

The *Ambachtsheer* Letter

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THE ‘POST-BUBBLE BLUES DECADE’:

IS ALL THE BAD NEWS ALREADY IN STOCK PRICES?

“History suggests that the investment regimes we remember tend to last between 10 and 20 years. This is not accidental, for such regimes are characterized by deep-seated structural developments that play out over one or two decades, and that impact market sentiment, and hence valuations only gradually”.

Woody Brock
February 2003

Investment Regimes and Stock Prices

We argued in March that over the long run, stock prices do not randomly walk around a 5% equity risk premium (ERP) over bonds. Instead, stock prices are persistently ‘high’ or ‘low’, depending on the in-place ‘investment regime’. The 20th century experienced six such regimes lasting 10-20 years, shifting in mood from pessimism to optimism to pessimism, and so on. We showed that stock valuations mirrored these moods in the sense that investors required increasingly high dividend yields during the pessimistic regimes, and were satisfied with increasingly low yields during the optimistic regimes.

In April we addressed the questions of whether such investment regimes could be identified well before they ended, and whether there is a theory that could explain the observed characteristics of investment regimes (ie. alternating between pessimism and optimism, with a duration of 10-20 years). We showed that during our 15-year career as a professional ‘regime spotter’, we did a reasonably good job of understanding and explaining the unfolding 1981-1999 ‘Pax Americana II’ regime.

Maybe most importantly, it was the ‘regime theory’ of stock market valuation that gave us the confidence to conclude that by 1999, all the conditions were in place for a major regime shift out of optimistic ‘Pax Americana II’, into a new investment regime dominated by an increasingly pessimistic investor mindset. During the last few years, we have been arguing as persuasively as we can that this regime shift would require the ‘reinvention’ of pension and endowment fund management, away from a static 5% ERP ‘long term’ mindset, towards a more dynamic, opportunistic approach.