

Thoughts on U.S. Market Valuations

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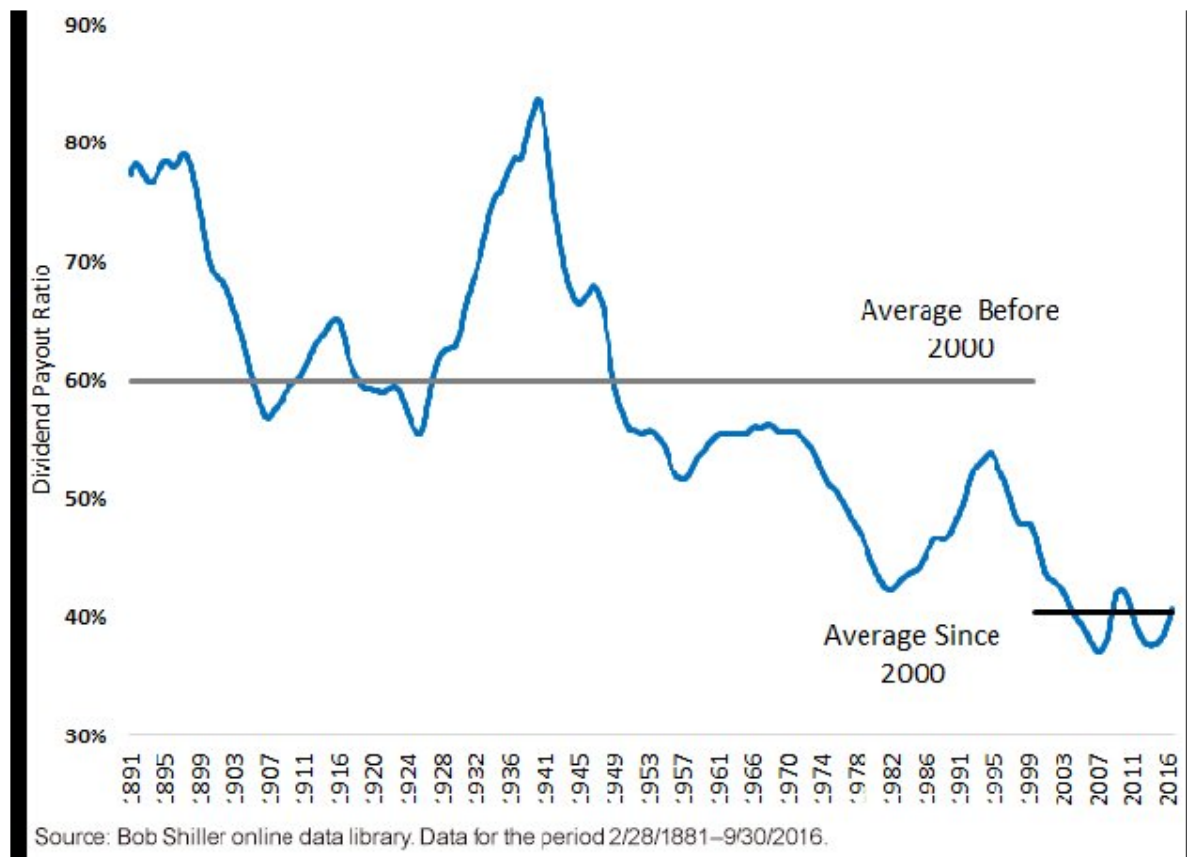
Global Chief Investment Officer

At the Chartered Financial Analyst (CFA) Institute Annual Conference in Philadelphia last month, there were a number of conversations with dour outlooks for the future of U.S. equity markets. The center stage of the conference featured a debate between Yale Professor Robert Shiller, designer of the CAPE (cyclically adjust price-to-earnings) ratio, versus my mentor, Professor Jeremy Siegel.

Shiller has a more subdued outlook for future returns than Siegel, who is a bit more optimistic. Jack Bogle also presented at the conference and suggested we've seen strong gains in the markets over the last 35 years that resulted from valuation expansion, and hence also had a more subdued outlook. Bogle's model was fairly simple: take the 2% dividend yield on the market today, add in his personal estimates of 4% earnings growth, and subtract 2% from speculative market activity or his anticipation of a decline in valuation ratios over the coming decade, and you come up with an outlook for 4% returns over the coming decade. If we assume there is 2% inflation, this would lead to just a 2% real return after inflation. Note that this is largely similar to Shiller's outlook for returns.

One chart that I think is not talked about enough in the context of valuation changes on the market is the dividend payout ratio of the market. I show a smoothed 10-year average dividend payout ratio in the spirit of Shiller's 10-year smoothed earnings for the CAPE ratio. Prior to 2000, the dividend payout ratio averaged 60%. Since 2000, the dividend payout ratio has averaged 40%. This change in the nature of how firms reinvest their earnings, conduct stock buybacks, and pay dividends is absolutely critical to the future earnings growth we are likely to get.

