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# A Tactical Implication of Predictability

Fighting the FED Model

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## Abstract

This article confirms that high earnings yields portend high equity returns. Absolute valuation levels of equity have predictive power over future long-run equity returns. The predictability is far less powerful in the short term. On a tactical investment horizon, investors tend to rely on the relative valuation of equity versus bonds to gauge whether equity markets are attractive. The FED model, which compares earnings yield and bond yield, is the preferred yardstick in the finance profession. First, this article examines the FED model and shows that it is not only theoretically flawed, but also unable to predict equity returns over long sample periods. Second, Salomons improves the model by adding corrections for perceived risk, enabling a better fit of the data. The article concludes with its main innovation, testing a tactical asset allocation model constructed on the basis of the improved FED model. A model portfolio taking advantage of the short-term deviation in relative value, corrected for risk, leads to superior performance.

**TOPICS:** [Security analysis and valuation](#), [fundamental equity analysis](#)

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**IN THIS ISSUE**

**The Journal of Investing**  
Vol. 15, Issue 2  
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[Table of Contents](#)  
[Index by author](#)

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