

COMPOUNDING EARNINGS: EQUITIES MARKETS' RELIABLE GROWTH ENGINE

November 2023

We believe equity investors should prioritize earnings growth, as data indicate it is the main driver of stock market returns over the long term.

Investors have no shortage of constructs through which to view the equities universe. Prominent among these is categorizing stocks into growth and value styles. Contrary to conventional wisdom, we don't view these categories as a binary choice. Seeking companies capable of compounding earnings over a multi-year horizon and exercising valuation discipline are both essential – and complementary – components of a fundamentals-based investment process that aims to maximize excess returns.

The contribution of earnings growth to broad equities market returns cannot be overstated. Over time, data suggest that stock prices follow earnings. But solely focusing on unearthing high-growth opportunities is not enough; investors must also be valuation conscious.

Applying valuation discipline with respect to selecting and holding securities can prove beneficial when navigating the market cycle. We consider this approach a complementary, middle path that bridges the gap between growth and value strategies. By replacing sometimes-rigid style investing with a more pragmatic – and nuanced – approach, equities investors stand to position themselves to more fully participate in the earnings growth that we believe is the main driver of long-term equity returns, while also reaping the benefits inherent in maintaining valuation discipline.



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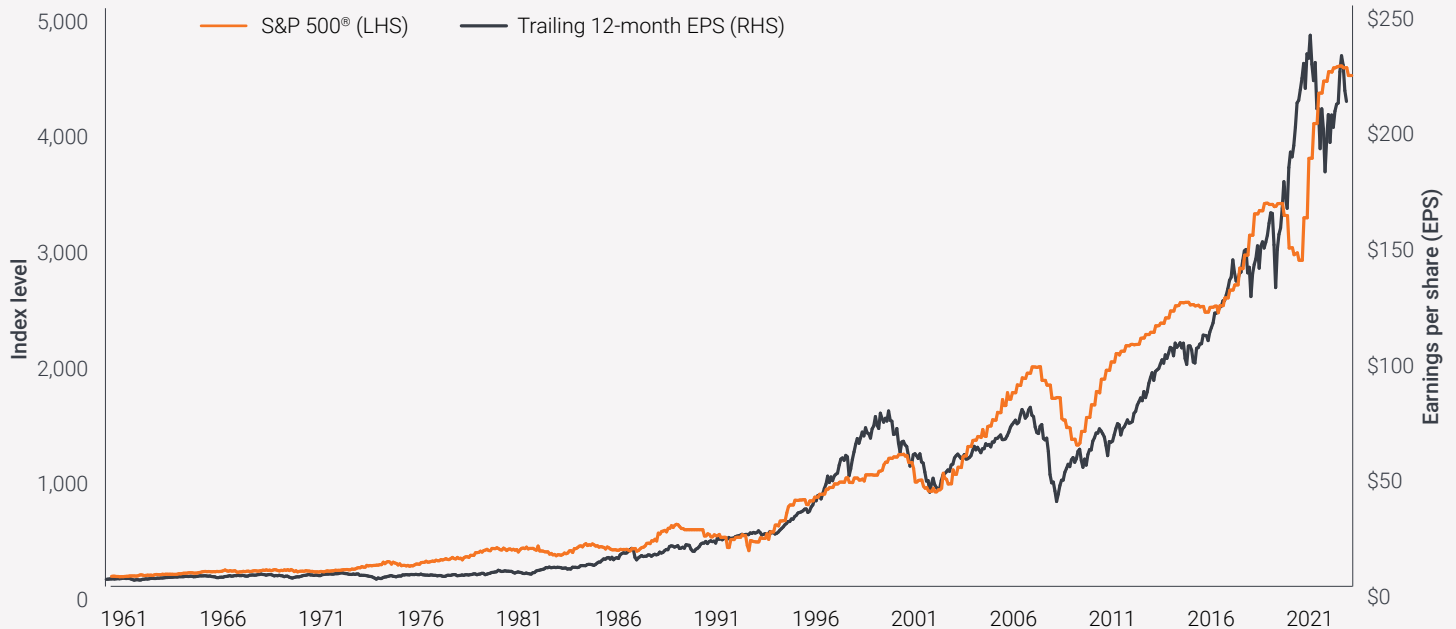
Key takeaways

- As stock prices typically follow earnings, we think investors should prioritize earnings growth to achieve their objective of consistently generating excess returns.
- Specifically, investors should seek to identify attractively valued companies with earnings visibility that are capable of delivering quality earnings growth.
- With the pace of disruption increasing, we believe companies that provide innovative solutions have the potential to generate durable earnings growth, as do their customers who embrace these services.

