What Drives Long-Term Stock Returns?

Analyzing the primary driver of equity returns.

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Q2 2023

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One oft-repeated investing phrase is that in the long run the primary driver of stock returns is growth. Whether it be earnings, free cash flow, or revenue growth, there are a few different flavors of this statement. Regardless of the form it takes, they say the same thing—in the long run it is business fundamentals, not changes in valuations, that drive the bulk of stock returns.

But how true is this statement? I've seen studies that look at a single measurement period and isolate the impact of various factors on stock returns, but does the impact of these various factors change over time? Just because something was true in the past decade doesn't guarantee that it was true two decades ago (or, critically, that it will be true in the future).

To examine these questions, we dug into S&P 500 returns from 2021 all the way back to 1927 (which was as far back as we could find the relevant data). Using data provided by Nasdaq and Bloomberg, we decomposed returns into three components:

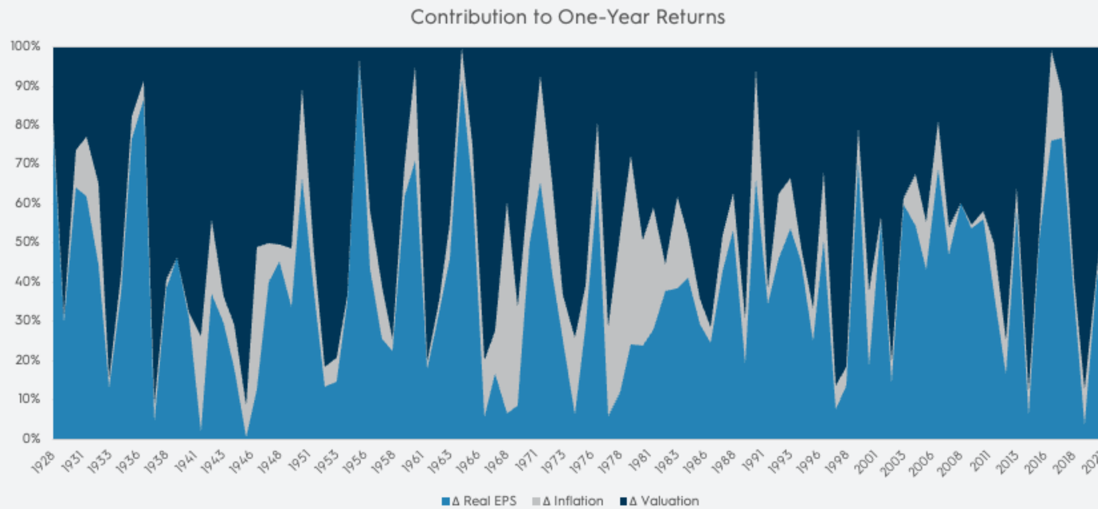
- Real (inflation-adjusted) earnings growth
- Inflation's impact on earnings
- Changes in valuation (P/E multiple)

The reason we removed the effects of inflation from earnings per share (EPS) growth was to determine the contribution of true value creation—over and above the prevailing change in prices—to investor returns. We also felt like it was timely to look at inflation on its own, given how high inflation has been trending above recent norms.

As a baseline, we started by examining returns over a one-year time frame. One of the implications of the idea that "growth drives long-term returns" is that short-term results are more random in nature, with a higher likelihood of valuation (aka investor sentiment) playing an outsized role. Or as the famous Benjamin Graham quote goes: In the short run, the market is a voting machine, but in the long run, it is a weighing machine.

This is what you see when you decompose one-year returns. As the chart below shows, the readily apparent pattern was that there was no pattern. But changes in the P/E multiple were frequently the largest contributor to the index's annual returns and, interestingly, P/E multiple changes were also more closely correlated with negative returns—whereas the market finished the year in the red only 21% of the time when

real EPS growth had the biggest impact on market returns, the market had a negative return 41% of the time when changes in the P/E multiple played the biggest role. Intuitively, this makes sense—major disruptions in the global economy notwithstanding, investor sentiment can be more fickle than changes in EPS.



