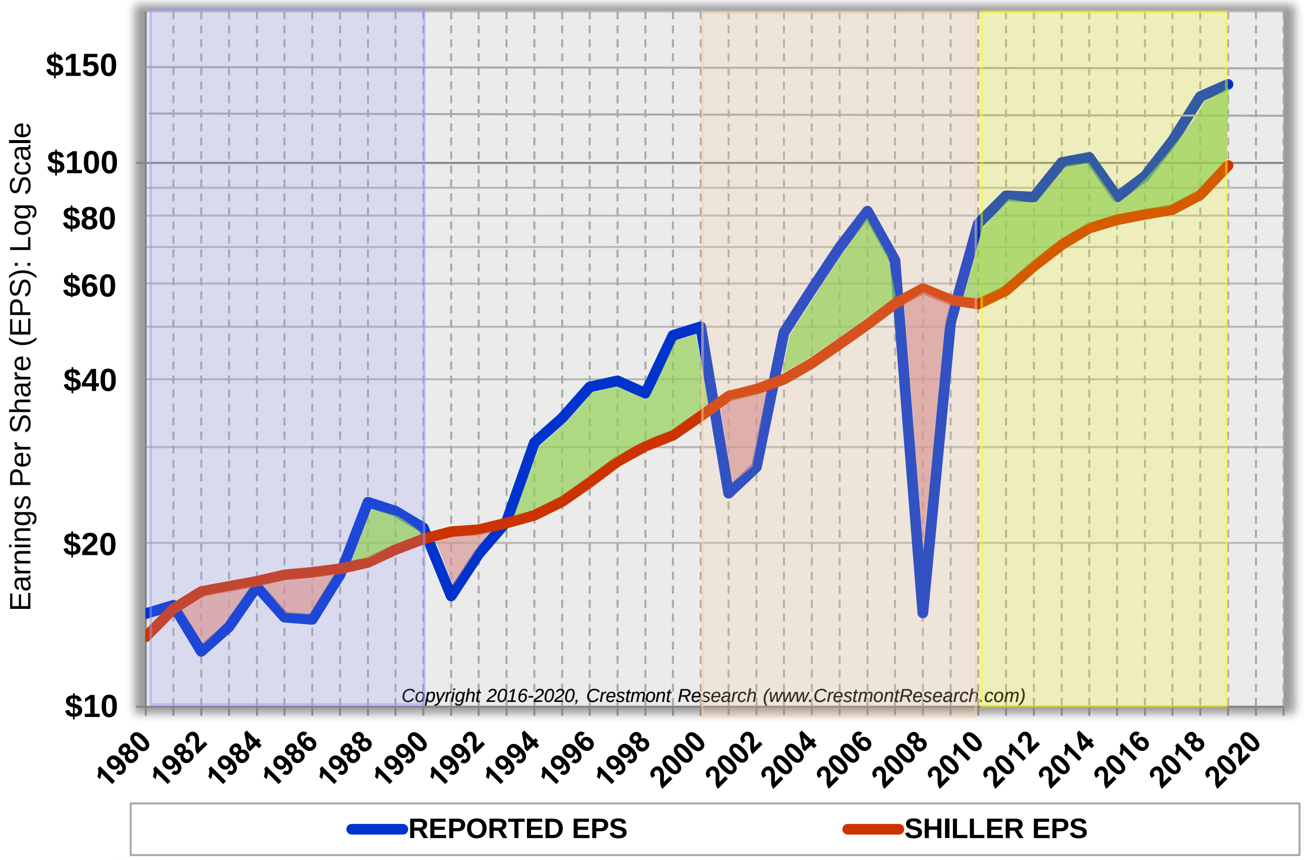
SIEGEL'S SHORTFALL:
How the Prof Taught Us the Value of Normalizing



For a decade, Jeremy Siegel criticized the validity of Robert Shiller's version of the cyclically adjusted price/earnings ratio (aka CAPE and P/E10) because of a supposed distortion of P/E10 due to the earnings plunge in 2008. In reality, for most of the past decade, the magnitude of above-trend profit margins more than offset the deep-yet-short 2008 chasm.

Reported earnings for the S&P 500 is highly variable, as reflected in the graph by the blue line. Therefore, a price/earnings ratio (P/E) based upon Reported earnings will often be distorted when Reported EPS is above or below its long-term trend (i.e., almost all years).

Robert Shiller (Yale) popularized a version of P/E that normalizes Reported EPS to smooth its variability and thereby reflects the underlying long-term trend of EPS (the red line in the graph). In effect, Shiller offsets the red-shaded areas and green-shaded areas in the graph.

The past ten-year period is shaded with yellow, and each preceding ten years has a color shade. (Note: The graph illustrates the effect of normalizing P/E. For P/E10, however, each year uses the specific ten years preceding that year.)

1. 2008 is no longer in current reports of P/E10, and caused minimal distortion.
2. Normalizing P/E is essential to avoid distortion from the Reported EPS cycle.
3. EPS for the past 10 years includes only high profit margin conditions; the economy and S&P 500 may find the next few years will have red shading.