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Past performance does not predict future returns.

Exhibit 1: Equities and earnings over the years

While many factors can influence stock prices, over the long term, their trajectory is largely determined by the prospects for corporate earnings growth.



Source: Bloomberg, as of 31 October 2023.

Why earnings growth?

To better understand the logic underpinning style investing, one needs to disaggregate total equity returns into their three components: earnings growth, changes in valuation (i.e., the price-earnings (P/E) multiple), and dividend yield. The first two can vary considerably across the market cycle, while dividends' contribution tends to remain fairly constant.

Growth strategies focus on earnings insofar that they expect the broader market has underestimated the pace or duration of earnings growth. Even when the P/E multiple remains constant, earnings growth that exceeds what has been priced in by the market should lead to a rising stock price.

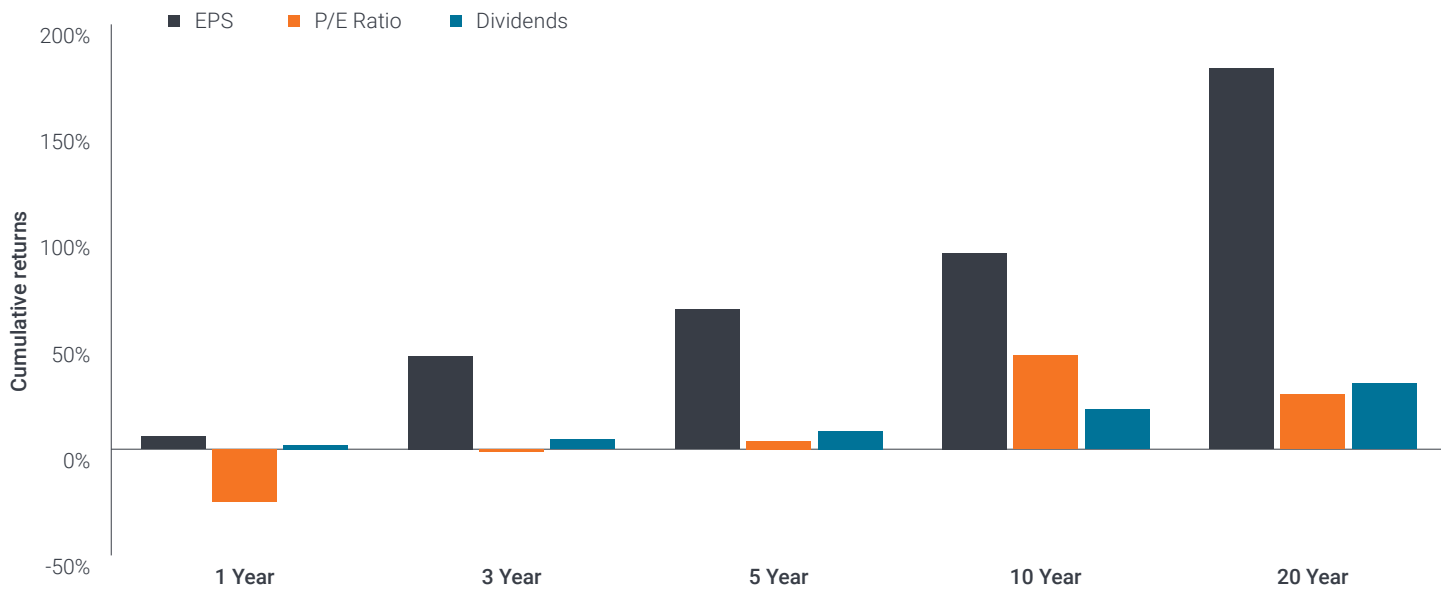
Within the context of growth investing, there is, however, a hint of the value style's key tenet, which is the market underappreciating a company's potential. In the eyes of a growth investor, if a stock's price truly reflected a company's long-term earnings prospects, there would be fewer – or no – future earnings surprises pushing the price higher. Growth investors believe such surprises exist, and that success is determined by having a differentiated view from the market on a company's prospects.

