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Securities or Security? Working through the Possibilities

It's been said that buying securities equals insecurity. On the other hand, avoiding securities will lead to security. At no time could these statements encompass more wisdom.

Just like buying tickets for a lottery carries risk, investing in the stock market does too. One reason is obvious. A lot of people buy high and sell low. For example on December 31, 2001 the 12 month trailing S&P P/E was 45.50. Today it is below 12. Those who bought a fund equivalent to the S&P at the high and are still holding it lost money, at least on paper.

On the other hand, those that have cash instead of depreciated stock might think the market is a bargain today with the trailing P/E below 12 when the long term average P/E ratio since 1942 is 15.90. They are asking themselves, "Should I invest now?"

No one knows the answer, but it is certain that to some investors with cash the market doesn't look so cheap even though the S&P P/E ratio is below average. These are the folks who look at historical data for the 12 month trailing P/E during economic downturns. On September 30, 1974 during another significant economic slump, the 12 month trailing P/E was 6.97. That P/E makes the current market look overpriced by a factor of two.

Though it is difficult to decide when to re-enter this market, Robert J. Shiller from Yale University, author of Irrational Exuberance, offers another determinant. He uses a cyclically-adjusted price-earnings ratio (CAPE) to average earnings for ten years. In this way he can establish an accurate P/E for the business cycles included within those ten years no matter where we are in a rotation. According to his analysis, the CAPE S&P P/E ratio is lower than average at this time.

Still, Professor Shiller isn't buying (http://www.businessinsider.com/shiller-stocks-not-yet-cheap-enough-for-me-2009-2). He's waiting until the CAPE P/E ratios are below 10. He is cautious. Of course, he could be wrong. The market might go up unexpectedly as it has many times before. For example, on September 21, 1987 the S&P gained 9.10% in one day. It increased further on November 2, 1987 - by 12.4%. These figures mean that those investors who were not in stocks during these sudden surges lost out.

Shiller is aware of massive upswings like this. Maybe that is why he chooses caution on the downside to control loss over taking risk for upside gain.

Another reason is that Shiller follows the Japanese market too, now down 82% from its peak in 1984. He knows that if the US were to go the same route, our market would have much further to fall. This is yet another danger of being in the stock market. It is risky not only because people buy high and sell low, but also because no one can predict with accuracy where it's going. Those that do are gambling, not investing.

It seems that being prepared for any eventuality in the stock market, positive or negative, is best. The trick (http://mymoneymd.com/Worst_Case_Scenario.pdf) is to balance cash and bonds for security against stock market participation for gain. It's the only way for most people to sleep free from market anxiety at night. What is given up in market exuberance is recaptured in comfort.