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EUROPEAN MARKET COMMENT

THE FTSE ALL-SHARE: SEARCHING FOR FAIR VALUE

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Robert Lang
Rowan Harmer

The FTSE All-Share: Searching for Fair Value

What is fair value P/E for the FTSE All-Share Index? Do today's relatively low interest rates, mild inflation, and greater economic stability justify a P/E ratio greater than its post-1962 mean of 14.5? After all, the index's P/E has averaged 22.1 and 20.3 over the last five and ten years, respectively; perhaps prospective multiples will rise to a higher and more stable plateau in accord with these recent averages (Table A).

Over the long term, equity prices are based on expectations of future cash flows, adjusted for inflation. If investors pay more for equities today because they believe future real cash flows will be higher and more stable than in the past, they should reasonably expect to receive lower equity returns in the future. In other words, over the long term, real equity returns should equal the earnings yield (inverse of the long-term average P/E ratio), or the real return investors would realize if all earnings were paid out as dividends. Therefore, if investors truly believe that a P/E ratio of 20 or higher is justified today, then they must also accept a long-term expected real return of 5% or lower, compared to the 6.9% return expected based on the FTSE All-Share's average P/E ratio of 14.5 from its inception in 1962 to the end of 2003.

While this relationship should hold over the long term, we have found it relatively useless over the short term, because P/Es can diverge meaningfully from their long-term averages for prolonged periods and multiple expansion can have a meaningful impact. Even the 42-year history of the All-Share is infected by these biases, as demonstrated by the real return of 5.8% posted since 1962, compared to the 6.9% that would have been expected on the basis of the post-1962 mean P/E of 14.5.

Another approach to determining forward-looking long-term return expectations is to examine return components. Theoretically, equity returns should equal the rate of real earnings growth plus the average dividend yield (DY); we refer to this sum as the "component return." From 1962-2003, the All-Share's DY averaged 4.6%, while real earnings posted an average annual growth rate of -0.7%, producing a component return of 3.9%. Given the index's historical real average annual compound return over the period is 5.8%, 1.9 percentage points of this historical return were due primarily to multiple expansion. However, using this approach from a forward-looking perspective, the All-Share's current DY (3.1%) suggests prospective equity real returns should range from 2.5% to 5.0%, depending on assumptions of future real earnings growth, with even the top end of the range below the real return experienced over the last four decades. With a current P/E of 18.9, it seems unlikely that multiple expansion will add to returns in the future, with contraction a more likely outcome. In sum, either real earnings must compound at a significantly higher rate than they have in the past or dividend yields must rise in order for future real returns to approach those of the last 45 years—unless one invokes the highly optimistic assumption of a further expansion in the multiple.

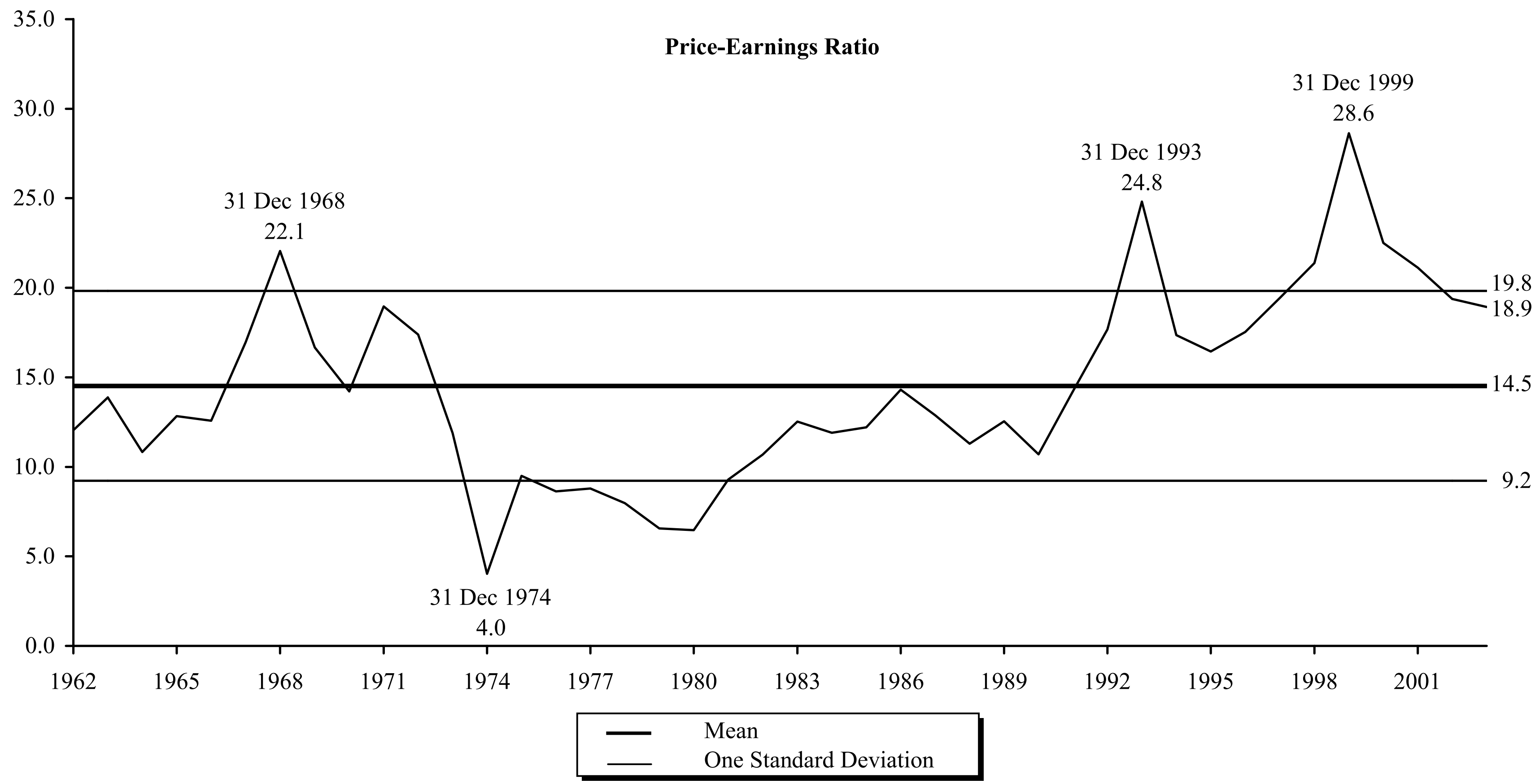
Table A

GLOBAL EQUITY MARKET VALUATIONS

FTSE All-Share Index

31 December 1962 - 31 December 2003

Price-Earnings Ratio



Source: Global Financial Data, Inc.