

## Perceptions versus reality

One of the more fascinating things about stock markets is how much they can move on a daily basis despite how little the underlying fundamentals, specifically the financial health of the underlying company, change on a day-to-day basis. The reason is that the fundamentals are only part of the story. The rest of the value is derived from its prospects in the future, the assessments of which are far more subjective and fickle.

To put it in more technical terms, the value of an equity is a function of the economic reality (i.e., corporate profitability) and perceptions of the future (i.e., valuation). Given that economic reality tends to change periodically, perhaps with earnings announcements, it stands to reason that the main determinant of price movements is most likely changes in valuation.

The breakdown of performance data for the S&P 500 Index over the last seven decades shows that over short time horizons, valuations (price-to-earnings) are effectively the sole driver of returns, with optimism pushing valuations higher and generating gains, while pessimism detracts.

### Breakdown of drivers of S&P 500 returns over different time horizons

Investment horizon	% contribution of price return*	
(months)	Earnings	Price-to-Earnings
1	2	98
3	14	86
6	26	74
12	34	66
24	56	44
36	57	43
60	61	39
120	77	23

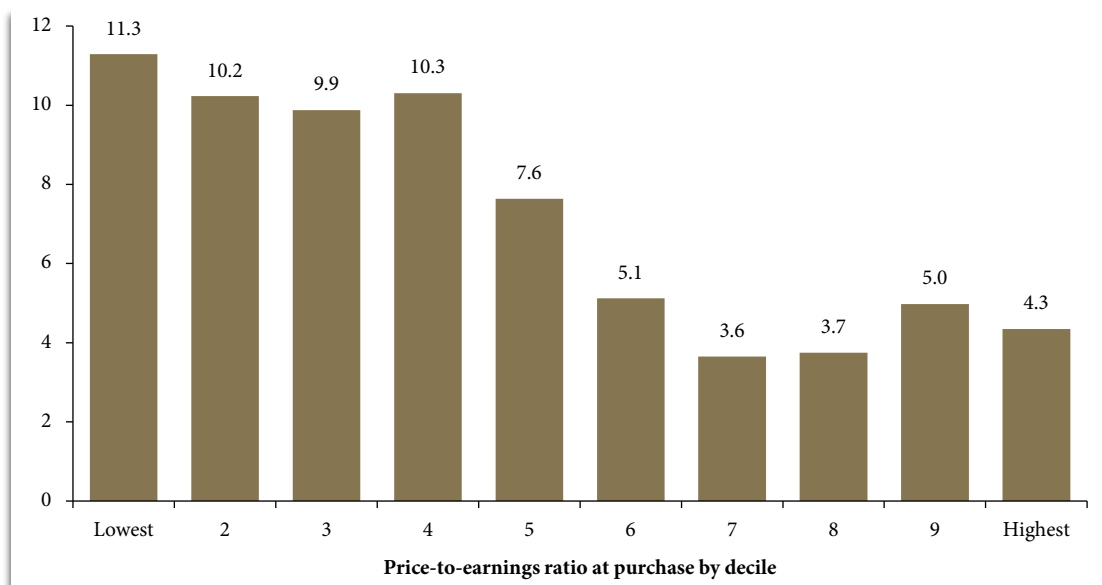
\*Median contribution over a given period based on data from January 1954 to April 2023

However, as the duration of investment lengthens, the shifts in perception about the future become less important and cede performance leadership to the fundamentals (aka earnings), and the added contribution from valuations only really comes when multiples are skewed toward extremes (highs or lows).

**In other words, the key to successful long-term investing is to buy and hold equity in high-quality companies that can generate sustained, above-average earnings growth that is reasonably valued.**

Not a new or revolutionary approach to building wealth, but one that requires the farsightedness and discipline to look past the short-term ebbs and flows of markets.

**S&P 500 10-year forward price return by valuation at purchase**  
(annualized percent)



Source: Guardian Capital based on data from Bloomberg from January 1954 to April 2023

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