ROBECO QUANTITATIVE INVESTING

Decomposing equity returns: Earnings growth versus multiple expansion

ROBECO
The Investment Engineers

- US equities led due to strong growth and rising valuations
- Small-cap and low-volatility stocks had strong fundamentals but lacked market appreciation
- Emerging markets struggled with weak earnings, except for Taiwan and India

Over the past decade, the stock market has been dominated by the US economy, with big tech stocks leading the charge. Fueled by strong earnings growth and amplified by significant multiple expansion, companies such as Apple, Microsoft, and Nvidia have become central to market performance. In the wake of this rally, US equities now hold a record weight in global indices and trade at valuations significantly higher than both their historical norms and the valuations of other markets.

Compared to US growth stocks everything else is relatively cheap nowadays: European equities, emerging markets (EM) equities, value stocks, low-volatility stocks, small-cap stocks, and so forth. But does this mean that the investment case for all these alternatives is the same?

In order to shed light on this question we decompose equity returns of different markets and styles into earnings growth and multiple expansion. This approach reveals substantial differences in the economics behind lagging performance. Small-cap stocks and low-volatility stocks underperformed despite delivering strong operating performance, because their valuations have remained stuck.

EM equities, on the other hand, have failed to deliver earnings growth, causing them to lag despite rising valuations. Exceptions within the EM space are Taiwan and India, which did deliver strong earnings growth, but not enough to offset the negative impact from markets such as China, Korea, and EMEA. In conclusion, small-cap and low volatility stocks suffer from a lack of appreciation by investors, while EM equities need a turnaround in operating performance.

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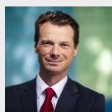

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Data and methodology

Our approach is inspired by the return decomposition formula of John Bogle:

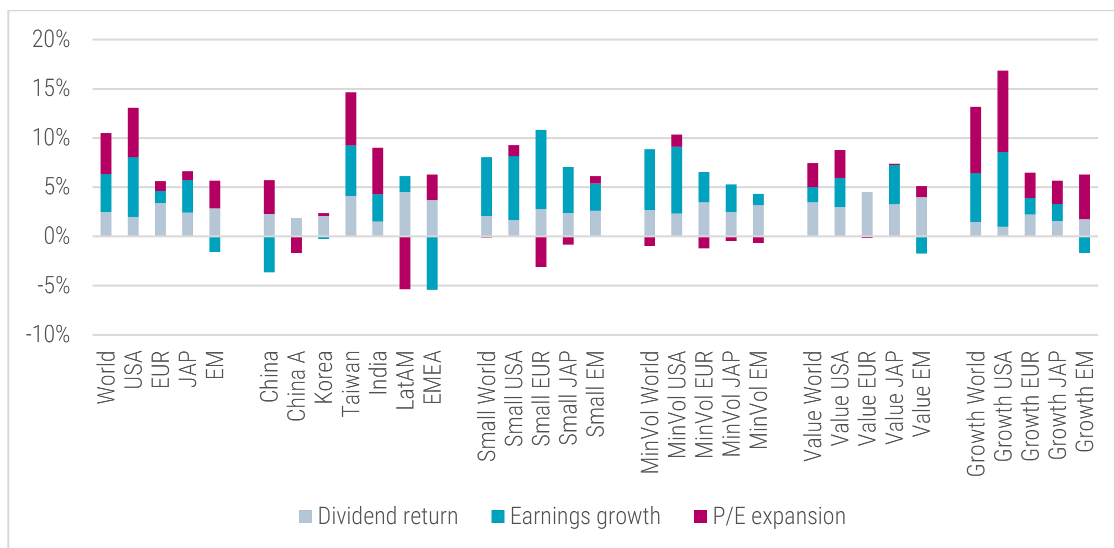
Return = Dividend Yield + Earnings Growth +/- Change in P/E Ratio

The application of this formula to the US equity market shows that stock returns in some decades are driven by earnings growth, while in other decades multiple expansion was the main driver. There can also be decades during which both components deliver or both fail to deliver.

We extend this analysis to MSCI country and style indices, for which returns and valuation data are both readily available. Subtracting price returns from total returns gives the contribution from dividends. Price returns can be further broken down into earnings growth and multiple expansion (or contraction) based on changes in the P/E ratio.[1] We will refer to the dividend income and the contribution from earnings growth together as the fundamental return.

Our sample consists of the 10-year period from the start of 2015 to the end of 2024. Some results could be more pronounced with a different starting date, for instance because EM has been lagging developed markets since 2011. However, a decade is an objective round number that should cover at least one full business cycle without unduly favoring or disadvantaging certain asset classes.