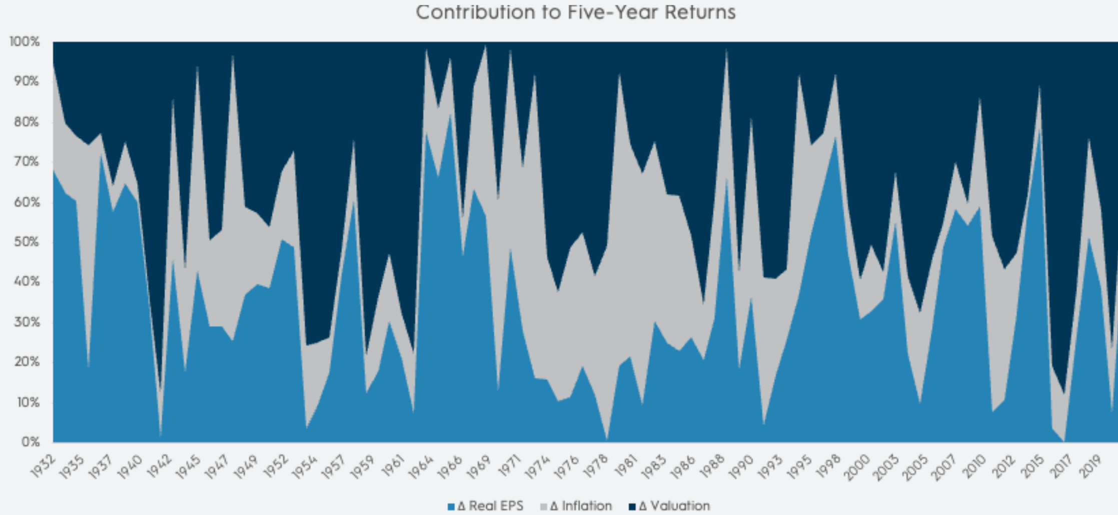
Source: Bloomberg, Nasdaq, author's calculations.

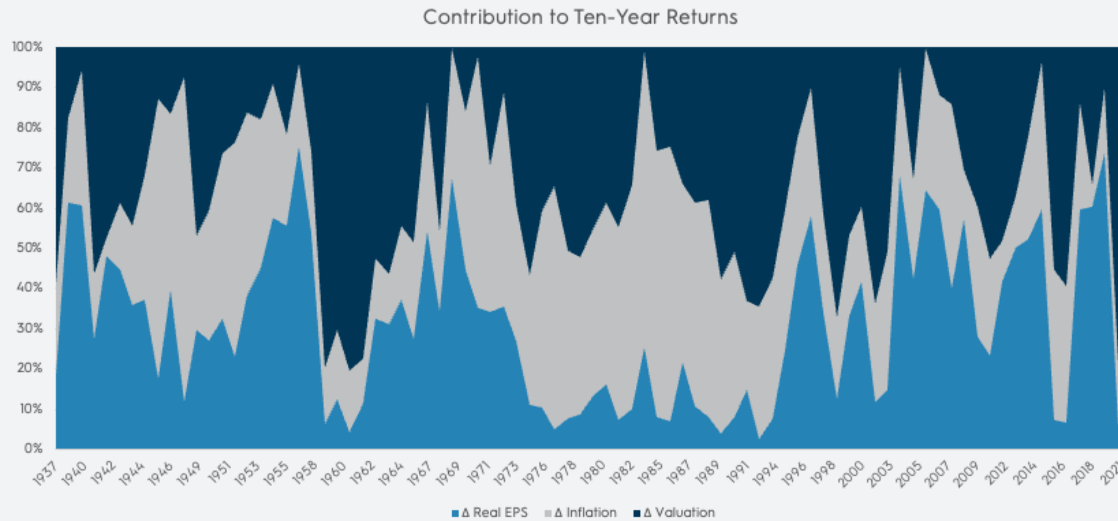
The Long Term and the Longer Term

Before jumping straight to our long-term time frame of 20 years, we analyzed the 5- and 10-year rolling returns, since these time frames can be considered "long term."

We were also curious if it would help illuminate any noticeable trends as you begin to stretch out your investment horizon. Although changes in valuation multiples were still the primary driver over these longer time frames, it was clear that its grip on returns was lessening.

Over the one-year time frame, changes in the P/E multiple was the largest contributor to returns an estimated 60% of the time, but this fell all the way down to 50% when the time frame is stretched out to five years. And it fell even further—to 44%—when using a 10-year time frame. Real earnings growth was closing the gap. And for the first time, you can also see the outsized impact inflation can have on returns, in particular during the high inflationary 1970s and 1980s. As we noted in a previous white paper, one of the most surprising aspects of the bull market of 1982-1987 was that adjusted for inflation, earnings per share actually *fell* over this time frame.





