classes) and strategies designed to keep total costs and taxes low. The capital markets offer long-term rewards for investors, but only if they can withstand the ups and downs. Want to speculate? Go to Las Vegas.

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