irrational exuberance

By Robert J. Shiller
Princeton University Press
296 pages

review rating

Every private investor, student of investment, fund manager or financial planner/adviser should read this book – and then re-read it every two years or so, particularly in buoyant market conditions. Such is the weight and wisdom of this small book.

This review will but skim the salient points, as to do otherwise would require inordinate length.

Professor Shiller teaches economics at Yale, and he is the author of other major works, one of which won the Paul A Samuelson award. His fame rose considerably after the publication of this book in early 2000, for the simple reason that he made a call on the market, which turned out to be correct. His reasoning for the run-up of the Dow to 2000, and for its subsequent fall (which he did not know of when writing the book) is also broadly correct, or to put it more accurately, this reviewer knows of no other widely accepted explanation. These, then, are matters of no small moment, and his ground breaking work also required considerable courage. How many other academics or industry practitioners have stood alone, against the howling winds of the market? Even Dr Greenspan gave up on doing that.

His Preface and Acknowledgements provide an interesting introduction and plenty of leaders as to how and why he reached the conclusions that he did in late 1999. His wife is a clinical psychologist, and he has worked closely with the father of behavioural finance: Richard Thaler. Shiller expresses gratitude to the Russell Sage Foundation for sponsoring behavioural finance workshops that he gave with Thaler for ten years at the National Bureau of Economic Research. He received invaluable research assistance from several colleagues at Yale, and was prompted to write this book by no less than Jeremy Siegel.

The book is essentially about the folly of group think, in relation to stock market pricing – what he calls "feedback loop". It is a warning not to accept collective wisdom of the day: "if millions of researchers and investors are studying stock prices and confirming their apparent value, why waste one's time in trying to figure out reasonable prices? One might as well take the free ride at the expense of these other diligent investors who have investigated stock prices and do what they are doing – buy stock." Well, the reason not to do this, is that: "Most investors seem to view the stock market as a force of nature unto itself. They do not fully realise that they themselves, as a group, determine the level of the market. And they underestimate how similar to their own thinking is that of other investors…. Little do they (private investors) know that most institutional investors are, by and large, equally clueless about the level of the market."

The title of this book is drawn from Chairman Greenspan's disparaging remark on the US market in the late 1990's, before he had to back-track, in the face of an ever rising Dow. As Shiller notes, there was a whiff of extravagant expectation in the air in late 1999. "There is a lack of sobriety about its downside."

Book structure and focus

He has divided the book into four parts: structural factors, cultural factors, psychological factors, attempts to rationalize exuberance, and finally a "call to action" – which every US equity investor would, today, wish they had taken in early 2000!

The historical perspective in chapter one contains some truly chilling data on the real returns from the US market after the three bear markets to 1999. The first graph is enough to make any post facto observer weep, if they were invested in the US or international markets (approx. 50% US) in early 2000: it traces 1860 to 2000 S&P Composite Stock Price Index against corporate earnings, both in real terms. This illustrates how incredibly irrational the bubble was.

PE's tell the same story. Again, this is illustrated using the real S&P Composite Price Index divided by the ten-year moving average real earnings on this index – as the ten year numbers smooth out temporary bursts in earnings, as happened during WW1. He observes: "Note again that there is an enormous spike after 1997, when the ratio rises until it hits 44.3 by January 2000. Price-earnings ratios by this measure have never been so high. The closest parallel is September 1929, when the ratio hit 32.6." He is always focussing on real (ie, inflation adjusted) data. Dealing with the aftermath of bubbles, it is fairly depressing to note that the S&P did not return to its real September 1929 value until December 1958 – yes, a mere 29 years. "The average real return in the stock market (including dividends) was: - 3.1% a year for the five years following September 1929; - 1.4% a year for the next ten years; - 0.5% a year for the next fifteen years; and 0.4% a year for the next twenty years."

He deals incisively with the structural factors and looks at the impact of Baby Boomers, the internet, and many other phenomena of the 1990's; such as DIY investors effectively creating for themselves a second job by trading stocks – one where they are, at last, their own boss. Investment analysts get a caning, for their optimistic forecasts, with the benefit of empirical evidence marshalled by Shiller.

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There are other indicia of the growing bubble, that fits history: turnover levels on the New York Stock Exchange and the NASDAQ – eg, the latter grew from 88% in 1990 to 221% in 1999.

In chapter three, he explains how Ponzi schemes work and how the overall market and the activities of exuberant investors can be likened to a giant, if fraud-less, Ponzi scheme. And, of course, this was assisted considerably by the publication of several serious and learned texts on the wisdom of patient long term investing, where fruits are always provided. There is a neat analysis of 1929, and how the media can influence the thinking of market participants. In fact, chapter four The News Media is less than flattering to the press, and also refers to his own 1987 Crash research, when he instigated the only contemporary survey of investor thinking in the immediate aftermath to the Crash. This contains numerus psychological insights and confirms his justification for the psychological feedback loop, whereby market participants feed on their own ignorance and misguided confidence.

He necessarily covers the "New Era" thinking that pervaded the 1990's, but does not poke Charley, and instead relates how this is not new in itself – something like it appears during most bubbles. There is a thorough analysis of the end of market bubbles around the world, and this will still be of value to a reader today – and in ten years time, just in case he/she has forgotten it. Australia features as 12th in the largest recent five year real stock market price index decreases: -73.5% down, Dec 1969 to Dec 1974; but then 81.5% up during the subsequent five year period.

After dealing with the behavioural aspects in detail, he proceeds to challenge his hypothesis against the efficient market hypothesis – where an excellent explanation is provided for what this theory stands for. Here the reader is left in some confusion as to whether the efficient market theory is truly antithetical to Shiller's main thesis, as although the efficient theory is on very sound ground in relation to stock-picking, this is not really challenged by Shiller. However, he must be right, and argues the case forcefully, that the efficient theory cannot justify a correct valuation of the market from time to time – as this has never been the case during any of the bubble burstings: 1929, 1966, 1973/4 and 2000; as economic and corporate valuation fundamentals during these burstings cannot possibly explain the disproportionate gyrations in market pricing.

Finally, he does appear to move out onto thinner ice when dealing with Speculative Volatility in a Free Society, as this reviewer doubts that: "as time goes on, the culture of investing will fade".

This is a scholarly work of incredible importance, and is ignored by investors at their peril.

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