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WELL-EARNED REWARD
WHY PATIENCE IS AN INVESTOR'S VIRTUE

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The answer is rising corporate profits. Like a contestant on *Jeopardy*, you might be asking, "What's the question?"

Right now, many investors don't have just one question, but rather a trio of concerns. First, why has the stock market been hitting new highs in 2021 when there's so much uncertainty, economically and otherwise? Second, why would anybody buy stocks when shares are so richly valued? Third, if inflation spirals out of control, what will prevent stocks from collapsing?

The S&P 500 companies are currently trading at a nosebleed-level 45 times trailing 12-month reported corporate profits, far above the 30-year average of 25 times earnings.[1] Meanwhile, signs of stress and excess—both in the financial markets and the broader economy—are popping up everywhere. Perhaps the most alarming indicator: Over the past 12 months, consumer prices have climbed 5%, the highest inflation rate in 13 years.[2]

And yet, the S&P 500 is up double-digits in 2021.

What's going on? In real estate, it may be location, location, location. But in the stock market, it's earnings, earnings, earnings. Analysts at S&P Dow Jones Indices expect the corporate profits of S&P 500 companies to surge 85% this year from 2020's level.[3] That means that if the S&P 500 ends the year at around 4250, close to its recent all-time high, stocks would be trading at 24 times earnings—below their 30-year average. Perhaps the recent market surge is entirely justified and maybe stocks aren't all that expensive.

But, that still leaves our third concern. Will accelerating inflation derail the stock market? It isn't clear how much of today's inflation is transitory—the result of supply chain disruptions and pent-up demand from the pandemic—and how much reflects a permanent shift upward in inflation's trajectory. Taming inflation can involve considerable economic pain, so let's hope it is indeed transitory. But even if it isn't, history suggests that stocks should fare just fine over any reasonable holding period.

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[1] *https://www.multpl.com/s-p-500-pe-ratio, as of 06/22/2021*
[2] *U.S. Bureau of Labor Statistics, https://www.bls.gov/news.release/cpi.nr0.htm, 06/10/2021*
[3] *S&P Dow Jones Indices, "S&P 500 Earnings and Estimate Report," 06/10/2021*

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Let's start by looking at the 50 years since year-end 1971. I'll again assume that the S&P 500 finishes the year at 4250 and I'll again use the 2021 earnings forecast from S&P Dow Jones. I'll also use the Federal Reserve's predictions for 2021 inflation and economic growth.

The upshot: For the 1971-2021 stretch, we're looking at nominal (meaning we aren't adjusting for inflation) average economic growth of 6.1% a year, corporate earnings per share at 7.1% and annual S&P 500 share price gains of 7.8%.[4] In other words, a growing economy drove up corporate profits, and investors responded by bidding up share prices.

Why did share prices rise faster than corporate earnings? That annual 0.7 percentage point difference was driven by the long-term rise in the market's price-earnings (P/E) ratio. No doubt about it, higher valuations have been a nice bonus for stock investors over the past 50 years. Still, the rise in the market's P/E has been far less important than the boost that share prices received from corporate earnings. The lesson: If you're a truly long-term investor—meaning you're investing for multiple decades—valuations may not be all that important and what may really matter is earnings growth.

What about inflation? For the 1971 through 2021 period, we're looking at a 3.8% average annual rate.[5] That means share prices comfortably outpaced inflation—and that's even before factoring in dividends, which since 1971 have added more than three percentage points a year to the S&P 500's return.[6]

To be sure, things were far less cheery during the 1970s, when inflation ran at an alarming 7.4% a year.[7] How did stocks fare? Faced with steep increases in the cost of labor and raw materials, many companies were able to raise prices for their goods and services, thus passing along those higher costs to consumers. Result: In the 1970s, earnings per share for the S&P 500 companies rose 9.9% a year, easily outpacing inflation.[8]

Unfortunately, that impressive earnings growth wasn't enough to ensure good stock market returns. Amid the economic gloom of the 1970s, P/E multiples were cut in half, leaving investors in the S&P 500 with a 5.8% annual gain,[9] including dividends. Clearly, over shorter time periods, changes in valuations do matter—and stocks can lose ground to inflation.

But the 1970s weren't all gloom. While the S&P 500 rose just 5.8% a year, both small-cap U.S. stocks and foreign markets notched double-digit annual gains.[10]

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4 Bureau of Economic Analysis, Robert Shiller, S&P Dow Jones Indices, Federal Reserve, author's calculations
5 Annualized Inflation Rate, http://www.moneychimp.com/articles/econ/inflation_calculator.htm, 01/01/1971-12/31/2021
6 Compound Annual Growth Rate with dividends = 8.31%, without dividends = 5.16%. http://www.moneychimp.com/features/market_cagr.htm, 01/01/1971-12/31/2020, adjusted for inflation
7 Annualized Inflation Rate, http://www.moneychimp.com/articles/econ/inflation_calculator.htm, 01/01/1970-12/31/1979
8 Calculations by the author, based on data from Robert Shiller, retrieved 06/14/2021.
9 Compound Annual Growth Rate, http://www.moneychimp.com/features/market_cagr.htm, 01/01/1970-12/31/1979
10 Small-cap U.S. stock return data = Ibbotson SBBI Small Stock Series; International return data = MSCI EAFE Index with gross dividends reinvested, 01/01/1970-12/31/1979

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That meant a globally diversified stock investor had a decent shot at keeping up with inflation. I'm not suggesting that stock returns in the 1970s were great—but they weren't so bad either, given the decade's economic turmoil.

Perhaps more important, tenacious investors were soon rewarded. After the lackluster performance of the 1970s, stocks came roaring back in the 1980s and 1990s, with $1,000 invested in the S&P 500 growing to more than $27,000.[11]

Are you worried about inflation? As with so many other concerns that investors have had over the years, I believe today's worries will pass—and handsome returns await those who have the courage to sit patiently with a well-diversified stock portfolio.

[11] *Compound Annual Growth Rate, http://www.moneychimp.com/features/market_cagr.htm, 01/01/1980-12/31/1999, includes dividends*

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