



THE DOUBLE BUBBLE BLUES ERA HAS ENDED: NOW WHAT?

“As technology makes the world ever wealthier, the returns on both riskless and risky assets will of necessity fall.”

William J. Bernstein
“The Paradox of Wealth”
Financial Analysts Journal, Sept-Oct 2013

An Eighth Investment Era?

Long-time readers of this publication will recognize Table 1 below. It has played a central role in our prognostications about capital markets prospects for decades for three reasons:

1. The table reminds us that financial markets have mindsets that swing from extended periods of growing optimism to extended periods of growing pessimism.
2. It also reminds us that these mindset swings impact pricing in the capital markets in predictable ways. Growing optimism leads to rising prices for risk assets, generous risk premium realizations, and hence falling pro-

spective risk premiums. Conversely, growing pessimism leads to falling prices for risk assets, negative risk premium realizations, and hence rising prospective risk premiums.

3. The table facilitates focused conversations about past investment eras, about the current one we are living through, and about periods during which one era transitions into another.

This *Letter* will focus on the third reason. We think it is becoming increasingly plausible that the *Double Bubble Blues* era ended a few years ago, and that we have been transitioning into a new era which for reasons set out in this *Letter*, we will tentatively call *Mature Capitalism*.

Table 1: The Eighth Coherent Era in the Last Hundred Years?

Investment Era	Investor Mindset	Approximate Time Span	Dividend Yield Change	Realized ERP*
<i>The WW I Decade</i>	Pessimistic	10 years	5% → 7%	- 5%
<i>Roaring Twenties</i>	Optimistic	10 years	7% → 4%	+ 12%
<i>Dirty Thirties/ Fateful Forties</i>	Pessimistic	20 years	4% → 7%	0%
<i>Pax Americana I</i>	Optimistic	20 years	7% → 3%	+ 8%
<i>Scary Seventies</i>	Pessimistic	10 years	3% → 6%	- 3%
<i>Pax Americana II</i>	Optimistic	20 years	6% → 1%	+ 9%
<i>Double-Bubble Blues</i>	Pessimistic	10 years	1% → 2%	- 6%
<i>Mature Capitalism?</i>	Optimistic?	20 years?	2% → 2%?	+3.5%?

* Stock returns come from *Triumph of the Optimists* by Dimson, Marsh, Staunton. Bond returns are based on a hypothetical CPI-linked bond with a real yield of 2.5%. If the actual LT TIPS return had been used for the *Double-Bubble Blues* era, the realized ERP would have been -10%.

While we have been pondering this transition question for some time, the cited FAJ article (front page) by William Bernstein was an important clarification catalyst. The article offers key elements of a plausible script for how the *Mature Capitalism* story might unfold.

Conventional Wisdom Stories about the Future

Many prognostications about the future today paint a rather dreary picture with three defining elements:

- **Demographics:** as populations age and worker/retiree ratios fall from 4:1 to 2:1 in the developed world, productivity and hence economic growth will decline.
- **Fiscal Deficits:** both families and governments are borrowing to make ends meet. This cannot go on forever. Eventually, a day of reckoning will come. This too will dampen future economic demand, and hence growth prospects.
- **Climate Change:** carries significant risks in the form of global warming and changing weather patterns, which in turn lead to wide-spread floods and droughts. The concomitant financial risk relates to assets becoming 'stranded' as the full costs of production are internalized (e.g., for carbon emission and water pollution).

If these three elements really defined the now-unfolding *Mature Capitalism* era, one would think they would be reflected in how markets are pricing long-horizon financial assets such as equities. Yet, the earnings yield of a broad index such as the S&P500 is 5% today, versus a long term average somewhere between 6% and 7%. In short, the pessimism embedded in the demographics, debt, and climate change stories don't seem to be embedded in the pricing of risky assets. Why? This is the question Bernstein addresses in his "The Paradox of Wealth" article.

The Paradox of Wealth

He invites us to imagine a subsistence society "plodding along at the precipice of starvation". People in this society face life-or-death decisions between consuming what they produce now, or saving part of today's production in the form of seed, implements, and shelter for tomorrow. Such societies face very high discount rates indeed! Only as this society painfully accumulates wealth (i.e., capital) over time, do discount rates (i.e., the cost of capital) begin to come down, or as Bernstein put it, does "the supply-demand equation shift in favor of capital's consumers".