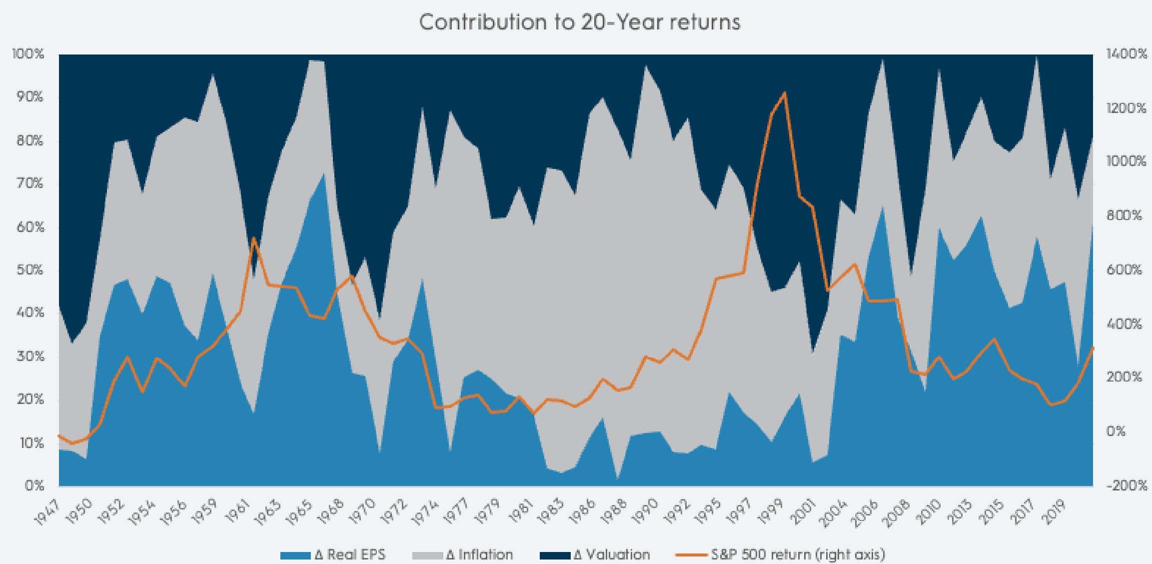
Source: Bloomberg, Nasdaq, author's calculations.

Moving on to our 20-year rolling time frame, valuation's reign as the frequent primary driver of stock returns has officially come to an end. In this longer-term picture, it trailed both real EPS growth and inflation. Looking at the chart below, there are a few things that stand out:

Although changes in valuation were no longer the frequent primary driver of returns, this is not to say it no longer mattered. As you can see in the chart, multiple (expansion) was the primary driver during the two highest peaks in the S&P's rolling-20-year returns (1960s and dot-com bubble).

The impact of the sustained high inflation of the 1970s and 1980s on the market is even more evident and resulted in it being the primary driver of returns all the way into the 1990s.

It is easy to see why the notion that growth drives equity returns in the long run has become such a widely adopted belief—real EPS growth has been the primary driver of rolling-20-year returns for much of the past two decades.



Source: Bloomberg, Nasdaq, author's calculations.

The Primary Driver of Equity Returns...

If there is one thing that I hope you take away from this analysis, it is this: Yes, it is true that growth can in fact be the primary driver of stock returns. And it can be so over short-, medium-, and long-term time frames. But it is also true that inflation and multiple expansion can be the primary driver of stock returns over those same time frames. Analyzing a single time period can be valuable, but it is also very dangerous if you then extrapolate those results backwards and assume that it is always the case.

The fact is, any time-period analysis is going to be highly dependent on the conditions of your starting and ending points. It is very easy to see how someone performing this analysis in the late 1980s would likely come to a very different conclusion than someone performing the analysis at the tail end of the dot-com bubble, or someone today who only looks at the past two decades. But the rolling-20-year analysis paints a

clear picture of changes in regimes, where the dominance of one factor sets the stage for another to drive returns in the subsequent years.

And this is why it is perhaps fair to say that the primary driver of equity returns is not growth, valuations, or inflation. It is time.

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