What Do Current Valuations Tell You About Prospective Returns?

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19th Mar 2021

The returns that you generate in the equity market is a function of probability. It is difficult to predict what returns you would generate, as the returns are a function of multiple possible outcomes that could play out during your investment period. But we can still use historical evidence to estimate whether the odds are in your favour or not.

What do the following examples of 3-year and 5-year returns tell you about the stock market?

i. If you had invested in Jan 2008 (when the market valuations were at a historical peak), your 3-year prospective returns (CAGR) would have been negative 2.1% and 5-year prospective returns (CAGR) would have been a negative 0.9%.

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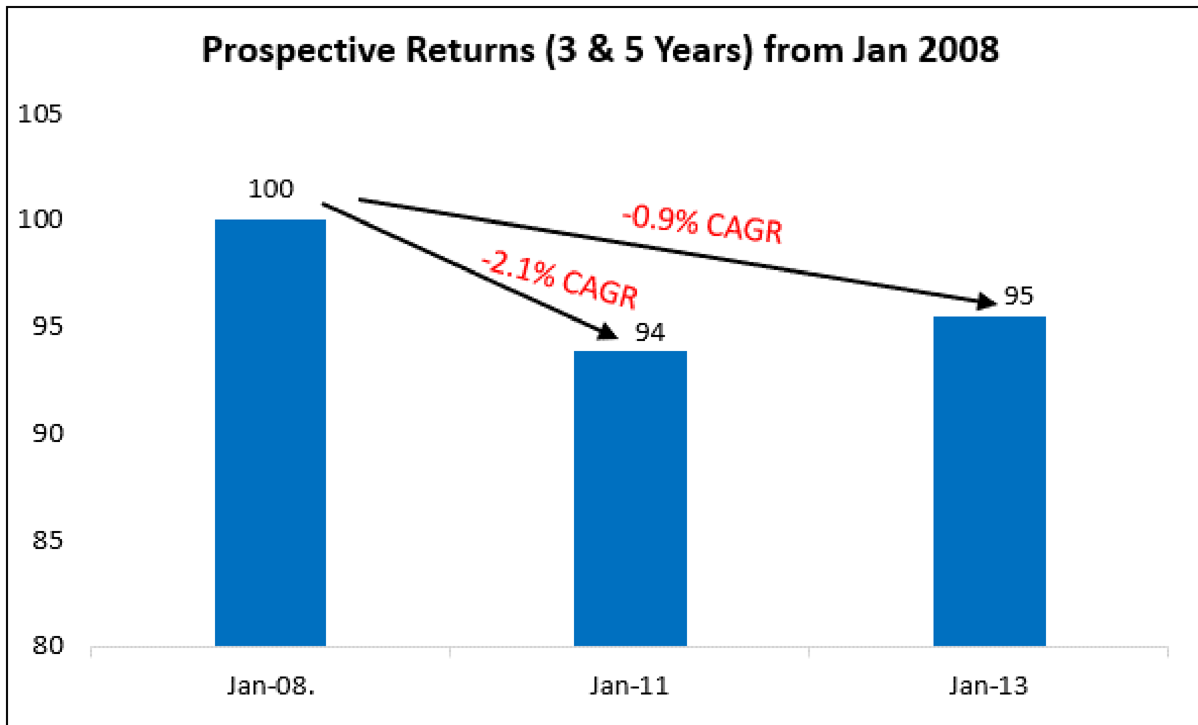
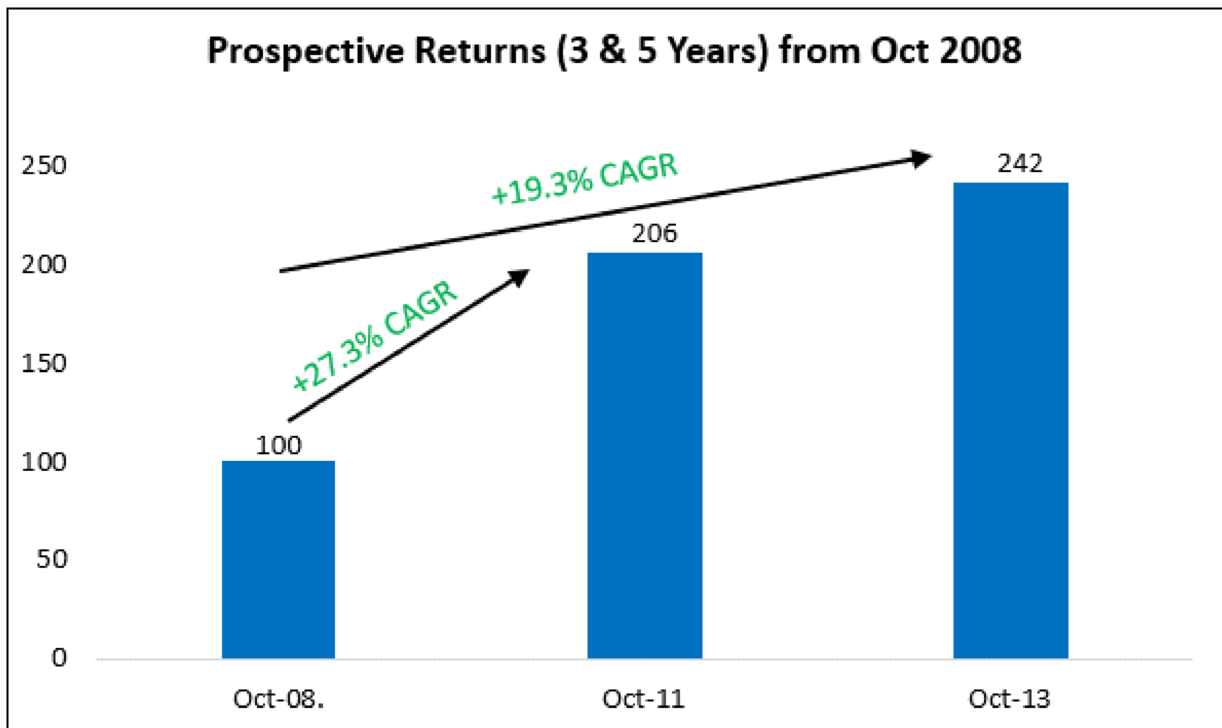