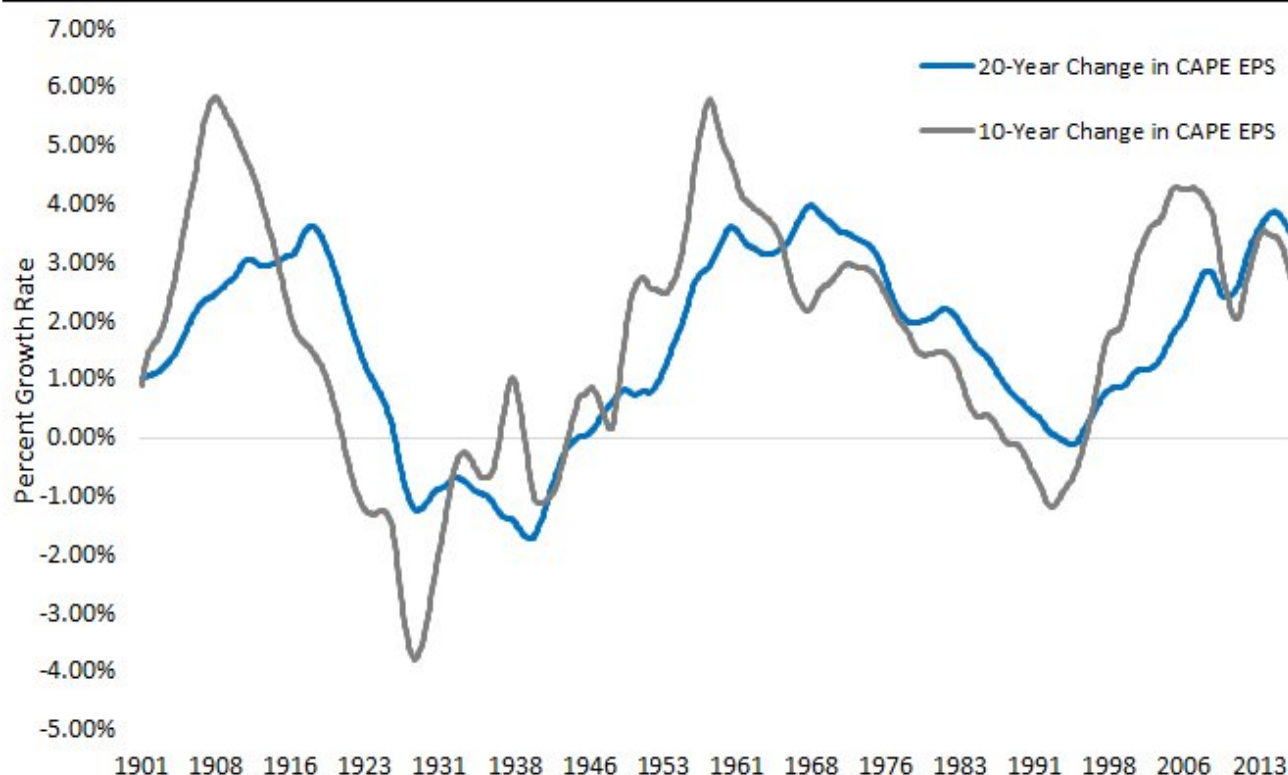
10-Year Average Smoothed Dividend Payout Ratio



Those who assume that earnings growth rates will revert to some historical average growth rate when firms paid out 60% of their earnings as dividends are assuming that all this money not being paid out—used for either buybacks or other reinvestment in business—is being completely wasted. That is an incorrect assumption, in my view.

This chart looks at the rolling 10-year and 20-year earnings growth rates of the CAPE earnings per share (EPS) that Bob Shiller uses to make his dour forecasts on the market. If these numbers were to “mean revert,” that would be a cautionary tale for the markets. But in my view, the earlier declining dividend payout ratio means we are likely to see upside changes to these earnings figures. What is possible?

Growth Rates in 10- and 20-Year CAPE EPS



Source: Bob Shiller online data library. Data for the period 2/28/1881–9/30/2016.

Changing dividend payout ratios have already translated to better earnings growth. Prior to 1982, the average dividend yield on the U.S. equity market was approximately 5% per Shiller's data, and we had an average dividend payout rate of nearly two-thirds of earnings paid out as dividends. With only a third of earnings reinvested, firms were still able to achieve earnings growth of 3.3% per year.