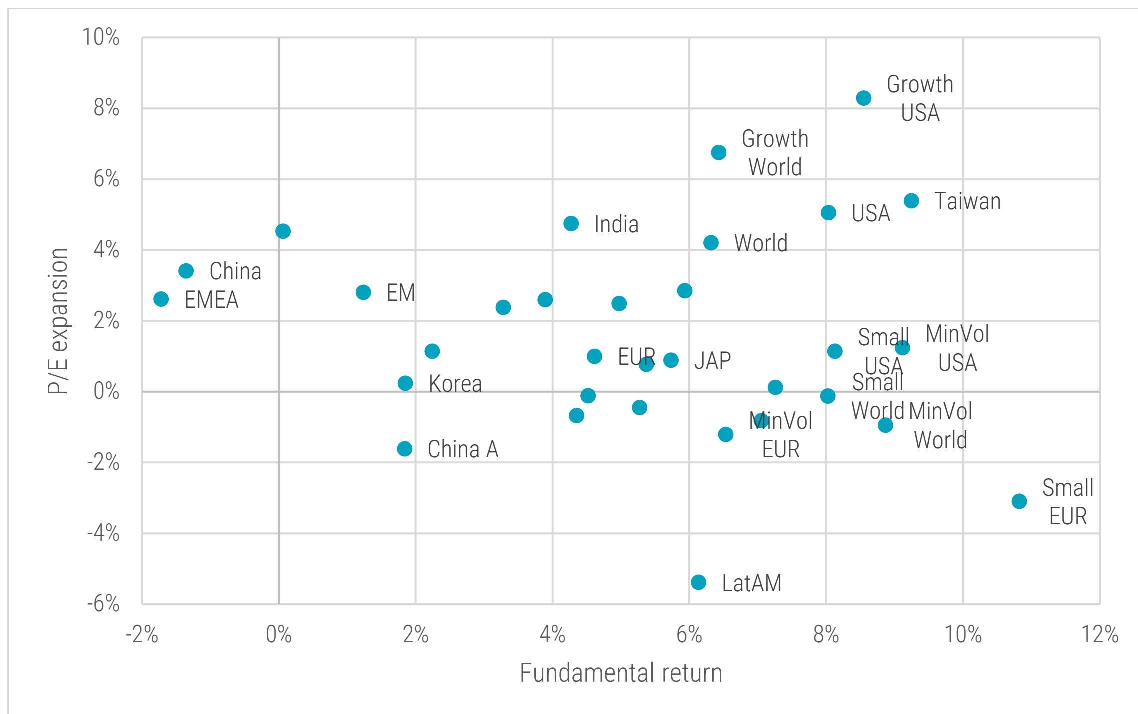
Figure 1 | Decomposition of annualized total returns 2015-2024



Source: MSCI, Robeco. This chart is for illustrative purposes only.

[1] A caveat is that index valuation ratios can also be affected by changes in the index composition, i.e. additions and deletions. For indices with low turnover, such as passive market indices, this effect will generally be small though. However, we acknowledge that our approach is unsuitable for indices that involve substantial turnover, such as the MSCI Momentum indices. Another caveat is that the breakdown can become unstable if earnings are negative or close to zero. To this end we use the MSCI P/E ratio based on cash earnings. Moreover, we have verified that the results are robust to the use of alternative valuation metrics, such as the price-to-book ratio.

Figure 2 | Fundamental return versus return contribution from multiple expansion, 2015-2024



Source: MSCI, Robeco. This chart is for illustrative purposes only.

Results

Figure 1 shows the results of our equity return decomposition by index, while Figure 2 contrasts the fundamental return against multiple changes. We consider different regions, some individual countries, small-caps, low-volatility stocks, and value versus growth stocks in different regions. Among the different regions, the US was clearly the top performer, driven by a combination of the highest realized earnings growth and the biggest boost from multiple expansion. Europe and Japan achieved considerably lower earnings growth and also very little multiple expansion, culminating in much lower total returns. Despite a rise in valuation, the lowest performance was realized by EM equities, which not only failed to grow their earnings, but even suffered some shrinkage.

Not all the emerging countries suffered a lost decade, though. Taiwan and India in particular realized solid earnings growth and benefited from multiple expansion, resulting in returns rivaling those of the US. However, China, Korea and EMEA experienced poor fundamental performance, while LatAM suffered from multiple contraction. This large variation in EM is a reflection of how individual countries can be in different stages of the business cycle and are much less integrated than developed countries, which tend to move mostly in tandem.

Small-caps stocks in all regions exhibited strong earnings growth, consistently beating their large-cap counterparts. Purely based on fundamental returns, i.e. dividends plus earnings growth, European small-cap stocks even emerge as the absolute winner among all the indices in the sample. However, small-cap valuation multiples have remained more or less the same, causing the total return of small-caps to lag, particularly in the US. The story for low-volatility stocks is more or less similar, with a combination of solid earnings growth rivalling US growth stocks, but little or no revaluation by the market.

Finally, we compare value and growth stocks. The total return of US growth stocks stands out the most, driven by a combination of the highest earnings growth and the most multiple expansion, again reflecting the rise of big tech. However, the US dominance is so strong that even US value stocks outperformed growth stocks in Europe, Japan, and EM. Within the developed markets, the weakest operating performance was delivered by European value stocks, with earnings essentially flat after ten years. In EM, both value and growth stocks had negative earnings growth. EM growth stocks benefited most from multiple expansion, while EM value stocks had a solid contribution from dividends.

