Proceed With Caution: Higher Probability for Normalized Market Returns Ahead
The current bull market in U.S. equities is entering its seventh year, and valuations are near all-time highs, but we believe there exists a higher probability of entering a more normalized return environment in which high-quality stocks should outperform.

Overview

The domestic equity markets have performed extremely well since the financial crisis, with most indices generating annualized returns in the mid- to high teens. Such returns are not unprecedented, but they are also unsustainable. As figure 1 shows, the annualized six-year rolling return of the Russell 3000 Index is approaching its all-time high, and prolonged periods of such positive performance generally reverse. In addition to the duration and strength of the current bull market, a number of other factors increase the probability of returning to a more normalized return environment, including the possibility of multiple compression off high absolute levels, the likelihood of higher interest rates, and the potential for increased market volatility. So, while we remain constructive on the domestic equity markets in general, we believe a return to a positive yet more normalized return environment, or possibly even market consolidation, is likely.

Accommodative Monetary Policy Fueled Low-Quality Rally, but a Reversal May Be Due

During the current bull market, an abundance of accommodative monetary policy and an extended period of historically low interest rates benefited lower-quality stocks in a number of ways. For example, the environment allowed lower-quality companies, generally more reliant on the capital markets, to refinance their higher levels of debt at historically low interest rates. Investors were further encouraged to take on the risk of lower-quality stocks given the extended period of extremely low volatility the highly accommodative monetary policy environment fostered.

This environment is likely to change—as the Fed’s accommodative monetary policy comes to an end and interest rates rise. These higher interest rates should put more pressure on the balance sheets and cash flows of lower-quality companies, potentially increasing the bankruptcy risk associated with lower-quality stocks.
Historically, higher-quality stocks have tended to outperform over the long term. To illustrate, we looked for a common measure as a proxy for quality. There are many available, including return on equity or assets, margins, leverage, and earnings variability, but in this analysis we use a company's return on invested capital (ROIC) because it provides an assessment of how efficiently management allocates capital to profitable investments. The universe is the Russell 3000 Index. High-quality stocks are those in the Russell 3000 Index within the top quintile of ROIC; low-quality stocks are those within the bottom quintile.

As you can see from figure 2, which shows the quarterly performance difference between the top and bottom quintiles as measured by ROIC, higher-quality companies have historically outperformed lower-quality companies. This has particularly been true when the market has been down, as the light blue shading—which represent negative calendar-year returns for the Russell 3000 Index—indicates.

Looking at the data on a more granular level, when the index has experienced a quarter of negative performance, higher-quality stocks have outperformed lower-quality stocks almost 80% of the time.

While lower-quality outperformance has occurred, the duration of such occurrences before 2009 was relatively short lived, often lasting only a quarter or two. Beginning in 2009, that changed—as we explained earlier, most likely due to the abundance of accommodative monetary policy and a prolonged period of extremely low interest rates, which benefitted lower-quality companies more than higher-quality companies. Looking ahead, however, we believe any tightening of monetary policy should lead higher-quality stocks to again outperform lower-quality stocks.

While we are not bearish on future market returns in general, we believe it is prudent to consider that downside risk (the financial risk associated with losses) may be higher given a prolonged period of high absolute valuations, the possibility of interest rate hikes, and low market volatility.
High Valuations Increase Concerns About Downside Risk

Consider the substantial market appreciation over the past several years, which is reflected in current multiples. Absolute valuations look expensive across the market-cap spectrum. Indeed, they are approaching 30-year highs, as shown in figures 3 and 4. The recent prolonged period of low interest rates and inflation may justify higher valuations, but we believe there is likely little upside given current levels. While expensive valuations do not guarantee that domestic equities will sell off in the year ahead, such levels heighten concerns about downside risk. Stocks could be vulnerable to negative catalysts. Investing in higher-quality companies (namely, those with higher ROIC) may help investors weather periods of market consolidation should valuations begin to moderate.


Fig. 3: Standard Deviations of Small-Cap Valuations (Russel 2000 Index)

Fig. 4: Standard Deviations of Large-Cap Valuations (S&P 500 Index)
In addition to an increased probability of multiple compression as a result of high absolute valuations, relative valuations indicate that higher-quality stocks are more attractive than lower-quality stocks. Figures 5, 6, and 7 show the relative valuation difference (as measured by price-to-book [P/B], price-to-sales [P/S], and forward price-to-earnings [P/E] ratios) between the Russell 3000 Index stocks in the top and bottom quintiles of ROIC. As shown, on a relative basis, higher quality is trading at a discount to lower quality, and is therefore more attractive. Similar to the earlier absolute valuation comments, a discounted relative valuation does not imply future outperformance, but we believe it should be taken into consideration when evaluating investment alternatives.

**Fig. 5: P/B Difference Between Highest- and Lowest-ROIC Stocks**

![Chart showing P/B difference between highest- and lowest-ROIC stocks.]

Source: Russell Investment Group, BofA Merrill Lynch Small Cap Research, as of 6/30/15. A direct investment in an unmanaged index is not possible.

**Fig. 6: P/S Difference Between Highest- and Lowest-ROIC Stocks**

![Chart showing P/S difference between highest- and lowest-ROIC stocks.]

Source: Russell Investment Group, BofA Merrill Lynch Small Cap Research, as of 6/30/15. A direct investment in an unmanaged index is not possible.

**Figure 7: Forward P/E Difference Between Highest- and Lowest ROIC Stocks**

![Chart showing forward P/E difference between highest- and lowest-ROIC stocks.]

Source: Russell Investment Group, BofA Merrill Lynch Small Cap Research, as of 6/30/15. A direct investment in an unmanaged index is not possible.
Tightening Favors Higher-Quality Companies

The domestic economy appears to be making progress toward sustainable growth, with the end of the Fed’s quantitative easing program and interest rate hikes coming closer into view. We believe a moderately improving economy, or one that necessitates Fed tightening to help restrain inflation, favors companies with higher ROIC, as figure 8 shows. Unlike lower-quality companies, such companies are generally less reliant on the capital markets because they are able to generate enough cash and access enough capital to fund initiatives as interest rates rise.

Increasing Volatility Favors Higher-Quality Companies

The last few years of the current market rally have been marked by a prolonged period of low volatility, as measured by the CBOE Volatility Index (VIX), shown in figure 9. But this prolonged period of low volatility may be coming to an end, thanks to a sell-off in oil and other commodities, concerns about a slowdown in global growth, a strong U.S. dollar, and geopolitical risks. If volatility does increase, we believe investors would likely benefit from a portfolio of higher-quality companies. As figure 10 shows, using monthly data points, there is a strong historical correlation between volatility and the performance difference between high- and low-quality stocks. With higher volatility risk to the upside more than to the downside, we believe there is an increased probability that higher-quality companies will outperform.
Conclusion
The bull market is now entering its seventh year, valuations are near all-time highs, the Fed is poised to tighten, and there is a higher likelihood of increased volatility. In this environment, the markets are primed to return to a more normalized return environment or experience a period of consolidation. Adding to these concerns are fears of a global economic slowdown and a constantly evolving geopolitical landscape. During such periods of uncertainty, we believe that downside protection—including a focus on investing in higher-quality companies—is of utmost importance.
About the Author

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