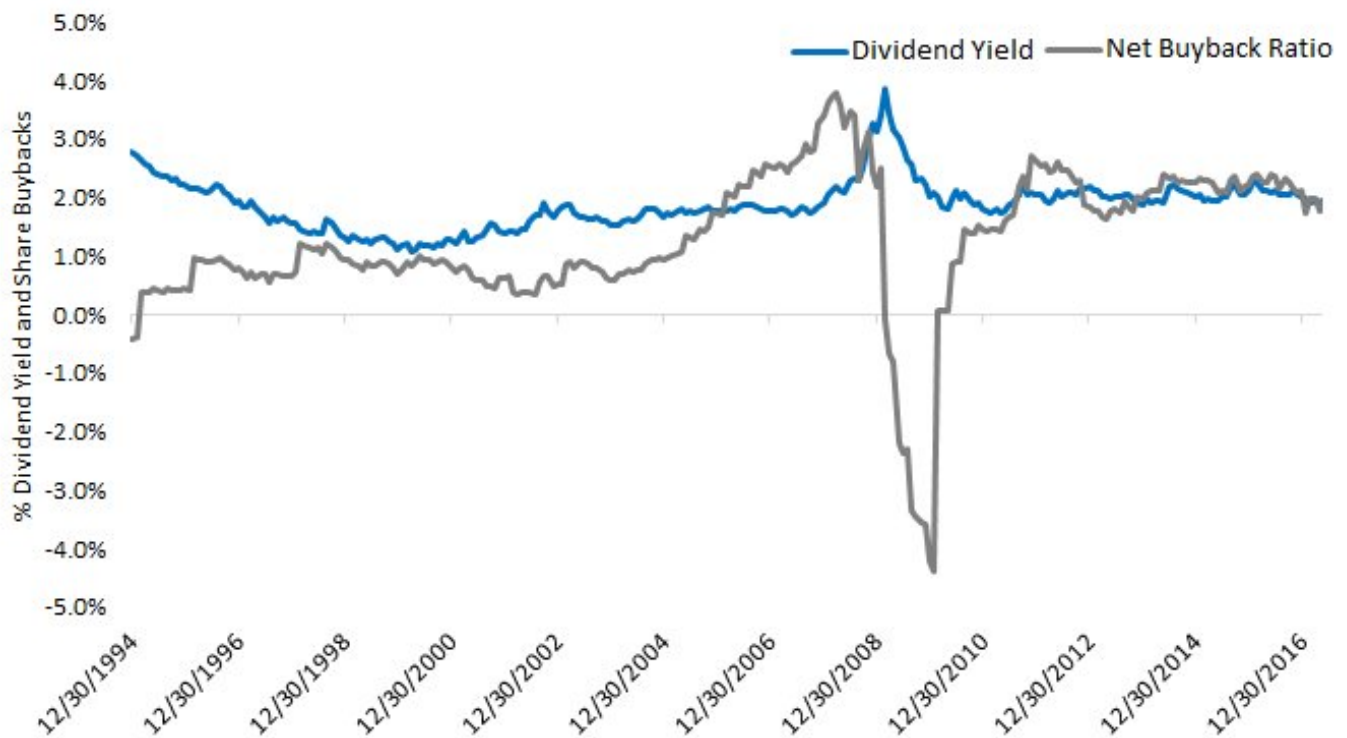
	EPS Growth	Avg Div Yield	Avg Payout
1871-1982	3.3%	5.0%	64.7%
1982-2016	4.9%	2.5%	51.1%

Source: Bob Shiller online data library. Data for the period 2/28/1881 –9/30/2016.

Past performance is not indicative of future results.

Since 1982, payout ratios declined to an average of 51.1%, while at the same time firms started conducting stock buybacks. The average EPS growth during this period of reducing dividend payout ratios was an increase of 160 basis points (bps) per year, from the previous long-term average of 3.3% per year to 4.9% per year.

When we look at the last 20 years, and particularly the last seven, we see consistent signs of 2% dividend yields with 2% net buyback ratios. These net buybacks are going to continue to support earnings growth for the 10-year look-ahead period. These firms have locked in future EPS growth because they reduced their shares outstanding.



Sources: WisdomTree, FactSet. Data for the period 12/30/1994–5/19/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

Returning to the table above, where I showed the earnings growth since 1982 as being higher than the previous 110 years, the current dividend payout ratios are consistent with an even further drop in the payout ratios from their average since 1982. I can see a case that earnings growth picks up even from that 4.9%-per-year mark that we had for the period 1982–2016. It would not surprise me to see earnings growth of 6% to 7% per year over the next decade.

The standard pushback is that firms are just leveraging up to conduct buybacks—that interest rates are at historical lows, leading to higher margins than are sustainable. The reverse case is that the changing composition of companies—into higher-margin businesses that have more revenue abroad with lower tax rates than in the U.S.—also means margins may not be mean reverting anytime soon either. Of course, no one knows how the future will unfold, including me.

The charts above caution anyone relying on historical patterns of earnings growth trends from overextrapolating them into the future. Professor Siegel looks at the current earnings yield of the market associated with a 20 price/earnings ratio and thinks 5% is a pretty good indicator of long-term, after-inflation real returns. Add in inflation of 2% and you get 7% nominal returns. This is a touch below their historical 6.5% to 7% that he showed in *Stocks for the Long Run* as being the historical return to U.S. equities, but it is not

dramatically different. I think his model for looking at the markets makes more sense than some of these more dour predictions—for what that's worth.

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