WALSKY INVESTMENT MANAGEMENT

Dr. Shiller's Remarkable Chart

by Craig D. Hafer, President

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In our office at Walsky Investment Management, there is a large red binder that sits inconspicuously on a credenza in our reception area. Inside the binder is a 23-year history of every quarterly letter that we have written to our clients. Early letters were penned by the firm's founder, Larry Walsky, and often captured the current economic or political events of the time. If there was one recurring theme throughout the years, it was that stocks with growing dividends are a good choice for investors.

Despite whatever the investing fad of the day was, Larry's letters never wavered. Dividends, he claimed, were what drove the market. Yet, without providing much empirical evidence, or charts, it was easy for critics to challenge this notion. Making the argument more difficult to defend was that it went against a widely accepted investment theory. It would take the work of a Nobel prize-winning economist, along with our own in-house research, to prove not only that dividends matter, but also that one of the most prized theories in investing is fallible.

Dr. Robert Shiller may not be a household name; however, in the financial world he is considered one of the greatest economists of all time. Shiller is best known for correctly predicting the U.S. housing crash that began in 2006. He also helped coin the phrase "irrational exuberance," which then-Federal Reserve Chairman, Alan Greenspan, popularized. Shiller is a soft-spoken Midwesterner. On the outside, he appears to be quite conventional, not the sort that would challenge one of the cornerstones of investing: the Efficient Market Hypothesis (EMH).

According to the EMH, at any point in time, a stock's price reflects all available information. A direct implication is that it is impossible to "beat the market" consistently on a risk-adjusted basis, since market prices should only react to new information and therefore a stock can never be overvalued or undervalued. In the 1980's, the EMH was the subject of one of the most popular investing books ever written, *A Random Walk Down Wall Street*, by Princeton economist Dr. Burton Malkiel. In his book, Malkiel argues that stock prices exhibit signs of a "random walk" and that price fluctuations cannot be predicted. With over 1 million copies sold, it is hard to overestimate the popularity of this idea and why those who challenged this hypothesis, be it Shiller, or those who touted dividends, were easily dismissed by the "experts" of the time.

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2650 Westview Drive, Wyomissing, PA 19610
www.walsky.com | P: 610-670-6918 | F: 610-670-6937