Furthermore, growth investors rely upon the P/E multiple to not only identify underappreciated stocks but also eliminate overpriced ones. Valuations, after all, can reach levels that cannot be justified by even the most bullish assumptions. This discipline can be best encapsulated in growth at a reasonable price (GARP), in contrast to the growth at any price mantra that often leads to unfavorable outcomes.

While we believe that the constructs of growth and value share more attributes than one would expect, they are not the same. As illustrated in Exhibit 2, in all but the shortest time horizons – which can be influenced by ephemeral cyclical factors – earnings growth has easily been the main driver of total equity returns.

Exhibit 2: Source of S&P 500® Index returns over a range of time horizons

In all but the shortest time horizons, earnings growth has been the primary driver of aggregate stock market returns.



Source: Janus Henderson, Bloomberg, as of 31 October 2023.

It's clear why earnings assume such a prominent role in a stock's trajectory. The benefits of compounded earnings growth are numerous. Foremost, management teams gain flexibility. They can reinvest in the business, reducing their reliance on capital markets when funding new initiatives, and cash flows in excess of reinvestment can be returned to shareholders. Consequently, we consider free-cash-flow growth to be an even more powerful barometer of delivering shareholder value than earnings growth, as the latter can include myriad noncash items.

Still, being valuation aware can yield tactical results as multiples can help identify price dislocations that may lead to outsized gains and serve as a sell signal should a stock price greatly exceed a company's intrinsic value. Valuations move continuously. In addition to company-specific factors, drivers of multiple expansion (and compression) include the market cycle, industry dynamics, and – as was the case in 2022 – the discount rate, as evidenced by rising interest rates weighing on equities.

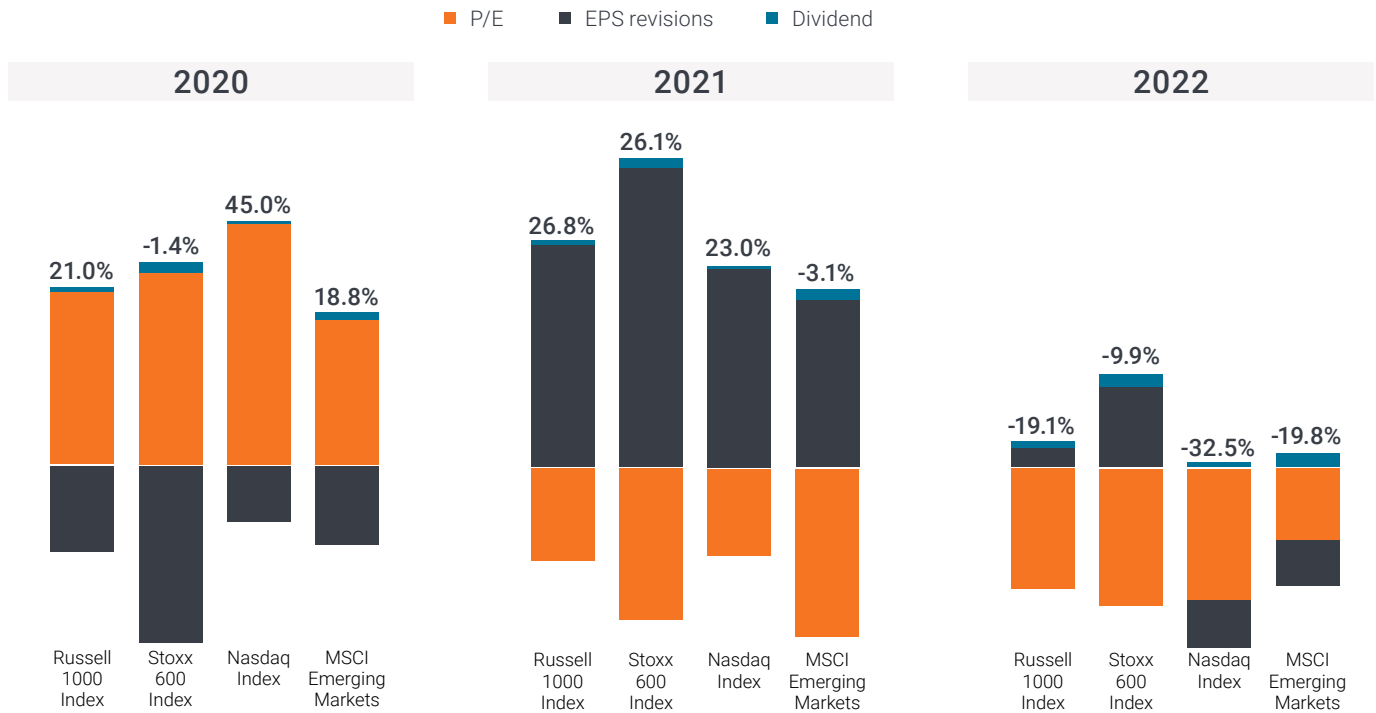
Multiple rerating only goes so far as a driver of excess returns; once fair value is reached, the potential for additional multiple expansion diminishes. As price discovery unfolds over time, the benefits of multiple expansion and compression tend to offset each other. Expecting to consistently generate excess returns by surfing oscillating valuations is, in our view, a daunting task and can lead