ii. If you had invested in Oct 2008 (when the market valuations were at a historical low), your 3-year prospective returns (CAGR) would have been 27.3% and 5-year prospective returns (CAGR) would have been 19.3%.



We have been very selective in quoting the above examples. In fact, in example # 1, we have calculated prospective returns when the valuations were above +2 SD (based on normalised valuations).

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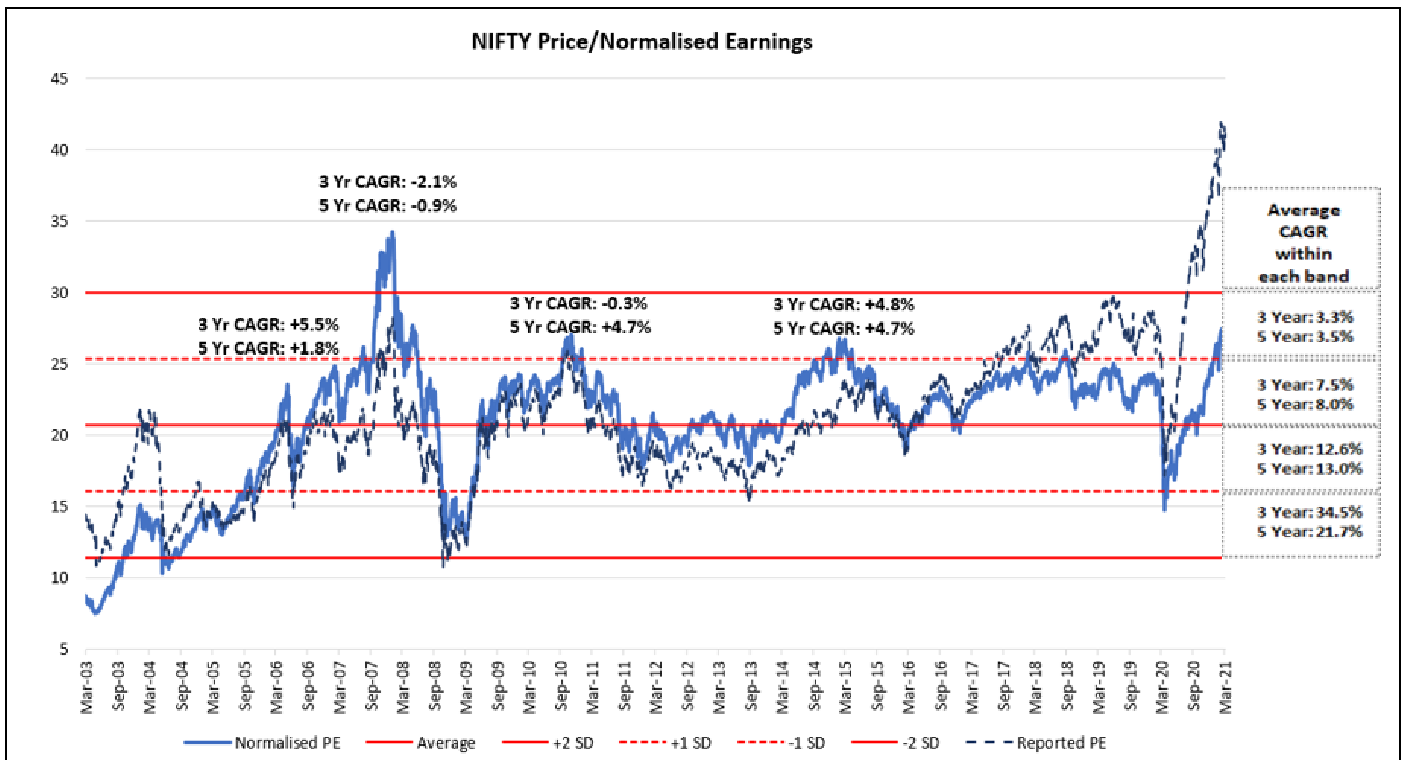
But you get the point, right?

These examples show the importance of entry points in the market. Valuations matter in determining medium to long term returns. Higher starting values mean future expected returns are lower, and vice versa.

Let's us understand this with the example of Nifty's valuations and prospective returns of 3 years and 5 years when the normalised valuations reach + 1 SD.

Nifty's Normalised Valuations Reached Above + 1 SD



Source: Multi-Act

From the above chart,

Whenever the normalised PE of Nifty goes above +1 SD, prospective return for 3 year and 5-year period shows a low single-digit return (even negative returns).

In the extreme case (Jan 2008 market peak), when the normalised PE went above + 2 SD, the prospective returns for the next 3-year and 5-year were negative.

Now let's look at the table on the right of the chart.

The table shows the average 3 year and 5-year CAGR from any given point within each standard deviation band.

If you would have invested at any point above +1 SD, the average return would have been around 3.5%. Conversely, if you would have invested at a point when the Nifty valuation was below -1SD, the average return would have been more than 20% from a 3 and 5-years perspective.

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Thus, if we look at it from a perspective of probability, the probability of making high returns diminish as valuations become expensive.

Clearly, the more you pay for an asset relative to its underlying fundamental returns as a business, the less return you should expect to receive going forward as a shareholder.

Apart from poor returns, an investor suffers from the drawdown risk. The below table shows the worst loss that the investor had to face over the next 3-5 year holding period during those 4 historical points shown on the chart.

Higher the Valuations, Steeper the Drawdown

Time period	Valuation Band	Drawdown
Jul-07	Above +1 SD	-45%
Jan-08	Above +2 SD	-60%
Nov-10	Above +1 SD	-28%
Mar-15	Above +1 SD	-23%

Source: Multi-Act

Thus, not only did the investor end up with poor returns, but he had to go through gut-wrenching mark-to-market loss in the interim.

As we know, when one experiences a 20% drawdown, to get back to the original level, one needs a 25% gain. Or take a 50% loss. Now, to come back to the original level, one needs a 100% gain.

The steeper the drawdown, the more daunting it is to get back to the starting point.

Not all investors have the ability to withstand such losses. More importantly, few have the discipline to hold on through the pain and may sell at the wrong time to minimise losses just as the odds in favour of the investor are improving.

The disciplined few, who may hold on, would be rewarded with only a low single-digit return at the end of 3-5 years.

Thus, at the end of 3-5 years, the investor would wonder if it was really worth it.

Against the Odds

Through this analysis, we are not suggesting a market crash is imminent. For someone who decides to invest today, might still end up making decent returns after 3-5 years if current high valuations go higher or remain the same.

However, one needs to consider the base rate. The base rate is a technical term for describing odds in terms of prior probabilities. For example, the base rate of having a drunken-driving accident is higher than those of having accidents in a sober state.

Similarly, investing when the valuations above +1 SD suggest a higher probability of mediocre returns in the coming 3- and 5-year period. Clearly, the odds are stacked against an investor today.

Considering the current market valuations, it is better to prepare for low returns and invest accordingly rather than expect high returns and be disappointed.

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