TFSA Investors: 3 Ways to Predict a Stock's Returns Over Time

Description

The stock market is unpredictable; that's no secret. Stock prices reflect investor sentiments and imprecise estimates of future growth. In the short term, accurately predicting swings in sentiment and the flow of new information is as difficult as predicting the weather.

Despite their short-term volatility, stock prices tend to reflect the value created by their underlying companies over time. Understanding how this value is created and reflected in the stock price is a critical step in any investor's journey. With that in mind, here's a basic overview of the three most important elements that determine a stock's long-term shareholder returns.

Earnings yield

A company's earning power is the most basic element of its intrinsic value. Earnings yield is simply the dollar amount of net income per share divided by the stock price.

For example, **TELUS** earned $2.89 per share over the past 12 months, while its stock price is $53.51 at the moment. This means an investor who buys the stock at the current market price could expect an earnings yield of 5.4% on their investment.

Of course, TELUS retains a portion of its earnings and pays the rest to shareholders, so the dividend yield is slightly lower than its earnings yield at 4.4%. By tracking the earnings yield, investors can make predictions about a stock's dividends over time.

Earnings growth

Growth in earnings is the primary target of nearly every corporation. By retaining and reinvesting earnings every year, the company hopes to expand its power of generating cash flows.

Even a modest 7% annual growth in earnings can double a company's earning power within 10 years. In this case, investors can expect either the dividend yield or the stock price to double as well to reflect this expansion in annual net income. To estimate the growth rate, simply multiple the company's retention rate of earnings with its return on invested capital.

Valuation adjustment

The final source of stock price returns is a *change* in valuation. The valuation ratios of most companies tend to be stable over time. Investors can generally expect a stock's valuation ratios to revert to their long-term averages over time, helping them make predictions about the stock's performance.

Fortis stock, for example, traded at an average price-to-earnings ratio of 17.75 between 2017 and 2018. It now trades at 21.6, which is far above its long-term average. To justify this higher valuation, Fortis needs to achieve higher-than-average earnings growth in the near future, otherwise investors can expect the valuation to revert to 17.75 over time.

The most common reasons for a change in valuation is the perceived change in an industry's prospects. For example, when the oil price crashed in 2014, energy stocks saw their valuations plunge. Meanwhile, the launch of a new product or entry into a new market could raise a stock's valuation because investors expect better profitability in the future. In other words, valuation is simply a representation of investor perception.

Example

A stock can double from $100 to $200 if its earnings double from $10 per share to $20 or if its stock valuation jumps from 10 times earnings to 20 times.

Bottom line

A company's stock price is a reflection of its earning power, earnings-growth rate, and valuation. TFSA investors must track and analyze these basic elements to make long-term investment decisions with conviction.

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