Is Now the Time to Buy Stocks?

Here is what the historical evidence suggests.

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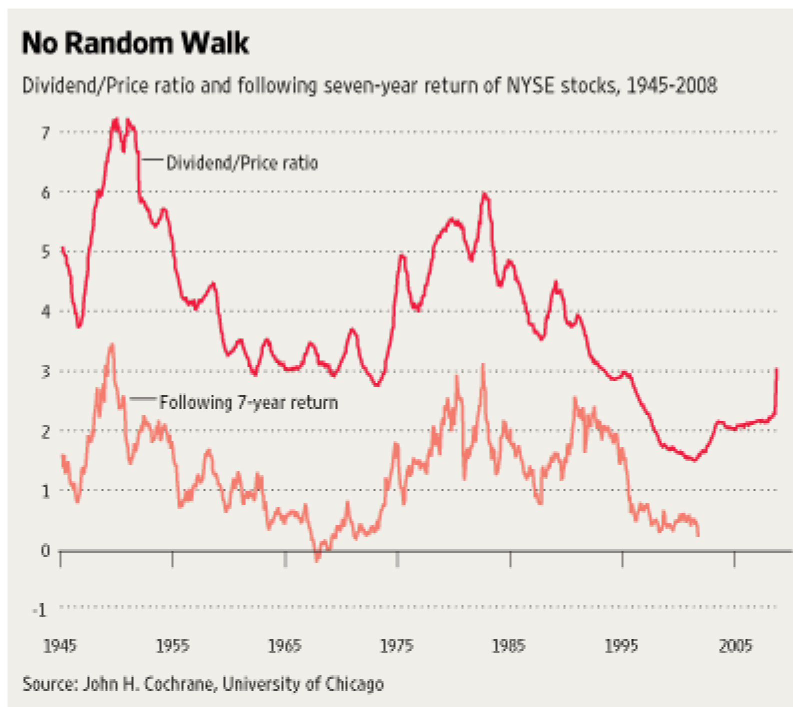
The markets are chaotic. The stock market (S&P 500) is down 34% for the year, and 17% in October alone. Volatility, which measures how much stocks move unexpectedly in a year, is even more dramatic. It's usually around 15%, but daily volatility in October was 75% on an annual basis. Meanwhile, the financial crisis continues. Is this the prelude to further losses, as in 1929? Or is it the mother of all buying opportunities? Even if we think the market is a bit undervalued, does huge volatility pose an unacceptable risk of catastrophic losses?



No one knows for sure -- but 30 years of research does offer some experience and insights. Consider the top line in the chart nearby, which depicts the dividend/price ratio for NYSE stocks. Dividends are stable over time, so this ratio lets us compare stock prices at different points in time. Read it as an upside-down price chart. When prices rise, as in the boom of the 1990s, you can see the dividend yield decline, and vice versa. The lower line is the following seven-year return; it tells you how much total return, if you invested $1 on a given date, you would have made in seven years.

The correlation is obvious: When prices are low relative to dividends, subsequent seven-year returns are likely to be high. Stocks do not follow a "random walk." More deeply, price declines above and beyond declines in dividends over the following year have entirely rebounded. This finding is confirmed by 30 years of research, ranging from "behaviorists" such as Robert Shiller and Richard Thaler to "efficient marketers" such as Eugene Fama and Ken French, to "economists" such as John Campbell and myself. The same pattern also appears in price/earnings, book/market and other ratios, and in many other markets.

The interpretation is pretty clear too. In a recession, or following losses, many investors become more averse to holding risks. They want to sell. But we can't all sell -- a fact routinely ignored in much financial advice and commentary. Instead, prices must fall and prospective returns rise until some investors are willing to buy. Unsurprisingly, upward spikes in the dividend yield came in bad economic times.

History is not a guarantee -- this time could be different. Rather than a higher return going forward, this price decline could reflect a consensus opinion that a massive depression is coming -- a 34% permanent decline in earnings and dividends and a massive wave of bankruptcies.

But as I read the news, the "risk aversion" story seems more plausible. We are in, or headed for, a recession. Anyone whose job or business will be impacted can't take stock-market risks, and should be selling despite low prices. We are seeing lots of "deleveraging," "disintermediation" and "forced selling." As losses mount, investors or institutions that have borrowed money must sell to avoid bankruptcy. Others, such as some university endowments or defined-benefit pension funds, have backstop commitments that must be honored, and they too must "capitulate" at some point. Still others may just be less willing to take risks after suffering a huge loss, a sensible "once burned, twice shy" mentality.

All of these actors become more averse to holding risks as the market declines, so they sell. This increasing risk aversion amplifies an initial price decline -- coming from bad earnings news or the huge rise in credit spreads -- into a rout.

If this is indeed what's going on, it also means that unleveraged, long-term investors should be buying, since prospective returns are better. They must be able to suffer through further mark-to-market losses, and not have recession-sensitive jobs or businesses. They must still have some money left to invest, so they can exchange some of their valuable Treasurys for assets that the suddenly risk-averse are trying to unload. The more these investors can understand and digest slightly exotic securities being dumped by leveraged intermediaries, the better. Warren Buffett is in the news, and he should be.

But this line of thought still does not justify wild optimism. The dividend yield and S&P 500 P/E are barely back to long-term averages, and dividends and earnings will surely fall next year, justifying some of the recent price decline. (Crazy yields in debt markets are another story.)

And what about volatility? Stocks could easily fall a lot more. The standard portfolio rule says that your stock percentage should rise with the expected return (stocks and bonds) divided by squared return volatility. So, if you were happy with a 50/50 portfolio with an expected return of

7% and 15% volatility (standard numbers), 50% volatility means you should hold only 4.5% of your portfolio in stocks!

Now, I might answer that, knowing this, everyone has tried to sell, pushing down prices and pushing up expected returns. But expected returns would need to rise from 7% per year to 78% per year to justify a 50/50 allocation with 50% volatility. Prices have not fallen anywhere near enough to make this a sensible forecast. Many sophisticated investors and hedge funds who use this standard formula are getting out, waiting for at least a return of lower volatility before getting back in.

The answer to this paradox is that the standard formula is wrong. It assumes that stocks are a random walk, and the chart tells us otherwise. Stocks act a lot like long-term bonds -- when prices decline and dividend yields rise, subsequent returns rise as well.

Good bond investors know this. If you have a 10-year Treasury indexed bond, and a 10-year liability (say, you want to retire in 10 years), and you desire complete safety, you can ignore quarterly statements. If you see interest rates rise, bond prices tank, and bond volatility go through the roof, you would be foolish to call your broker and cry, "We've got to sell! I can't take any more losses." If bond prices go down more, bond yields and long-run returns will rise just enough that you face no long-run risk. (Foolish or not, many bond investors pay far too much attention to short-term returns.) Stocks are much riskier, of course. But the same logic explains why you can ignore "short-run" volatility in stock markets.

The average person must end up holding the stocks and bonds that are out there. Therefore, you should only ever buy, sell or rebalance if you're different than the average person. We all like to think we're smarter than average, but at least half of us are deluded, so that's a dangerous way to invest.

If you're less leveraged, less affected by recessions, and have a longer horizon than the average, it makes sense to buy. If you're more leveraged, more affected by recession or have a shorter horizon, it might be the time to sell, even though you might be cashing out at the bottom. If you're about the same as everyone else, do nothing and relax. If you're wrong, at least you will have excellent company.

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