

WHAT'S THE PRIMARY DRIVER OF INVESTMENT RETURNS?

(Spoiler Alert: It's *NOT* Earnings!)

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Part 1: The Evidence That Stares Us in The Face



What drives investment returns? In Finance and investing, the loudest answer is, “It’s the Earnings, stupid!”

Quarterly, anxious investors scrutinize company earnings reports, rewarding those meeting their ‘expected’ numbers, beating the ‘whisper,’ and providing strong future guidance while punishing all others. The percentage of earnings ‘meets/exceeds’ is taken as an indicator of the overall market strength.

Apart from Earnings, Dividends and P/E (Price-to-Earnings multiple) complete the classic investment returns equation:

Return Growth = Earnings Growth + Dividends Growth + P/E Growth (multiple expansion/contraction).

Now you know. You have graduated, right?

Not exactly.

We believe that this widespread 20th-century idealization is just an ‘undergraduate’ fiction that doesn’t withstand the ‘graduate’ scrutiny of modern analysis. Here is a table (popularized by Vanguard’s Bogle) tracking the three drivers per decade across the entire recorded US market history (S&P 500). For pattern recognition, each driver’s values are range-shaded from red (below-average) to green (above-average):

Notice how the asterisked data contradicts the notion that Earnings are the primary driver of Returns: above-average Earnings (9.9%) in the 40s and 70s accompany below-average returns (8.6% and 5.9%, respectively), while below-average Earnings in the 50s (3.9%) and 80s (4.4%) coincide with above-average returns (20.1% and 17.3%, respectively). In contrast, the P/E Multiple driver correlates well (80%) with the Returns distribution—above-average multiples match above-average returns, and vice versa!

Wow, how is it possible that the P/E Multiple hasn’t been recognized as the primary Returns driver?!

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In Part 2, we will analyze the nature of this all-powerful but elusive driver and the breakthrough insights it can provide.

RETURN DRIVERS (based on S&P 500)

	Earnings (descending)	Dividends	P/E Multiple	Annual Returns	
2010s	10.6	2.0	1.0	13.6	
1940s	9.9	5.0	-6.3	8.6	* ? *
1970s	9.9	3.5	-7.5	5.9	* ? *
2020s	7.8	1.6	2.5	11.9	
1990s	7.4	3.2	7.2	17.8	
1920s	5.6	5.9	3.3	14.8	
1960s	5.5	3.1	-1.0	7.6	
1900s	4.7	3.5	0.8	9.0	
1980s	4.4	5.2	7.7	17.3	* ? *
1950s	3.9	6.9	9.3	20.1	* ? *
1910s	2.0	4.3	-3.4	2.9	
2000s	0.8	1.2	-3.2	-1.2	
1930s	-5.6	4.5	0.3	-0.8	

Source: J. Bogle, *Don't Count on it!* (2011) updated for 2000's via S&P Global and YCharts.

Part 2: *Market Regime*—The Super Driver

Part 1 showed how 20th-century practitioners and academics felt the need to anchor Returns in the Earnings of the corporations that issue stocks and bonds to secure their 'fundamental' reality and make them tractable. Buffet popularized that fiction.

Yet, the unfolding evidence hasn't been supportive: strong Earnings in the 40s and 70s led to below-average returns, while poor Earnings in the 50s and 80s underwrote strong returns!

Meanwhile, some noticed that the P/E Multiple hinted at a stronger driver—as the table shows, its below-average values line up uniformly with below-average Returns, and vice versa!

However, understanding this driver's nature has been challenging. Many consider it a derivative backfill of the Returns equation, while others speculate it reflects investor sentiment—an ethereal factor quantifiable only in hindsight.

Utilizing modern theoretical frameworks (witness the Fed's invocation of interest rate 'regimes') and tools that extend beyond the 3rd-generation of Factor investing, our research and strategies have come to understand that this mysterious driver represents the market's organizational dynamic—its health, investment-worthiness, or *Market Regime* status.

While most view the markets as a collection of prices shaped externally (by corporate earnings, the economy, central bank decisions, and geo-/politics), we understand that the market's immense complexity and scale endow it with the emerging self-organization and self-regulation of a Regime. This gives the market a resilient directional orientation, sustained homeorhetically against most exogenous forces.

In our work, we use two sets of proprietary tools to actively monitor the status of the Market Regime *before* it registers retrospectively as a P/E Multiple. This enables our strategies to position adaptively for a robust or weak return cycle, which can make a significant difference!

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2010s	10.6	2.0	1.0	13.6
1900s	4.7	3.5	0.8	9.0
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