Until recently, most financial economists believed future equity returns were unpredictable. The stock market offered investors some positive expected return above cash rates for bearing the additional risk of investing in equities. Yet changes in the expected future return were still considered unpredictable.

If markets are highly competitive (efficient), then all available information should be reflected in stock prices. Only new information – “news” that is unknowable today by definition – would drive future changes in stock prices. From this perspective, below-average equity valuations should result from below-average anticipated growth rates rather than from higher expected future returns. Conversely, high equity valuations would be due to higher anticipated growth rates, not lower expected future returns.

However, studies have shown that changes in dividend yields forecast future equity returns in the intermediate term, not just changes in future dividend growth.¹ This predictive power holds true for a number of valuation-based metrics, including cash flow yields. Future returns can depend on initial dividend and cash flow yields, suggesting that there can be a higher expected return after a period of poor returns and a lower expected return after a period of high returns.

Regardless of this evidence, many investors remain hypersensitive to the latest financial news on future economic and growth prospects. So to better illustrate and reinforce the concept, we offer a simple multiple choice question:

WHAT BEST EXPLAINS THE NEXT FIVE YEARS OF EQUITY RETURNS?

A. Next five years of earnings growth
B. Next five years of gross domestic product (GDP) growth
C. Today’s cash flow yield
D. Today’s earnings yield

¹ Refer to Footnote 1 for more information.
ARE EQUITY RETURNS PREDICTABLE?

Of the four potential answers, only cash flow yield and earnings yield are observable today. Future earnings growth and future GDP growth can be forecast but are not observable today, as they will play out over the next five years. Based on the historical record since 1970, the correct answer is “C,” today’s cash flow yield. Exhibit 1 shows how much return variation is explained by different initial valuation metrics and concurrent growth rates.


<table>
<thead>
<tr>
<th>Valuation Metric</th>
<th>Explained Return</th>
<th>Observable Today?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Yield</td>
<td>47%</td>
<td>Yes</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>35%</td>
<td>Yes</td>
</tr>
<tr>
<td>Book Yield</td>
<td>31%</td>
<td>Yes</td>
</tr>
<tr>
<td>Shiller Cyclically Adjusted Earnings Yield</td>
<td>31%</td>
<td>Yes</td>
</tr>
<tr>
<td>Earnings Yield</td>
<td>21%</td>
<td>Yes</td>
</tr>
<tr>
<td>Future 5-Year GDP Growth</td>
<td>34%</td>
<td>No</td>
</tr>
<tr>
<td>Future 5-Year Earnings Growth</td>
<td>9%</td>
<td>No</td>
</tr>
</tbody>
</table>


Initial cash flow yields offer the best explanation since 1970. They account for 47% of the variation in subsequent five-year equity returns versus 34% for future GDP growth and just 9% for future earnings growth, a possibly surprising result. Importantly, the confidence level in the explanatory power of that 47% is statistically meaningful. This still leaves approximately half of return variation unexplained by initial cash flow yields, suggesting the evolution of future news continues to play a role.

What best explains the next five years of equity returns? Today’s cash flow yields.
Exhibit 2 below plots the relationship between five-year global equity returns predicted from initial cash flow yields (teal) and realized subsequent five-year global equity returns (green). For example, the first observation at January 1970 shows the predicted five-year annualized return from the initial cash flow yield in January 1970 (teal) versus the subsequent realized return from January 1970 to December 1974 (green). In the last four years and 11 months up to March 2013, we do not yet have realized five-year returns to compare to predicted returns at the far right of the graph. The orange line represents the 8.7% compound annualized return of global developed equities from January 1970 to March 2013. (Note that predicted five-year returns in the graph are not cash flow yields per se but are based on the linear relationship between the natural logarithm of cash flow yields and subsequent five-year annualized returns.)

Although clearly not a perfect predictor, the graph shows that the predicted five-year returns based on initial cash flow yields explain about half of the variation (47%) of subsequent realized five-year returns. Importantly, initial cash flow yields track better over time than merely relying on the historical average compound annualized return during the full period.
Two key observations are highlighted for long-term investors. First, many investors exited the stock market in 2008 as they experienced the acute distress of the financial crisis. However, as stock prices fell, cash flow yields increased and the predicted five-year return spiked upwards. Investors were exiting the market precisely when predicted five-year returns were increasing. In contrast, predicted five-year returns trended downward and turned negative during the technology bubble in the late 1990s. Investors chased returns exactly when cash flow yields suggested caution.

Second, the stock market’s recovery from its trough in early 2009 has been strong, prompting some investors to consider reducing their allocation to equities. Indeed, the predicted five-year return at March 2013 (far right of the graph) is below the historical average annualized return. But we highlight that the predicted return is still meaningfully positive and higher than bonds or cash, the opportunity cost for investors. We believe long-term investors should be careful not take money off the table after a run in equity returns, as equities can still offer an economically meaningful return premium.

The conclusion from this analysis suggests that long-term investors should worry less about the latest financial news on future economic and growth prospects, as this is often noise that can derail a sound long-term investment strategy. Instead, we believe long-term investors should stay the course and occasionally consider cash flow yields when they are extreme.

Note: