MORNINGSTAR Managed Portfolios

Investment Insights
Valuation: The Key to Understanding Past and Expected Returns

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Key Takeaways

- All investment strategies will experience times of underperformance. If investors trade out of a portfolio after it underperforms, they lock in those losses—something that can destroy wealth over time.
- Often periods of underperformance are followed by rebounds. But when might an investor expect a portfolio to rebound?
- We believe valuation is key to understanding past and expected returns. Valuation changes are like the wind—sometimes at our backs, sometimes in our faces. We should understand when performance is aided or hindered by valuation changes.
- Also, valuations can inform expected returns because historically very high and very low valuations tend to revert to the mean, or move back to normal levels (without predicting *when* prices might change direction).

How Can Investors Avoid Procyclical Behavior?

One of the more well-known social aspects of investing is the behavioral challenges we face, both as investors in individual stocks as well as at the portfolio level. For instance, when a stock has performed well, we are tempted to assume its prospects are improving and we tend to nudge up our fundamental estimates. When the stock is a laggard, we might start to lower our expectations to fit the market's pessimism. This is called *recency bias* because we tend to more easily recall the recent past than we do other information. Biases like this can let price—rather than an asset's fundamental characteristics—dictate the investing narrative. This leads to procyclical behavior—buying after (and often *because*) something's gone up, or selling after (and often *because*) something's gone down.

This phenomenon is universal across investing, not just stock investing. We also know this behavior as *performance chasing*.

How do we keep ourselves and our clients from mistakenly bailing on a stock or strategy when performance has suffered? Speaking from experience and first-hand accounts, the strategy I now manage hit such a rough spot a few years ago. After a number of years of strong performance, the tide turned. Inflows became outflows. Advisor cheers turned to doubts. What changed?

I came aboard to manage our Dividend Select Equity Portfolios in August 2018, near the nadir of underperformance. In my estimation at the time, the portfolio was sound. Many of the same companies that had driven upside in years past were still owned and the underlying businesses were performing as well as ever. The difference was the market's appetite for these companies, that is, valuation. Staying

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the course by maintaining positions in high-quality, wide-moat businesses—sticking to the strategy's design—is usually the best call. And in this case, valuations slowly recovered and performance improved.

Understanding Opportunities

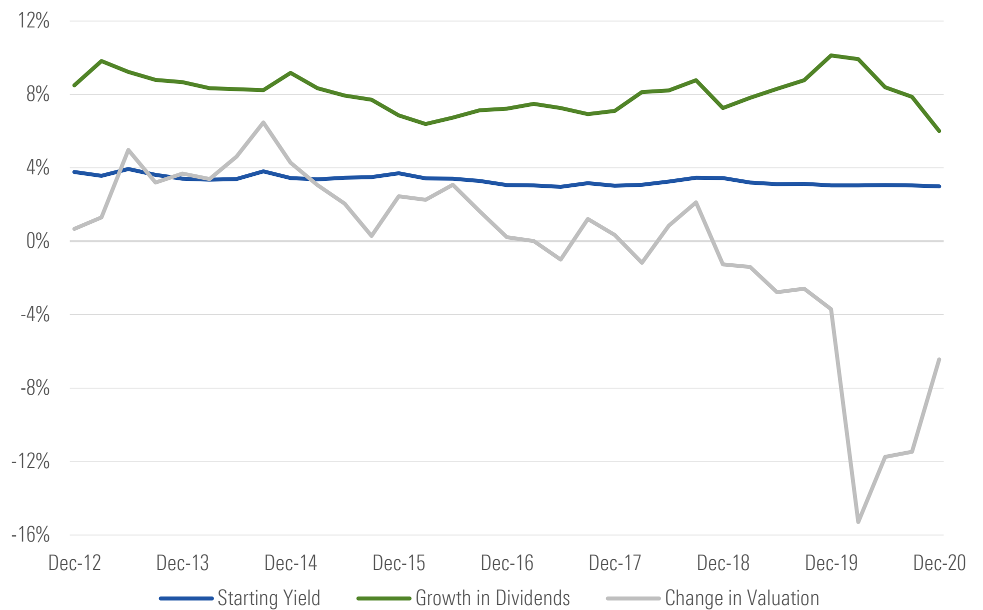
So again, how can investors know when to stick it out and when to realize it's time to sell? We believe the answer lies in focusing on fundamentals while keeping a close eye on valuation. Doing so can give us a better understanding of the drivers of return, which in turn can help us know when to stay the course and when to chart a new one.

Being valuation-driven investors, we are acutely aware of how valuation, or more specifically, the change in valuation, will impact our returns. Ignoring these impacts can have serious consequences for investors. Finding a company whose stock has a well-covered dividend yield and accurately estimating an entity's long-term growth isn't enough to fully understand the potential reward and risks in owning a security. Evaluating the components of total return—including expected changes to valuations—can help investors to take advantage of market opportunities and to stay the course when necessary.