Performance over time

To assess if some turnarounds are perhaps already in progress we examine the return decomposition over time for some of the key markets. Figure 3 shows that US growth stocks are still going strong. Earnings growth suffered a hiccup in the 2019-2020 period while multiples contracted in the 2021-2022 period, but both have picked up since. For EM, Figure 4 shows that earnings have been cyclical around a flat or perhaps even negative long-term trend. Signs of a turnaround are not visible yet.

Figure 3 | US growth

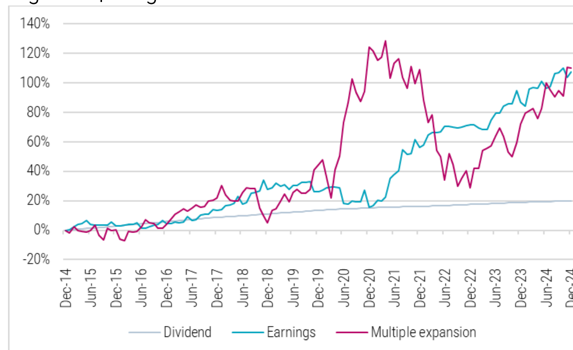


Figure 4 | Emerging markets

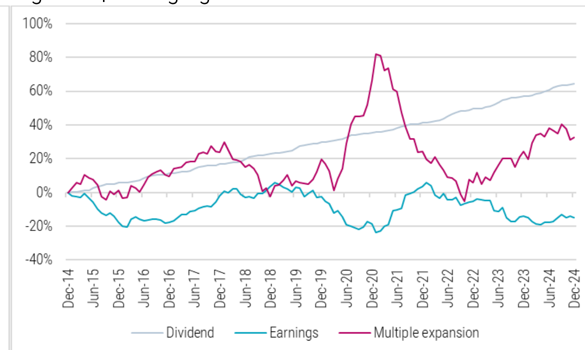


Figure 5 | Global small caps

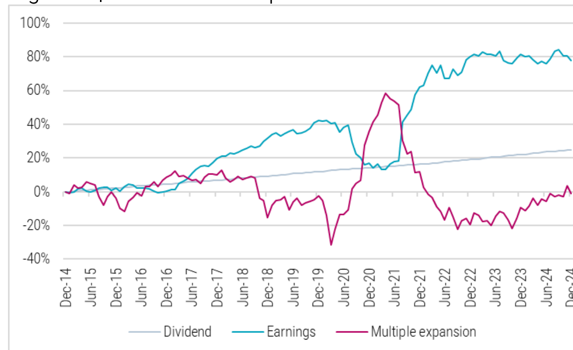
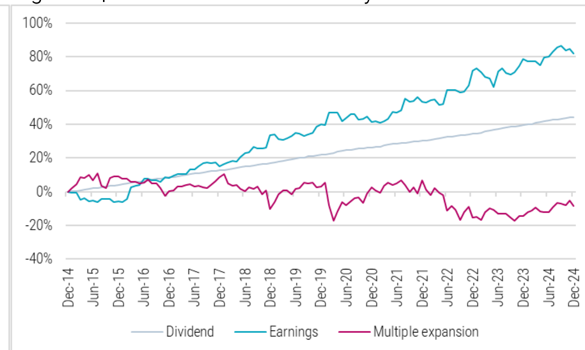


Figure 6 | Global minimum volatility



Source: MSCI, Robeco. These charts are for illustrative purposes only and do not represent the performance of any specific investment product or portfolio.

Based on Figure 5, the earnings growth of global small-caps has mostly alternated between flat periods and rallies, with a clear upward trend overall. Multiple expansion seems to have only come to the rescue when earnings briefly declined in 2020-2021. Global low-volatility stocks have delivered the most steady earnings growth, delivering almost every year as shown in Figure 6. However, with valuations seemingly frozen, these stocks appear to be particularly unloved by investors.

Summary and outlook

Over the past decade, US equities, led by big tech, have dominated the stock market, achieving record weights in global indices and high valuations, while other markets and styles, such as European equities, EM, and value stocks, remain relatively cheap. A breakdown of equity returns uncovers differing reasons for underperformance: small-cap and low volatility stocks delivered solid earnings growth but lagged due to stagnant valuations, while EM equities suffered from weak earnings growth despite rising valuations. For a turnaround, EM equities need improved operating performance, especially in China, Korea, and EMEA, while small-cap and low volatility stocks do not really have a profitability problem but need to regain favor among investors.

History suggests that dividends and earnings growth are the main driver of long-term stock returns and that valuation multiples tend to mean-revert. Although US exceptionalism may persist for some time, and US growth stocks in particular may remain the darling of investors, the healthy fundamentals of small-cap and low volatility stocks should ultimately be rewarded. Earnings in EM will also rebound at some point, and, if the US earnings cycle peaks, US stocks could face multiple contraction.

Thus, instead of simply extrapolating from the recent past, investors should prepare for the possibility that the coming decade will be very different from the last one. A diversified portfolio that balances exposure across regions, sectors, and asset classes ensures resilience against potential shifts in market leadership and macroeconomic conditions. Such a portfolio allows investors to position themselves to capture opportunities, regardless of how the next decade unfolds.

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