Long-Term Perspective: Understanding How Valuations Impact Portfolio Returns

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The S&P 500 has rallied +50% since the start of 2023 and more than +150% from the COVID pandemic low in March 2020. The rally has produced a long list of all-time highs and boosted investment portfolios, but it has made broad market indices more expensive. The S&P 500 currently trades at over 21 times its next 12-month earnings estimate, a level not seen outside of periods like the late-1990s tech boom and the recent post-COVID recovery, when interest rates were near zero. Why do high valuations matter? History shows that while valuations have a limited impact on short-term returns, they play a critical role in determining long-term performance.

Figure 1 shows the relationship between the S&P 500's starting valuation and future returns. The horizontal axis represents holding periods in years, and the vertical axis shows the R-squared (R2) between the S&P 500's starting valuation and its forward return. R2 is a statistical measure that shows the predictiveness between two variables. For example, an R2 of 0.40 indicates that 40% of the changes in one variable can be attributed to changes in the other variable, while the remaining 60% is due to other factors or random variation. The left side of the chart tracks short holding periods of only a few years, revealing a low R2 between valuations and forward returns. The takeaway is that the S&P 500's starting valuation doesn't explain a significant portion of its short-term return. However, the R2 increases as you move across the chart, showing that valuation explains a larger portion of longer-term returns. For a 10-year holding period, the S&P 500's starting valuation explains ~80% of the variability in returns, highlighting valuation's importance for long-term investors.

Figure 2 expands on the importance of valuations by plotting the S&P 500's starting valuation against its next 10-year annualized return. The starting valuation represents the S&P 500's normalized price-to-earnings (P/E) multiple, which is calculated as the current price divided by the average inflation-adjusted earnings over the past ten years. The line slopes from the top left to the bottom right, indicating that as the starting valuation increases, forward returns decrease. The current normalized P/E ratio of 37 times is marked on the chart, suggesting the S&P 500 could produce a low single-digit annualized return over the next ten years.

The previous statement carries significant weight, but it's important to put context around historical analysis like this. While past performance offers valuable insights, it doesn't guarantee future outcomes, and timing the market is difficult. Figure 1 shows that valuations

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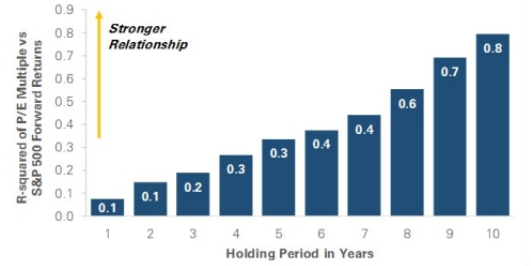
aren't reliable indicators of short-term market returns, and markets can remain expensive longer than expected. However, given the rarity of today's starting valuation, it's important to acknowledge the potential impact on forward returns when setting expectations for the years ahead.

FIGURE 1 – Historical Relationship Between Valuation & Holding Period



Source: Past performance does not guarantee future results. Data is based on Shiller Economic Library using monthly data from January 1, 1985 to December 31, 2024. Price to Earnings data is represented by the Cyclically Adjusted Price-Earnings (CAPE) ratio. CAPE is a valuation metric that measures the price of a stock relative to its average inflation-adjusted earnings over a 10-year period.

FIGURE 2 – S&P 500 P/E vs Forward 10-Year Annualized Return

Source: Past performance does not guarantee future results. Data is based on Shiller Economic Library using monthly data from January 1, 1985 to December 31, 2024. Price to Earnings data is represented by the Cyclically Adjusted Price-Earnings (CAPE) ratio. CAPE is a valuation metric that measures the price of a stock relative to its average inflation-adjusted earnings over a 10-year period.

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The S&P 500 Index or Standard & Poor's 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

The Russell 2000 index measures the performance of approximately 2,000 small-cap US equities.

The MSCI EAFE Index is a stock market index that measures the performance of large- and mid-cap companies across 21 developed markets countries around the world. Canada and the USA are not included.

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The Nasdaq 100 Index is a stock index of the 100 largest companies by modified market capitalization trading on Nasdaq exchanges.

The Russell 1000 Growth index is an index that tracks large cap, growth stocks. This benchmark is important for investors that might tilt their investments towards large cap growth. Growth stocks, in comparison to value stocks, are considered companies with a more growth potential, and a higher risk profile.

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The Dow Jones Industrial Average, or simply the Dow, is a stock market index that indicates the value of 30 large, publicly owned companies based in the United States, and how they have traded in the stock market during various periods of time. These 30 companies are also included in the S&P 500 Index. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company. The sum is corrected by a factor which changes whenever one of the component stocks has a stock split or stock dividend, so as to generate a consistent value for the index.

The Bloomberg US Aggregate Bond Index is used as a benchmark for investment grade bonds within the United States. This index is important as a benchmark for someone wanting to track their fixed income asset allocation.

The Bloomberg US Corporate Index covers performance for United States corporate bonds. This index serves as an important benchmark for portfolios that include exposure to investment grade corporate bonds.

The Bloomberg US Corporate High Yield Index covers performance for United States high yield corporate bonds. This index serves as an important benchmark for portfolios that include exposure to riskier corporate bonds that might not necessarily be investment grade.

Treasuries, also known as Treasury securities, are debt obligations issued by the United States government. They are used to raise cash needed to fund government operations and help finance the federal deficit. Treasuries are backed by the full faith and credit of the US government, making them one of the safest investments. They are an important instrument in monetary policy, allowing central banks to control the money supply.

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