ETF Securities Equity Research: Don your CAPE to outperform

Summary

- CAPE serves as a more effective valuation metric in forecasting long term equity market returns relative to its 12-month trailing PE
- The wide gulf in valuations of global equity indices provides investors an opportunity to outperform global benchmarks by increasing exposure to cheap countries while reducing exposure to expensive countries
- A simple active strategy used in the CAPE model has successfully outperformed global benchmarks over the past 11 years by an average of 1.8% annually

Hunting for value in CAPE

Investors are frequently known to misjudge when to gain exposure or exit the stock markets as fear and greed prevail over rational thought. In fact most economic forecasts and analyst reports at the start of the year have misguided investors due to their inability to predict the unknown unknowns that occur over time. In the current scenario of high volatility and mediocre corporate profit growth, we believe it would be prudent for investors to turn to valuations as a superior predictor of long term global equity market returns.

The cyclically adjusted price-earnings ratio (CAPE), measures the ratio of the current market price to the average inflation-adjusted profits of the ten preceding years. It was popularised by economist Robert Shiller and is considered the most reliable yardstick for valuations as it adjusts for temporary, highly misleading swings in profits thereby addressing the weakness of the classic price to earnings (P/E) ratio. CAPE helps to gauge whether the valuation of an equity market is high or low compared with its profit level. We believe CAPE to be the single best gauge for measuring future stock market returns as it has outperformed not only P/E ratios but other well-known metrics such as government debt to GDP, dividend yield and the Fed model (Earnings yield/Bond yield). However, it is worth pointing out that CAPE is not as efficient in timing market bubbles and chasing short term profits as it is in forecasting long term future returns from global stock markets. Conversely, it can shield investors from making brash decisions in times of crisis.

Divergence of global CAPE valuations beckons an opportunity

The past 8 years of excessive monetary easing, political uncertainty, diminishing corporate profits and a rise in share buybacks and changing dividend pay-outs have created a wide gulf in valuations globally favouring some countries over others. On observing the Cape valuations of 52 global equity markets, the United States small caps emerged as the most expensive market globally at 43x. In addition US large caps feature in the top 10 most expensive countries with a cape of 21x. The S&P 500 Index is trading at a 30% premium to its long term average of 16x, these levels were last exceeded before the 1929 great depression, the 1990 dot com bubble and the 2008 financial crisis. Irish stocks appear the next most expensive and therefore hold a less favourable outlook.

Greece remains the world’s cheapest market with a CAPE valuation as low as 1.7x. Among the emerging markets – Russia, Brazil and Turkey appear attractively valued and CAPE valuations have been suggesting this for a while. While the slump in oil prices at the start of 2016 and Western sanctions have deterred investors from investing in Russia, the country’s equity markets remains attractive and is the second cheapest market globally. In Europe – Spain, Portugal and Poland are poised to deliver higher inflation adjusted annual returns over the next decade. While Spain is struggling with high unemployment levels and structural issues, its economic growth currently and over the last three years has outpaced the European Union. Not to mention its equity market remains home to highly successful multinational companies such as BBVA, Santander, Inditex and Telefónica.

Investments may go up or down in value and you may lose some or all of the amount invested. Past performance does not guarantee future results.
The CAPE model works

We believe the wide differences in the CAPE valuations among 52 global equity markets provide investors with an opportunity to exploit. This can be executed by taking a positive exposure to the cheapest ranked 10 global equity markets and a negative exposure to the most expensive ranked 10 global equity markets according to CAPE. The strategy is rebalanced on a quarterly basis to reflect the changes from quarterly earnings season. Each quarter, the long and short positions in the portfolio are rebalanced based on the changing CAPE valuations versus the long term average. On back testing this strategy since 2005, the model successfully outperformed its benchmarks – the MSCI All Countries World Index and the FTSE All World Index by a significant margin of 31% and 25% respectively.

The CAPE model yielded an annualised return of 5% exceeding the global benchmarks at a lower volatility of 16.3%. The model was able to deliver a Sharpe and Information ratio of 0.21 and 0.11 respectively at a remarkably lower beta of 0.48 over the past 11 years. Furthermore, it trades at a relatively low frequency of once a quarter with an average annualised gross portfolio turnover of 40%.

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<thead>
<tr>
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<th>CAPE model</th>
<th>MSCI All Countries World Index</th>
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<tbody>
<tr>
<td>Volatility</td>
<td>16.3%</td>
<td>19.9%</td>
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<tr>
<td>Annual returns</td>
<td>5.0%</td>
<td>3.2%</td>
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<tr>
<td>Max drawdown</td>
<td>-56.0%</td>
<td>-59.6%</td>
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<tr>
<td>Max recovery</td>
<td>6.2</td>
<td>4.7</td>
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<tr>
<td>Beta</td>
<td>0.48</td>
<td>1.00</td>
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<tr>
<td>Correlation to benchmark</td>
<td>0.59</td>
<td>-</td>
</tr>
<tr>
<td>Tracking error</td>
<td>16.7%</td>
<td>-</td>
</tr>
<tr>
<td>Sharpe ratio (vs cash)</td>
<td>0.21</td>
<td>0.09</td>
</tr>
<tr>
<td>Information ratio</td>
<td>0.11</td>
<td>-</td>
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</tbody>
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**Source:** ETF Securities, Bloomberg.

- Data in USD from Jan 2005 to July 2016. Volatility and returns are annualised. Max drawdown defines as the maximum loss from a peak to a trough based on a portfolio past performance.
- Max recovery is the length of time in number of years to recover from the trough to previous peak. Risk free rate equals to 1.5% (Cash – a simulated combination of the IMF UK Deposit Rate and the Libor 1Yr cash yield).
- Quarterly rebalancing assuming no trading costs with average annualised gross portfolio turnover of 40%. Out-of-sample backtest.

Diversify your risk & reap modest returns

The wide gulf among global equity market valuations offers investors the opportunity to favour the cheap global equity markets versus the expensive. The CAPE model enables this, by using a tactical strategy to gain exposure to the cheaper markets and reduce exposure to the more expensive, thereby spreading an investors risk over the long term. In doing so, investors are able to contend with current heightened levels of volatility whilst achieving modest annualised returns over the long term. While CAPE by no means is a perfect indicator, it is superior to the majority of valuation metrics in forecasting long term equity returns. While there is always the risk that cheap gets cheaper and expensive could outperform, we believe prices will eventually mean revert to reflect underlying fundamentals.
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