This simple thought experiment prompts some fundamental questions. For example, does this wealth accumulation ever stop? Or, to use a popular current framing of the question by the pessimists: is there "an end to history?" In an earlier, longer article Bernstein argues for a "no" answer, offering a 4-factor argument in favor of ongoing prosperity:

1. **Scientific rationalism:** it is unduly pessimistic to assert that all things worth discovering or inventing have already been discovered and invented. It is in fact highly likely that new discoveries and inventions will continue to accumulate and add to societal wealth in this century.
2. **Property rights buttressed by the rule of law:** the evidence in support of this prosperity factor is overwhelming. Simply put, wealthy developed economies have this attribute, while it is still a work in progress in poorer developing economies.
3. **Well-functioning capital markets:** it was one thing for Edison to invent the light-bulb and to patent it, it was quite another to mass produce it, and to build the power-generation and transmission systems for millions of people to benefit from it. The latter required the ability to turn savings into wealth-producing capital on a large scale.
4. **Modern communication and transportation technologies:** it is not sufficient to simply produce the goods and services consumers want. They also need to know about them and be able to easily access them.

We agree with Bernstein when he argues that none of these four prosperity factors is about to go out of style anytime soon. The best-estimate future is a continuation of history, not the end of it.

But now for the paradox: increasing wealth does not logically mean increasing returns on capital. In fact, quite the opposite: increasing wealth logically means lower returns on capital. Why? Because, as Bernstein puts it: "Far from being the investor's friends, rapid technological advancement and the wealth it produces are triple-barreled destroyers of returns":

1. **By increasing societal wealth:** increasing capital productivity decreases the cost of capital by decreasing the need to spend income on immediate consumption, and it also increases the supply of capital.
2. **By encouraging investor enthusiasm:** gullible investors are more easily persuaded to part with their savings in a new era of innovation.

3. By diluting the quantum of shares outstanding: new share issuance is required to capitalize new forms of technology.

Before we move on, there is an important distinction to make: the difference between the 10-20 year 'era' framework we have been using (Table 1) and Bernstein's multi-century framework summarized above.

Is the Cost of Capital in Secular Decline?

Table 1 captures the ebbs and flows of the pricing of financial risk in the timeframes of 10-20 year 'eras' of investor rising and falling pessimism/optimism since the early 20th Century. Bernstein postulates a secular decline in the price of financial risk since the beginning of modern capitalism by the Dutch and the English in the 17th Century. He offers some evidence of this in the form of the P/E ratio series for U.S. stocks calculated by Robert Shiller, which stretches back to 1881.

Calculating the line of best fit between P/E ratios and time over the 1881-2012 period, the relationship is indeed positive, producing a 'normal' estimate of 14x earnings in 1881 and of 20x earnings in 2012. Converting these ratios to earnings yields produces an estimated 'normal' earnings yield of 7% in 1881 and of 5% in 2012. These findings are indeed consistent with a falling cost of risk capital over time. The caution is that even the 1881-2012 period provides only 14 independent 10-year data points. So the finding that the 'normal' cost of risk capital has been declining at a rate of 14 bps per decade over the course of the last 140 years must be treated with caution.

The Transition to *Mature Capitalism*: a Closer Look

Table 2 offers a closer look at S&P500 and Long TIPS pricing dynamics over the course of the *Double Bubble Blues* era, and the transition to a possible new *Mature Capitalism* era, say in the 2010/11 period. It clearly shows the impacts of the bursting dot.com bubble early in the decade, and the even more dramatic housing/financial leverage bubble that became the Global Financial Crisis later in the decade. S&P500 earnings also took hits as the bubbles burst, as did dividends during the GFC, falling from \$28 in 2007 to \$21 in 2009. Dividends did not recover from their 2007 level until 2012. Meanwhile, long TIPS yields fell from 3.7% in 2000 to 0.4% in 2012, rebounding to 1.6% at the end of 2013.

Taking the difference between Earnings Yield and the Long TIPS Yield as a rough estimate of the forward-looking Equity Risk Premium at the time, the expected ERP was effectively zero at the start of the *Double Bubble Blues* era. (With tongue in cheek, we invited readers in 2000 to take the decade off as the ERP for the coming decade had already been earned). Note that the expected ERP had climbed back up above 6% at the start of the *Mature Capitalism* era, dropping closer to 4% today with stock prices and bond yields both on the upswing. This sets up the key question of today: is a 4% ERP sufficient compensation for investing in equities in the *Mature Capitalism* era? The answer of course is: 'it depends'.

