

Chart of the Month | January 2025

Long-Term Perspective: Understanding How Valuations Impact Portfolio Returns

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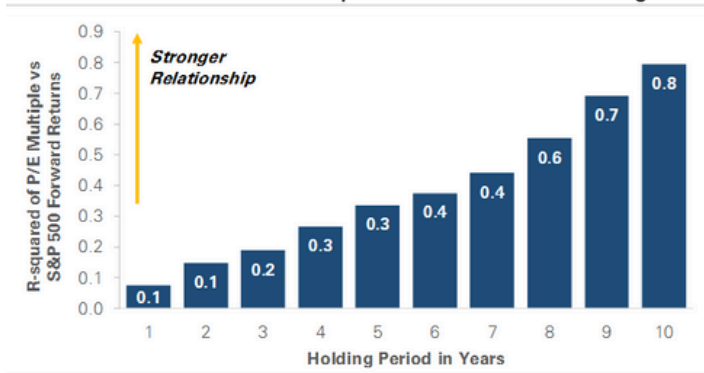
The S&P 500 has rallied +50% since the start of 2023 and more than +150% from the COVID pandemic low in March 2020. The rally has produced a long list of all-time highs and boosted investment portfolios, but it has made broad market indices more expensive. The S&P 500 currently trades at over 21 times 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 (R^2) between the S&P 500's starting valuation and its forward return. R^2 is a statistical measure that shows the predictiveness between two variables. For example, an R^2 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 R^2 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 R^2 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 somewhat lower returns over the next ten years. This highlights the importance of staying diversified with exposure to other areas of the global markets with more reasonable valuations.

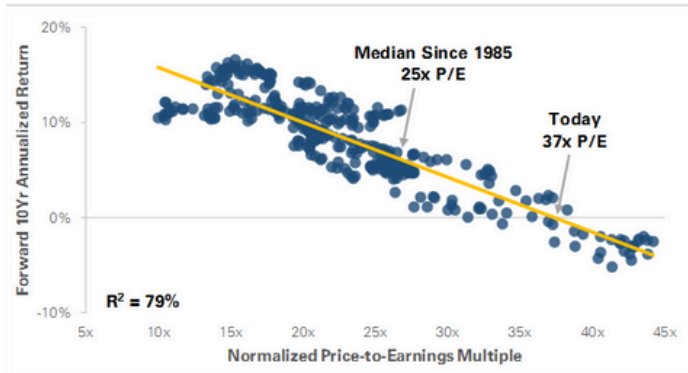
While current valuations carry significant weight, it's important to put context around historical analysis like this. While past performance offers valuable insights, it doesn't guarantee future outcomes, and timing the market is difficult. Figure 1 shows that valuations aren't reliable indicators of short-term market returns, and markets can remain expensive way 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



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