Valuation Changes, Illustrated

To demonstrate, below we evaluate rolling three-year performance of a broad-market dividend index,

Exhibit 1 With Yield and Dividend Growth Steady, Valuation Changes Drove Performance



Source Morningstar Direct. Data is three-year periods, rolled quarterly (for 33 3-year periods), for the Dow Jones US Select Dividend Index for 10/01/2009 to 12/31/2020. The full data period was determined by index data availability.

the Dow Jones US Select Index, over the 11.25 years ended Dec. 31, 2020,[1] to identify attribution of the various components of total return. In summary, we found:

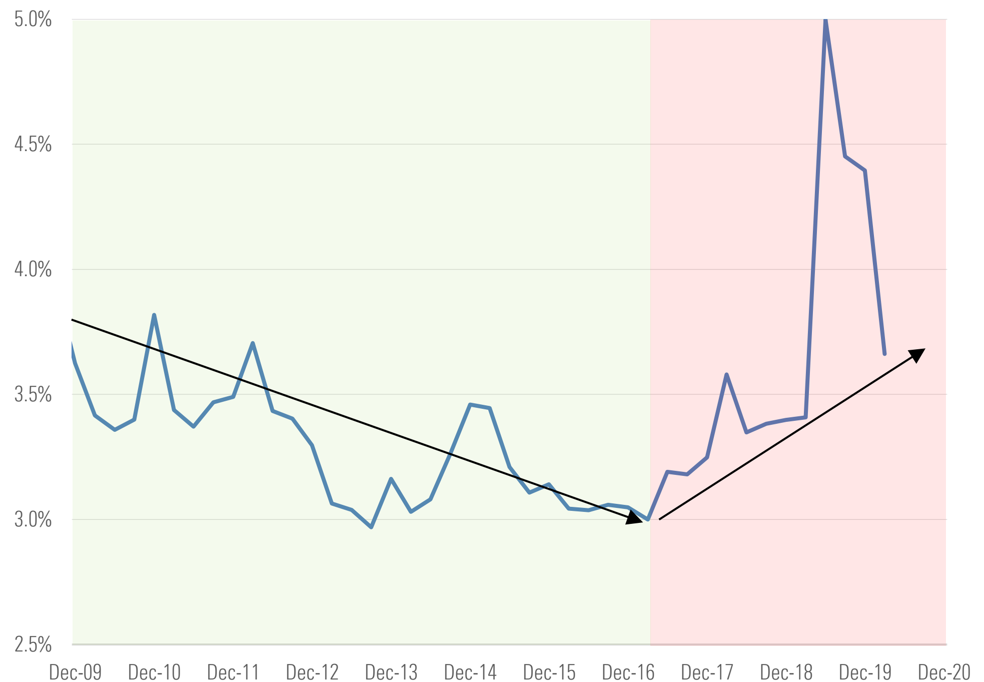
- Starting yield was always positive and fell in a range of roughly 3%-5%.
- Three-year compounded annual growth for dividends was positive for all three-year periods, and growth ranged between 6%-10% annually.
- The contribution from change in valuation had the widest range, oscillating between positive and negative and going deeply negative during the height of the COVID-19-driven market panic.

To emphasize the point, let's look at two different three-year holding periods, one ending 12/31/2017 and the next ending 12/31/2020.

At year-end 2017, the Dow Jones US Select Dividend Index had posted a trailing annualized three-year return of 11.0%. We attribute this total return to 1) a starting yield of 3.0%; 2) growth in dividends of 7.1%; and a small positive amount for change in valuation as the yield fell from 3.03% to 3.00% at the end of the period.

Compare that to year-end 2020, where the index posted a trailing annualized three-year return of 3.0%—fully 8 percentage points lower than the 2017 period. Was starting yield terribly low in the 2020

Exhibit 2 Falling Dividend Yields [%] Tend to Boost Returns, While Rising Dividend Yields Stifle Them



Source Morningstar Direct. Data is dividend yield for the Dow Jones US Dividend Select Index as of 12/31/2020.

1 The data begins Oct. 1, 2009—the earliest available for the index—and tracks three-year periods, rolling quarterly, until Dec. 31, 2020.

period? Growth negative? Neither was the case. Starting yield was 3.0% and growth in dividends was 6.0%—both closely comparable to the 2017 case. The difference was largely explained by change in valuation, which accounted for a whopping negative 643 basis point headwind to total return.

In both cases, investors knew the starting yield. We presume most could have made a reasonable estimate of growth. However, in one case change in valuation rewarded investors with an outsized return and in the other, it acted as a bitter headwind. The change in valuation has the effect of magnifying or minimizing the returns available from the underlying fundamental factors of current yield and dividend growth.

The appearance of a steady yield (the blue line in Exhibit 1) is shown to be anything but when inspected in isolation in Exhibit 2.

There was a clear trend in the post-financial crisis period where dividend yields compressed lower. The nadir was reached in mid-2017. Since then, the last several years have seen a reversal of this trend as yields reverted back toward the average. Valuation-inflated returns through mid-2017 gave way to valuation-compressed returns after. And with it, investor enthusiasm for dividend investing went from euphoric to despondent.

Underlying both periods was a steady stream of current income that grew in excess of the rate of inflation. Focusing on these fundamentals, with an eye on valuation and its impact on expected return, is the right approach, in our opinion.

Of course, in the short run, changes in valuation are much like shifts in the wind. At times, they will be at our back, and at others, they produce a headwind. Typically, it is only with hindsight that we fully understand what drives changes in the short run. But in the long run—that is, over the full holding period for our investments—fundamentals drive the change. Deep fundamental research can help us identify those opportunities where the winds are likely to shift and incorporate the additional return into our expectations.

What Do Valuations Look Like Today?

Where to from here is the question investors most desire the answer to. And, of course, the answer depends on time horizons and risk tolerance. That said, we can look at total return fundamentals and see what may make sense.

For an investor who desires an 8%-10% return from their equity investments and presumes the long-term growth rate of dividends to track that of corporate earnings at 5%-6%, then a 3%-4% dividend yield is appropriate. As yields approach the lower end of that range, investors would be wise to not extrapolate out stronger-than-average returns. Likewise, when markets sell off and yields approach the upper end the range, investors might take a page out of Charlie Munger’s book and view the returns with the equanimity required to be long-term investor. M

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