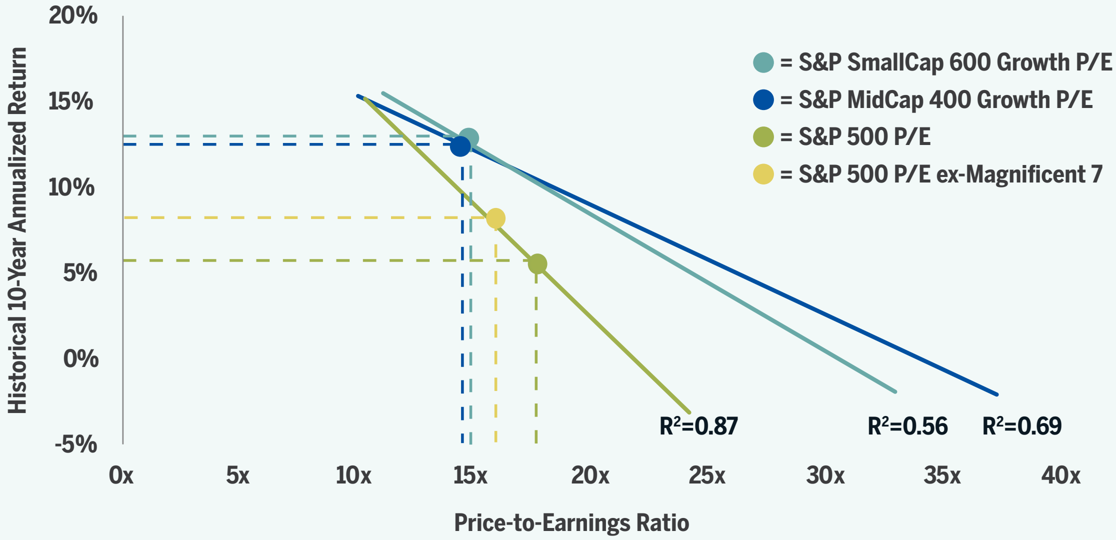
ALGER

Alger On the Money

What Can Valuations Tell Us?

Shorthand valuation multiples, such as price-to-earnings (P/E), do not tell investors much about the prospective returns of individual companies, in our opinion. However, these kinds of valuation multiples may provide important information about broad-based index sentiment. So, what are they telling us now?

Valuations and Historical Returns



Source: FactSet. Each line is the result of regressing historical index P/E vs. subsequent historical 10-year annualized returns from September 1998 through October 2023. R-squared is a statistical measure used to analyze how differences in one variable can be explained by the difference in a second variable. In the context of the chart, it measures the proportion of the variability of the dependent variable (10-year annualized return) that can be explained by the independent variable (price-to-earnings). The "Magnificent 7" are Apple Inc., Alphabet Inc., Amazon.com Inc., Meta Platforms Inc., Microsoft Corp., Nvidia Corp., and Tesla Inc. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

- The chart depicted above illustrates the historical relationship between P/E ratios and the subsequent 10-year annualized returns for various indexes. As of October 2023, the S&P 500's P/E ratio is 17.3x, as shown on the green line in the chart above, potentially implying annualized returns in the mid-single digits over the next decade. However, a handful of mega-cap stocks with strong consensus estimated earnings growth rates above 20%, in aggregate, skew the S&P 500 P/E higher. Excluding these stocks, the S&P 500 P/E is about two points lower, potentially implying a higher corresponding return over the next decade, given the historical relationship.
- Smaller-cap stocks, however, may look even more attractive for long-term investors. Particularly, small and mid-cap growth stocks, whose valuations have compressed due to rising interest rates, are trading at P/E multiples which have historically produced double-digit annual returns over the following decade.
- While past performance is not indicative of future returns, investors may find it reasonable to allocate into areas of the equity market that are statistically attractive relative to history.

Inspired by Change, Driven by Growth.

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