



Tobin's Q Now Bearish Long-Term

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The latest data for Tobin's Q-Ratio, a valuation metric shown by academic studies to be highly predictive of market performance, show that investors should brace themselves for sub-par returns over the next 10 years.

"Tobin's Q is now sending a long-term bearish signal," said John Mihaljevic, whose publication, [The Manual of Ideas](#), provides regular updates on movements in the Q-Ratio. Mihaljevic was a research assistant for James Tobin, the Nobel Prize-winning economist who introduced the Q-Ratio.

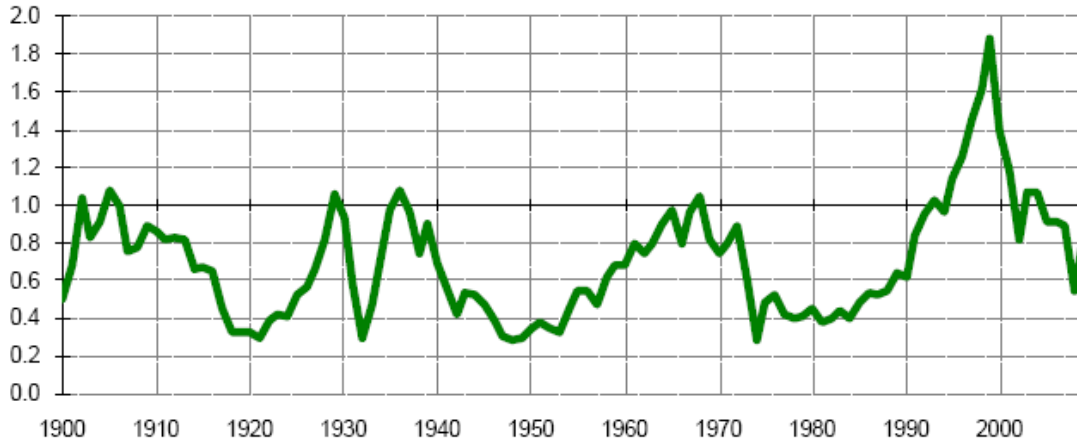


The Q-Ratio measures the market value of a company (its stock price) relative to the replacement cost of its assets. A value greater than one indicates that a company's assets could be purchased more cheaply than the company itself and, hence, the market is overvaluing the company, while Q ratios less than one indicate market undervaluation.

We have written about the Q-Ratio twice previously (see [here](#) and [here](#)).

As of September 21, the market-wide Q-Ratio was 0.86. Putting that in perspective, since 1900 the Q-Ratio has reached that level 11 times:

Tobin's Q Ratio, 1900 – September 18, 2009



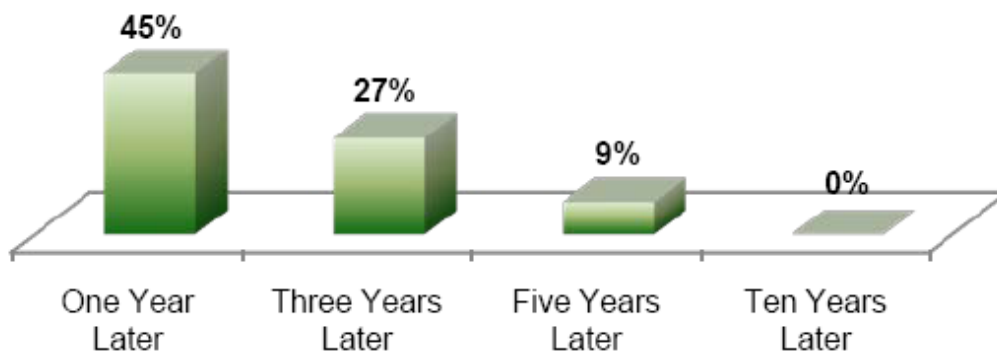
This chart consists of two data sets: 1900-1944: We use a modified Blanchard, Rhee, Summers series. We adjust the data to reflect the series' upward bias as compared to the Tobin (new) methodology developed by James Tobin and John Mihaljevic. 1945-2009: We use the Tobin (new) series. We believe this combined set of data from 1900-2009 provides the most accurate historical rendering of the Q ratio. Source: The Federal Reserve; Blanchard, Rhee, and Summers; *The Manual of Ideas*.

The Q-Ratio was higher one year later in five instances and unchanged in one instance. Only three out of eleven times, the Q-Ratio was higher three years after the initial increase (it was lower in seven instances).

The most remarkable insight, according to Mihaljevic, is that 10 years after the other times the Q-Ratio reached 0.86, it was lower 10 out of 11 times. In the final instance (2002-3), the 10 years have not yet passed.

When Tobin's Q Rises to 0.86+, Is It Higher or Lower After One Year, Three Years, Five Years and Ten Years?

(percentage of instances when subsequent Q was higher; based on data from 1900-2009)





“Given the consistently bearish historical experience when measured over ten-year time horizons, investment managers deciding to buy equities today at an estimated Q of 0.86 are implicitly arguing that this time will be different,” Mihaljevic said.

He added that the Q-Ratio’s signal over the short-term is much less certain, so investment managers decreasing their equity positions based on this signal do so at the expense of creating significant “career risk” for themselves.

He added one important caveat regarding the bearish mid- to long-term outlook for U.S. equities: Erosion of Tobin’s Q may not necessarily translate into declining equity prices if replacement costs increase at an accelerating pace, perhaps because of inflation.

The replacement cost of structures, equipment, software, and inventories represents the denominator of the Q-Ratio. Replacement cost has historically increased at a single-digit annual pace, though increases have been higher during inflationary periods. If replacement costs rise sharply, Tobin’s Q could decline even as market value remains constant or increases. If the Fed’s “quantitative easing” and other liquidity-boosting measures, coupled with the government’s record fiscal stimulus, produce an inflationary environment, equity prices could rise, Mihaljevic said.

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