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# Long term equity returns are always positive: Myth or Reality

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We keep hearing that Equity Returns are almost always positive in the long run. We, the Mutual Fund Distributors, are fond of saying this to investors. It has been repeated so often that it is commonly believed to be a fact

The real question is whether "long term equity returns are always positive"? If it is, then all we really have to do is invest and forget for the long term or as they said in the famous Hero Honda ad, "Fill it, Shut it and Forget it" and why not? The history states - when it comes to Indian indices, most 10-year periods have seen positive returns.

However,the other side of the story isn't same. There have been extended periods of time in the US when equity returns were negative. Most recently the period from Jan 2000 to March 2009 gave significant negative returns to investors. Japan's Nikkei is still below the 1990 peak. Which means, any investment in Nikkei is still negative after 28 years.

Thus, the answer is clear. When it comes to developed markets, while a lot of 10-year periods have given positive returns, we cannot make a generalized statement that equity returns are always positive in the long run. But then, the fact is we live in India and what we want to know is whether Indian equities will give positive returns in the next 10 years?

So, let's try to answer this question in a logical manner.

The first thing to note is that the price of any security, and in our case we are talking of Nifty,depends on two factors:

1. Earnings per Share, and
2. Price to Earnings multiple.

To be more specific:

Price of Nifty = Earnings per Share of Nifty X P/E of Nifty.

EPS is an economic factor which measures the profit per share that the companies in the index make. The PE is however a sentiment factor. The value of the Price multiple depends completely on factors like money flow, liquidity in the market, sentiments about the future etc.

A change in any of the factors can lead to a change in the price of Nifty and therefore impact the returns from an investment in Nifty.

Let us take a look at an example where we see a 12% increase in Earnings Growth over one year and see its impact on the Total Returns experienced by the investor.

Table 1

| | | Nifty | | EPS | | P/E | % Return |
|---|---|---|---|---|---|---|---|
| | Year 0 | 10000 | = | 400 | X | 25 | |
| Scenario 1 | Year1 | 11200 | = | 448 | X | 25 | 12% |
| Scenario 2 | Year 1 | 8960 | = | 448 | X | 20 | -10% |
| Scenario 3 | Year 1 | 13440 | = | 448 | X | 30 | 34% |

As shown in the table, at the beginning Nifty EPS was 400 and PE was 25 leading to a Nifty value of 10000. We can look at 3 scenarios. All 3 scenarios assume a 12% earnings growth across one year. Despite same earnings growth, the returns experienced by the investor can be different depending on the PE of the Nifty at the end of one year. Even if Earnings grow by 12%, the returns experienced by the investor can vary wildly from Minus 10% to plus 30%

Notice that in economic terms nothing has changed. The Earnings growth is 12% in all 3 scenarios, but the returns experienced are very different depending on the Final PE which is completely a sentiment factor and therefore almost completely unpredictable.

Therefore, the returns of an investor are, in essence, unpredictable in the short term of a year or two because while we might be able to predict the economic factor of EPS growth, we can never reliably predict the sentiment factor of PE.

However, if we increase this period of investment to 10 years and assume the same Earnings Growth of 12% then we get the following results.

Table 2

| | | Nifty | | EPS | | P/E | % Return |
|---|---|---|---|---|---|---|---|
| | Year 0 | 10000 | = | 400 | X | 25 | |
| Scenario 1 | Year10 | 31058.48 | = | 1242.339 | X | 25 | 12% |
| Scenario 2 | Year 10 | 24846.79 | = | 1242.339 | X | 20 | 10% |
| Scenario 3 | Year 10 | 37270.18 | = | 1242.339 | X | 30 | 14% |

Notice that we have taken the same Earnings Growth and the same Final PE as in the earlier instance. However, for a 10-year investment the return experienced by the investor is very close to the Earnings growth of 12% in all 3 scenarios unlike the first instance where the one-year returns varied wildly with the PE change.

What this shows is that as the investment horizon increases EPS becomes much more important than the sentiment factor PE.

Therefore, in order to answer the question whether Indian equity markets will give positive returns in the next 10 years, we have to answer whether we can reasonably predict the EPS growth in Indian indices for the next 10 years.

For this, we take help of the fact that EPS growth has been shown to be more or less equal to nominal GDP growth, not in the short term but over a period of 10 years. Indian GDP growth in nominal terms should be equal to around 12% assuming a real Growth of 7% and an inflation of around 5% in the long term.

GDP is in some way a measure of number of labor hours multiplied by the productivity of the labor. In India, given our population growth as well as the age of the population, it is reasonable to expect that we will continue to grow at least at 7% in real terms and 12% in nominal terms across the next 10 years. If this is true we can reasonably surmise that EPS growth across 10 years will also be in the same region of 12 -15%

We have already shown in Table 2 that investor returns across long term matches more or less the EPS growth in that period. Since we expect Indian nominal GDP and consequently EPS to grow at 12% over 10 years, Indian equity investors can make around 10 to 15% return across a period of 10 years.

Of course, if you find a good mutual fund distributor (read Way2wealth!!!) who can help you find mutual funds that will outperform then you as investors can make even more returns!