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What History Tells Us About the Market

The breathtakingly volatile week has left investors numb. A close study of the Great Crash, and the decades that followed, offers some unnerving context, and some reasons for optimism.

By JASON ZWEIG

July 9, 1932 was a day Wall Street would never wish to relive. The Dow Jones Industrial Average closed at 41.63, down 91% from its level exactly three years earlier. Total trading volume that day was a meager 235,000 shares. "Brother, Can You Spare a Dime," was one of the top songs of the year. Investors everywhere winced with the pain of recognition at the patter of comedian Eddie Cantor, who sneered that his broker had told him "to buy this stock for my old age. It worked wonderfully. Within a week I was an old man!"

The nation was in the grip of what U.S. Treasury Secretary Ogden Mills called "the psychology of fear." Industrial production was down 52% in three years; corporate profits had fallen 49%. "Many businesses are better off than ever," Mr. Cantor wisecracked. "Take red ink, for instance: Who doesn't use it?"

Banks had become so illiquid, and depositors so terrified of losing their money, that check-writing ground to a halt. Most transactions that did occur were carried out in cash. Alexander Dana Noyes, financial columnist at the New York Times, had invested in a pool of residential mortgages. He was repeatedly accosted by the ringing of his doorbell; those homeowners who could still keep their mortgages current came to Mr. Noyes to service their debts with payments of cold hard cash.

Just eight days before the Dow hit rock-bottom, the brilliant investor Benjamin Graham -- who many years later would become Warren Buffett's personal mentor -- published "Should Rich but Losing Corporations Be Liquidated?" It was the last of a series of three incendiary articles in Forbes magazine in which Graham documented in stark detail the fact that many of America's great corporations were now worth more dead than alive.

More than one out of every 12 companies on the New York Stock Exchange, Graham calculated, were selling for less than the value of the cash and marketable securities on their balance sheets. "Banks no longer lend directly to big corporations," he reported, but operating companies were still flush with cash

-- many of them so flush that a wealthy investor could theoretically take over, empty out the cash registers and the bank accounts, and own the remaining business for free.

Graham summarized it this way: "...stocks always sell at unduly low prices after a boom collapses. As the president of the New York Stock Exchange testified, 'in times like these frightened people give the United States of ours away.' Or stated differently, it happens because those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap."

After the epic bashing that stocks have taken in the past few weeks, investors can be forgiven for wondering whether they fell asleep only to emerge in the waking nightmare of July 1932 all over again. The only question worth asking seems to be: How low can it go?

Make no mistake about it; the worst-case scenario could indeed take us back to 1932 territory. But the likelihood of that scenario is very much in doubt.

Robert Shiller, professor of finance at Yale University and chief economist for MacroMarkets LLC, tracks what he calls the "Graham P/E," a measure of market valuation he adapted from an observation Graham made many years ago. The Graham P/E divides the price of major U.S. stocks by their net earnings averaged over the past 10 years, adjusted for inflation. After this week's bloodbath, the Standard & Poor's 500-stock index is priced at 15 times earnings by the Graham-Shiller measure. That is a 25% decline since Sept. 30 alone.

The Graham P/E has not been this low since January 1989; the long-term average in Prof. Shiller's database, which goes back to 1881, is 16.3 times earnings.

But when the stock market moves away from historical norms, it tends to overshoot. The modern low on the Graham P/E was 6.6 in July and August of 1982, and it has sunk below 10 for several long stretches since World War II -- most recently, from 1977 through 1984. It would take a bottom of about 600 on the S&P 500 to take the current Graham P/E down to 10. That's roughly a 30% drop from last week's levels; an equivalent drop would take the Dow below 6000.

Could the market really overshoot that far on the downside? "That's a serious possibility, because it's done it before," says Prof. Shiller. "It strikes me that it might go down a lot more" from current levels.

In order to trade at a Graham P/E as bad as the 1982 low, the S&P 500 would have to fall to roughly 400, more than a 50% slide from where it is today. A similar drop in the Dow would hit bottom somewhere around 4000.

Prof. Shiller is not actually predicting any such thing, of course. "We're dealing with fundamental and profound uncertainties," he says. "We can't quantify anything. I really don't want to make predictions, so this is nothing but an intuition." But Prof. Shiller is hardly a crank. In his book "Irrational Exuberance," published at the very crest of the Internet bubble in early 2000, he forecast the crash of Nasdaq. The second edition of the book, in 2005, insisted (at a time when few other pundits took such a view) that residential real estate was wildly overvalued.

The professor's reluctance to make a formal forecast should steer us all away from what we cannot possibly know for certain -- the future -- and toward the few things investors can be confident about at this very moment.

Strikingly, today's conditions bear quite a close resemblance to what Graham described in the abyss of the Great Depression. Regardless of how much further it might (or might not) drop, the stock market now abounds with so many bargains it's hard to avoid stepping on them. Out of 9,194 stocks tracked by Standard & Poor's Compustat research service, 3,518 are now trading at less than eight times their earnings over the past year -- or at levels less than half the long-term average valuation of the stock market as a whole. Nearly one in 10, or 876 stocks, trade below the value of their per-share holdings of cash -- an even greater proportion than Graham found in 1932. Charles Schwab Corp., to name one example, holds $27.8 billion in cash and has a total stock-market value of $21 billion.

Those numbers testify to the wholesale destruction of the stock market's faith in the future. And, as Graham wrote in 1932, "In all probability [the stock market] is wrong, as it always has been wrong in its major judgments of the future."

In fact, the market is probably wrong again in its obsession over whether this decline will turn into a cataclysmic collapse. Eugene White, an economics professor at Rutgers University who is an expert on the crash of 1929 and its aftermath, thinks that the only real similarity between today's climate and the Great Depression is that, once again, "the market is moving on fear, not facts." As bumbling as its response so far may seem, the government's actions in 2008 are "way different" from the hands-off mentality of the Hoover administration and the rigid detachment of the Federal Reserve in 1929 through 1932. "Policymakers are making much wiser decisions," says Prof. White, "and we are moving in the right direction."

Investors seem, above all, to be in a state of shock, bludgeoned into paralysis by the market's astonishing volatility. How is Theodore Aronson, partner at Aronson + Johnson + Ortiz LP, a Philadelphia money manager overseeing some $15 billion, holding up in the bear market? "We have 101 clients and almost as many consultants representing them," he says, "and we've had virtually no calls, only a handful." Most of the financial planners I have spoken with around the country have told me much the same thing: Their phones are not ringing, and very few of their clients have even asked for reassurance. The entire nation, it seems, is in the grip of what psychologists call "the disposition effect," or an inability to confront financial losses. The natural way to palliate the pain of losing money is by refusing to recognize exactly how badly your portfolio has been damaged. A few weeks ago, investors were gasping; now, en masse, they seem to have gone numb.

The market's latest frame of mind seems reminiscent of a passage from Emily Dickinson's poem "After Great Pain a Formal Feeling Comes":

This is the Hour of Lead --
Remembered, if outlived,
As Freezing persons recollect the Snow --
First -- Chill -- then Stupor -- then the letting go.

This collective stupor may very likely be the last stage before many investors finally let go -- the phase of market psychology that veteran traders call "capitulation." Stupor prevents rash action, keeping many long-term investors from bailing out near the bottom. When, however, it breaks and many investors finally do let go, the market will finally be ready to rise again. No one can spot capitulation before it sets in. But it may not be far off now. Investors who have, as Graham put it, either the enterprise or the money to invest now, somewhere near the bottom, are likely to prevail over those who wait for the bottom and miss it.