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# How should investors value stocks? And do valuations matter?

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**Valuing equities is both art and science. While discounted cash flow models are the theoretical gold standard, they are difficult to apply at the market level.**

Investors often rely on shorthand metrics like price-to-earnings (P/E) ratios. The P/E ratio for an index, like the S&P 500, tells you how much investors are willing to pay for each dollar of earnings generated by all the companies in that index. But these have limitations. A P/E based on expectations of earnings over the coming 12 months has the advantage of being forward-looking. However, analyst forecasts can be unreliable. Trailing earnings can be seen as more solid, but they may not reflect future growth.

The cyclically adjusted price-to-earnings (CAPE) ratio, also known as the Shiller P/E, measures stock prices relative to average earnings over the past 10 years, adjusted for inflation. Its main advantage is that it smooths out short-term fluctuations and business cycle effects, giving a better sense of long-term market valuation. However, it can be misleading if structural changes—such as tax reforms or shifts in accounting standards—distort historical earnings, and it may not accurately reflect current market conditions or future growth prospects. As a result, CAPE is best used as a broad valuation tool rather than a precise timing indicator for investment decisions.

Finally, investors can consider the equity risk premium, which is the extra return investors expect from stocks compared to safer government bonds, reflecting the higher risk of owning equities. It helps gauge the relative appeal of stocks

—if the premium is high, stocks look more attractive versus bonds; if it's low, investors may prefer the safety of bonds instead.

Crucially, one-year P/E ratios have shown little predictive power for short-term returns, based on our analysis. Even cyclically adjusted P/Es, which smooth out earnings over a decade, only loosely correlate with long-term outcomes. Relying solely on these metrics would have kept investors out of the market for much of the past 30 years—a costly mistake given the strong returns.

Original report – [CIO Tutorial: Should investors fear an equity bubble?, 10 November 2025.](#)

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