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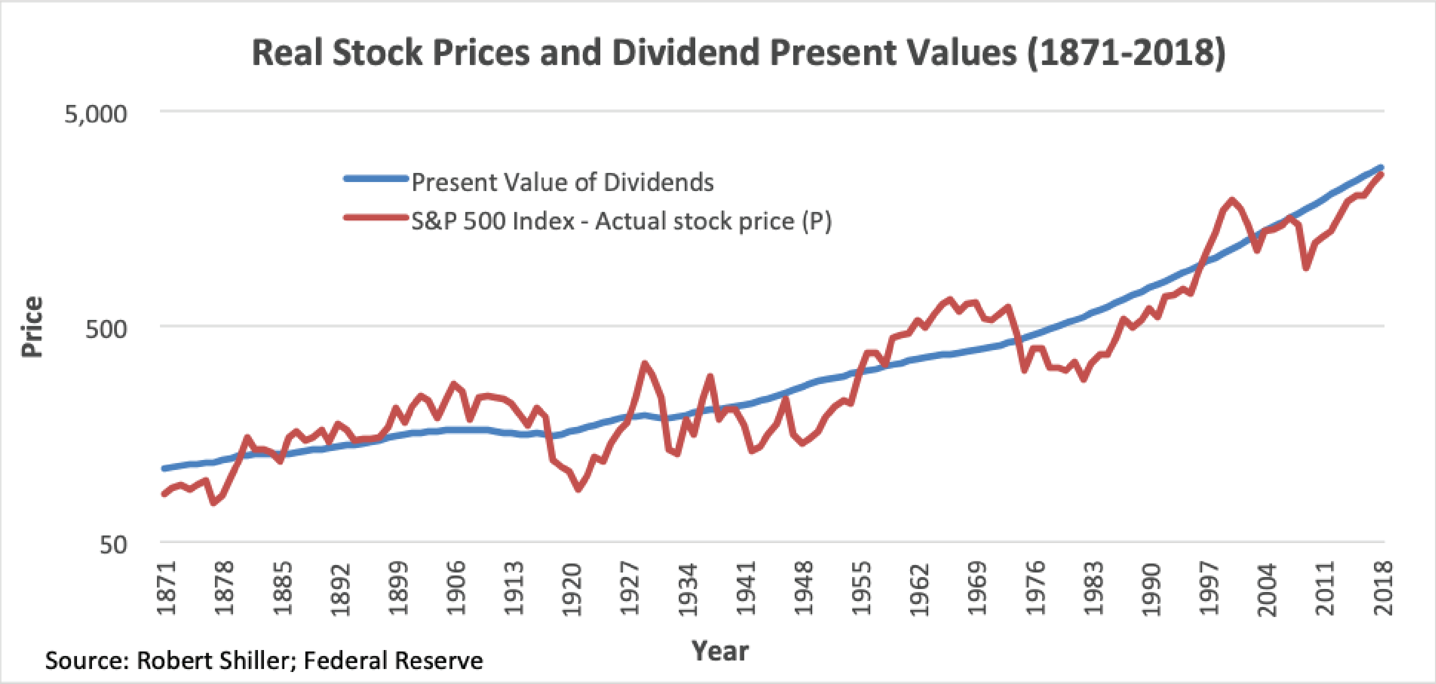
As we explored in our previous letters, in the 1980's and 90's, economists were claiming that consumers (which includes investors) were rational, and therefore markets, including Wall Street, were efficient. It is during this time that Shiller made a controversial discovery. Through painstaking research, he realized that contrary to what the Efficient Market Hypothesis claimed, the stock market was *not* efficient. According to Shiller, if investors were rational, then stock prices would always reflect the discounted value of the future dividends that companies were expected to pay; however, far from being rational, investors are moody and *irrational*, often swayed to buy and sell stocks based on a myriad of variables that have no correlation to the underlying value of a stock. A result of this irrational behavior by investors is the volatility that is often seen in the market. In other words, contrary to the popular opinion of the time, a stock's price and its intrinsic value are seldom one and the same. In 2013, Shiller was awarded the Nobel Prize for his analytical work regarding the inefficiencies of markets.

In *Market Volatility*, Shiller diligently presents his argument that not only displays his mastery of the subject, but also argues that the true underlying value of a stock is the dividends that it pays. For readers of our letters, Shiller's work would be both startling *and* familiar. In his book, *Irrational Exuberance,* he expounds upon this idea by comparing the S&P 500 Index from 1871-2013 to the present value of dividends paid in the index. As the data in the book was not up to date, I reached out to Dr. Shiller and agreed to revise his work. The updated chart from 1871-2018 is below.



Looking at Shiller's chart, the long-term relationship between the S&P 500's performance and the dividends paid by the companies in the index is amazing: a simple regression model indicates that 80% of the S&P 500's long-term performance is correlated to dividends. Shiller used this chart to prove that the stock market is not efficient, as stock prices will often differ from the dividends they are expected to pay. In the short-term, the market can be volatile and investors irrational; however, over the long run, this "irrationality" is smoothed out. What is clear is that dividends play a significant role in the overall return of the stock market.

By showing that the EMH is not absolute, Shiller has opened the door for other studies that point in the same direction. For the past five years, I have been working on my own model that I believed proves the EHM wrong. As I was analyzing the stocks we selected in our clients' portfolios from 1998-2018, I discovered that these stocks (which have growing dividends) not only had performance similar to the S&P 500 over the long run, but had significantly less risk (as measured by beta). As a group, the stocks in our clients' portfolios were 23% less volatile (risky) than the S&P 500. While the EMH claims that there is a direct relationship between a portfolio's risk and its return, our data proves this is not the case. Risk and return do not always go hand in hand.

As Shiller wrote, "Now that one sees present value [of the S&P 500 Index and dividends] plotted over a long range of time, it seems obvious from what some of us have always known at gut level." Since the early days of Walsky Investment Management, our experience told us that buying stocks with growing dividends may be the most rational thing any "intelligent investor" can do, and after 23 years of analysis, we have the empirical evidence to prove it.