

The Critical Role of Valuation in Long-Term Investing

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Key takeaways:

- Distinguishing between price and value
- A high-valuation environment increases the need for discipline and selectivity
- Durable, long-term returns are anchored in valuation

Valuation is currently top-of-mind for equity investors. In today's market, sentiment, liquidity and thematic momentum, particularly surrounding artificial intelligence, have propelled US stock valuations to record highs, leaving many investors questioning the role of valuation amid a so-called "new investment paradigm" for stocks. Yet history repeatedly demonstrates how markets can falter when valuations are ignored. To borrow Oscar Wilde's observation, "A cynic knows the price of everything and the value of nothing." As long-term stewards of capital, we must stay anchored to the fundamentals that drive returns. As such, valuation isn't just relevant — it's essential.

What is a stock? It is the current value of its future cash flows. ▲

— Dave Schindler, portfolio manager

Valuation vs. Price: A Critical Distinction

An often-misunderstood concept is the distinction between valuation and price. Price is merely what someone is willing to pay. Valuation, however, requires analysis as it reflects a deeper assessment of a company's earnings potential, growth trajectory and the risks inherent to achieving those outcomes. Ultimately, earnings and cash flows must support the price over the long term. If they don't, future returns are likely to disappoint.

It's also important to note that a low price doesn't necessarily indicate that a stock is undervalued, nor does a high price automatically mean that it's expensive. The true measure of value lies in what happens after you buy a stock: Did the price you paid align with its intrinsic worth? For this reason, long-term investors focus on valuation to determine whether they are paying an appropriate or discounted price relative to a company's true earnings potential. This is in sharp contrast to traders, who focus on price and prioritize short-term price movements typically driven by sentiment, momentum or market technicals.

When Valuation Matters Most

Valuation often becomes most critical during periods of market extremes, whether euphoric bull runs or panic-fueled selloffs. Human behavior, even when mediated by algorithms, ensures that markets will continue to experience these extremes. While sentiment may fluctuate wildly, a stock's intrinsic value remains far more consistent, creating opportunities for disciplined investors.

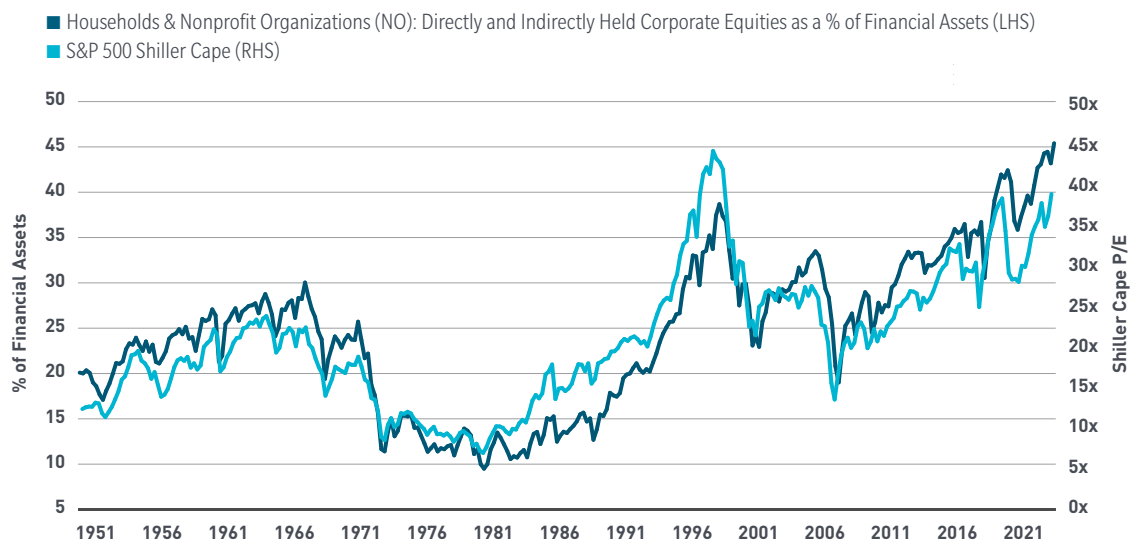
Traditional valuation models may differ in application and approach, as well as by industry or company specifics, but these tools are incredibly useful for understanding the value of a business. Additionally, they help investors assess the risk premia in concentrated markets and avoid overexposure to crowded trades. However, in early-stage or hyper-growth companies, traditional metrics may be less informative, as they rely heavily on assumptions about distant future earnings. Those scenarios demand greater conviction, as the risks of overestimating growth or underestimating challenges increase exponentially the further out one forecasts. In essence, when faith and luck become integral to your valuation model, the margin for error increases.

