

# Profitable INVESTING Tips

## Stock Market Investing Tips, Techniques, and Resources



### What Is the CAPE Ratio?

By [www.ProfitableInvestingTips.com](http://www.ProfitableInvestingTips.com)

The CAPE ratio averages out the P/E ratio over a ten year period. This acts like important moving averages to reduce the influence of fluctuations in the economy and the market. CAPE is an acronym for cyclically-adjusted P/E ratio and was made popular by Robert Shiller, an economics professor at Yale University. We recently wrote about the [dangers of a high P/E ratio](#). Using the CAPE instead of the standard P/E ratio reduces this risk. While the P/E ratio shows stock price divided by earnings per share the CAPE averages out the stock price and earnings over a decade. This measure is more commonly applied to market indices like the S&P 500, NASDAQ, or Dow Jones industrial average than to individual stocks. As such it is a useful indicator of an over-priced or underpriced market.

### CAPE Ratio Formula and What It Tells You

Here is how to calculate the CAPE ratio.

CAPE Ratio = (Share price ten year average adjusted for inflation) divided by ten-year inflation-adjusted earnings

This approach is useful for long term investors who use [intrinsic stock value](#) as a guide. The CAPE ratio for individual stocks gives you a better picture than the immediate P/E ratio of how good an investment will be over time.

Although Professor Shiller has popularized the CAPE in recent years, it was first suggested by Benjamin Graham and David Dodd in the 1930s in their book, *Security Analysis*. Shiller and John Campbell used the approach in the run up to the dot com crash and accurately predicted how badly the market would fall due to its being overpriced in the late 1990s.

The limitation of the CAPE, like the P/E ratio, is that it is backward-looking and does not take into account new technology or trends.

### CAPE Ratio 2021

Will the CAPE ratio be useful as we move into 2021 with the pandemic peaking and the economy tanking? The value of the CAPE ratio is that its value at any given time is closely correlated with the prospects of a security over the following 20 years. Thus, it may not give a lot of insight into if and when there will be a market crash in 2021 or a raging bull market. But, it does tell us what to expect from any given sector, stock, or market over the coming years. Since long term investing depends on holding stocks for seven to ten years or more, the CAPE is useful for long term planning. If you believe that stocks are hugely overpriced in relation to the current CAPE ratio you may be able to predict a correction or crash but not the exact timing.

## **NASDAQ Cape Ratio**

Over the last few years the CAPE ratio for the NASDAQ 100 has consistently come in higher than the P/E ratio. P/E ratios the tech giants in NASDAQ have been high over the last few years. This indicates the potential for corrections. The higher-still CAPE ratios indicate the potential for long-term corrections. This would most-likely happen as interest rates rise, society comes out of the Covid-19 pandemic, and work-from-home becomes an option instead of a necessity.

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