to performance volatility. Such a tactic is premised on impeccably timing the market, which runs counter to our philosophy of "it's not timing the market, but time in the market" – a point all the more salient when discussing the possibility of compounding earnings growth.

In 2020, for example, global equities' strong gains were driven by substantial multiple expansion as investors positioned themselves to reap the benefits of stimulus-financed consumption. At the same time, company earnings were generally down due to the impact the pandemic had on economic activity. In the ensuing year, market gains were driven by upward earnings revisions as the economy reopened. By 2022, however, even modestly positive earnings revisions were not sufficient to keep stocks out of correction territory as historic rate increases led to multiple compression greater than 20% across most major markets.

Exhibit 3: Components of total global equity returns

Each of the years illustrated below had different total returns drivers, with 2020's multiple expansion and 2022's multiple compression offsetting each other as investor sentiment shifted based on near-term forces.



Source: Bloomberg, Janus Henderson Investors

Major swings in P/E multiples across equities markets during this three-year stretch would have created a conundrum for short-term investors seeking appropriate entry and exit points. Yet, over this period, the resurgence of earnings growth after the cessation of lockdowns resulted in mid-single-digit annualized total returns across most major equities markets.

Quality growth and the market cycle

Investors often reference valuations when tactically adjusting equity allocations as they navigate the market cycle. This practice, in our view, is not in conflict with our belief that earnings growth should take center stage throughout the cycle. To reconcile these approaches, one must understand the relevance of quality – or smart – growth.

In a sluggish economy, investors are willing to accept a higher multiple to access stocks with the promise of generating earnings growth higher than the broader market. In the recent period of ultra-low rates, investors scrambled for stocks that promised just that. But many companies survived only on easy access to cheap capital as well as the elevated valuations afforded to them by low discount rates. Some had little chance of consistently generating free cash flow. Investors that focused on quality growth – meaning strong business models capable of steady earnings –

were able to gain exposure to earnings growth in a low-growth, low-rate world, but not set themselves up for failure once the cycle turned. As rates increased in 2022, resilient growth companies fared much better than those with lower-quality earnings profiles.

Similarly, as an economy nears recession – often at the hands of monetary tightening – investors can take a defensive stance by focusing on quality growth companies that have the potential to compound earnings even in a downturn.

Once the market begins to look through the economy's nadir, some investors take that as an "all clear" sign and allocate toward a broad swath of low-multiple stocks. Here, too, by focusing on quality and recognizing that multiple rerating should be premised on an improved earnings profile, investors can avoid eventual value traps.

More than hype

Future market and economic trends, in our view, lend themselves to prioritizing earnings growth and deemphasizing traditional style strategies when constructing equities portfolios.

Foremost, the pace of technological innovation, including artificial intelligence (AI), across the economy has never been faster. It's not just hype. We believe companies that create innovative solutions should grow earnings far faster than peers who fail to grasp the magnitude of this paradigm shift. The same holds true for organizations that integrate these services into their businesses.

While valuations can get stretched and markets can sometimes overestimate the near-term value (underscoring the need for a valuation discipline), we believe the market also tends to underestimate the long-term power of such shifts. Discerning the winners from the losers within the context of these secular themes requires increased emphasis on fundamental analysis.

Consequently, investors that focus on the ascendent trends in the global economy – including geopolitical realignment, demographic changes, and the impact of a higher cost of capital – should be well positioned to identify which companies are on the right side of these forces and, thus, can grow earnings faster than the broader market expects.

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Russell 1000® Index reflects the performance of U.S. large-cap equities.

STOXX® Europe 600 Index represents large, mid and small capitalization companies across 17 countries in the European region.

MSCI Emerging Markets IndexSM reflects the equity market performance of emerging markets.

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