Table 2: S&P500 Fundamentals in the Transition from *Double Bubble Blues* to *Mature Capitalism*

Date	Trailing 12M Earnings	Trailing 12M Dividends	% of Earnings	S&P 500 Index	Dividend Yield	Earnings Yield	LT TIPS Yield	Implied ERP
12/29/2000	53	16	30%	1,320	1.2%	4.0%	3.7%	0.3%
12/31/2001	31	15	48%	1,148	1.3%	2.7%	3.5%	-0.8%
12/31/2002	33	16	48%	880	1.8%	3.8%	2.7%	1.1%
12/31/2003	45	18	40%	1,112	1.6%	4.1%	2.3%	1.8%
12/31/2004	60	20	33%	1,212	1.7%	5.0%	1.9%	3.1%
12/30/2005	71	22	33%	1,248	1.8%	5.7%	2.0%	3.7%
12/29/2006	82	25	30%	1,418	1.7%	5.8%	2.8%	3.0%
12/31/2007	85	28	32%	1,468	1.9%	5.8%	2.5%	3.3%
12/31/2008	72	26	34%	903	2.9%	8.0%	2.4%	5.6%
12/31/2009	32	21	64%	1,115	1.9%	2.9%	2.0%	0.9%
12/31/2010	75	23	31%	1,258	1.8%	6.0%	1.8%	4.2%
12/30/2011	90	26	29%	1,258	2.1%	7.2%	0.8%	6.4%
12/31/2012	100	32	32%	1,426	2.3%	7.0%	0.4%	6.6%
12/31/2013	106	35	33%	1,848	1.9%	5.7%	1.6%	4.1%

Sources: Bloomberg and Standard & Poor's

Three ‘It Depends’ Answers

For one, it depends on the plausibility of Bernstein’s ‘paradox of wealth’ premise. The premise suggests that the long secular decline in the earnings yields of equities now makes an earnings yield of 5% ‘normal’, and likely, a Long TIPS yield of 1.5% ‘normal’ too. Together, they make an expected ERP of 3.5% the new ‘normal’ ERP in the *Mature Capitalism* era, and the current 4% calculation in Table 2 well within the ‘normal’ range.

A second ‘it depends’ answer surfaces from Woody Brock’s writings where he sets out three public policy requirements for a functional *Mature Capitalism* era (see SED Profile 121, May 2013):

1. Functional fiscal policies: raise output productivity through value-creating infrastructure investments.
2. Functional financial policies: maintain price stability in goods, services, and asset markets; institute flexible leverage ceilings.
3. Functional incentive structures: raise output productivity through raising human capital productivity, extension of the rule of law and property rights, facilitate ‘creative destruction’ processes, and deregulate goods, services, and labor markets.

A third ‘it depends’ answer relates to the degree and rate at which we can integrate ‘mature capitalism’ with ‘fiduciary capitalism’. Last October’s *Letter* investigated that question in some detail (see “Embracing Fiduciary Capitalism: From Saying To

Doing”). Here we can place it in the context of Table 2. It shows S&P500 dividend payout ratios ranging from a high of 64% (2009) to a low of 29% (2011). ‘Normal’ experience today seems to be to payout 1/3rd of earnings as dividends, and to retain 2/3rd. This raises important questions: what are corporate boards and managements doing with the earnings they are retaining? Are they reinvesting in the business? Buying other existing businesses? Reducing the number of shares outstanding through buybacks? Piling up a cash hoard? Are these activities adding value? In our view, very few investors really know the answers to this latter question. Fiduciary capitalism requires that they do.

Is this *Letter* Good News or Bad News?

So in conclusion, is the main message of this *Letter* good news or bad news? Actually, it is both. It is good news in the sense that if the valuation norms for equities have shifted from 14x earnings in the late 19th Century to 20x earnings today, indexes like the S&P500 are not over-valued at current price levels. The bad news is that it is now fundamentally wrong to use historical real equity returns in a 6%-7% band as a realistic prospective return assumption. A 4%-5% real return band for equities is now the new normal.

Such ‘normal’ prospects for equities, coupled with a ‘normal’ 1.5% real return on long term TIPS, are well below the return projections still being used to calculate the ‘normal’ cost and contribution rate in many pension arrangements around the world today. Pension fiduciaries must take note.



The information herein has been obtained from sources which we believe to be reliable, but do not guarantee its accuracy or completeness.

All rights reserved. Please do not reproduce or redistribute without prior permission.

Published by KPA Advisory Services Ltd., 151 Bloor Street West, Suite 702, Toronto ON CANADA M5S 1S4
416.925.7525 www.kpa-advisory.com