Today's Market Drivers and Risks: A Cautionary Tale

While recent headlines have celebrated the outperformance of cyclical and tech stocks, driven by factors such as the AI capex cycle, monetary easing, and fiscal stimulus, we believe caution is warranted. The current market environment, characterized by easy money, technological breakthroughs and record levels of individual stock ownership, displays all the hallmarks of a bubble.

Traditionally, we observe a strong correlation between household stock ownership and valuation, as shown in Exhibit 1. Today, equities represent nearly 45% of US household financial wealth, the highest level ever recorded. This increased ownership has in part helped to drive higher price-to-earnings levels, with today's Shiller P/E ratio only exceeded by that of the market just prior to the dot-com bubble in the early 2000s.

Exhibit 1: A strong correlation between valuation and household stock ownership with both near record levels

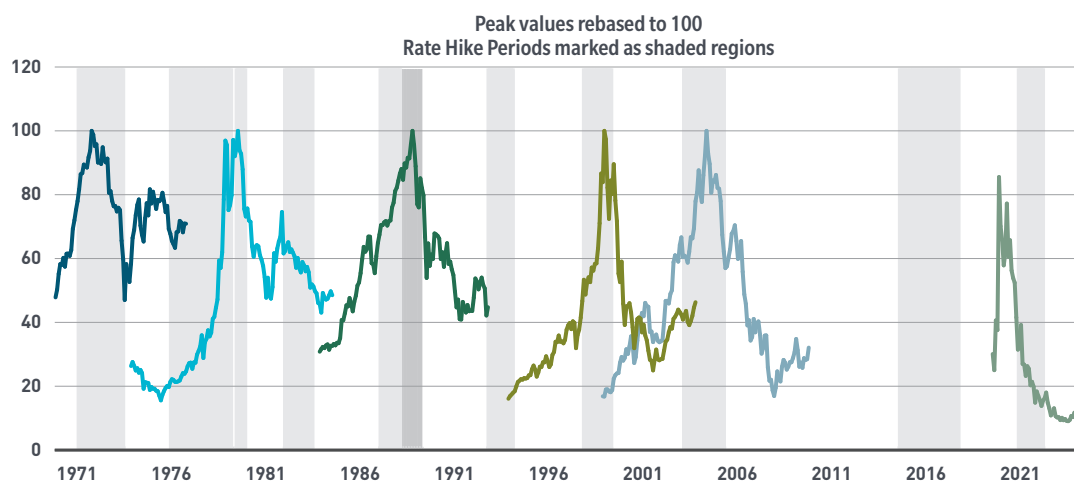


Source: Households & Nonprofit Organizations (NO): Directly and Indirectly Held Corporate Equities as % of Financial Assets sourced from Board of Governors of the Federal Reserve System (US), retrieved from Federal Reserve Bank of St. Louis (FRED) on 14 October 2025. S&P 500 Shiller Cape sourced from FactSet, Robert Shiller, Yale University Department of Economics. US Shiller Cape ratio is the price-to-earnings ratio based on average inflation-adjusted earnings from the previous 10 years. Quarterly data from 31 December 1951 to 30 June 2025 (Households & Nonprofit Organizations (NO): Directly and Indirectly Held Corporate Equities as % of Financial Assets) and 30 September 2025 (S&P 500 ShillerCAPE).

Yet bubbles rarely burst simply due to age. Instead, they unravel when revenues disappoint in the face of slowing growth or when interest rates rise, creating problems for those who have taken on too much leverage. As the saying goes, the worst loans are made in the best of times. Today, there is no sign of interest rates rising in the US; in fact, expectations point to further cuts over the next year, and fiscal support remains robust. However, events such as an unexpected inflation shock, which would push rates higher, or cracks in the AI narrative could risk derailing the current momentum.

Exhibit 2: Rising rates historically coincide with bubble bursts

■ Nifty 10 ('72) ■ Gold ('79) ■ Nikkei ('89) ■ Nasdaq ('00) ■ US Housing ('05) ■ Meme Stocks ('21)
 ■ US Rate Hike ■ Japan Rate Hike

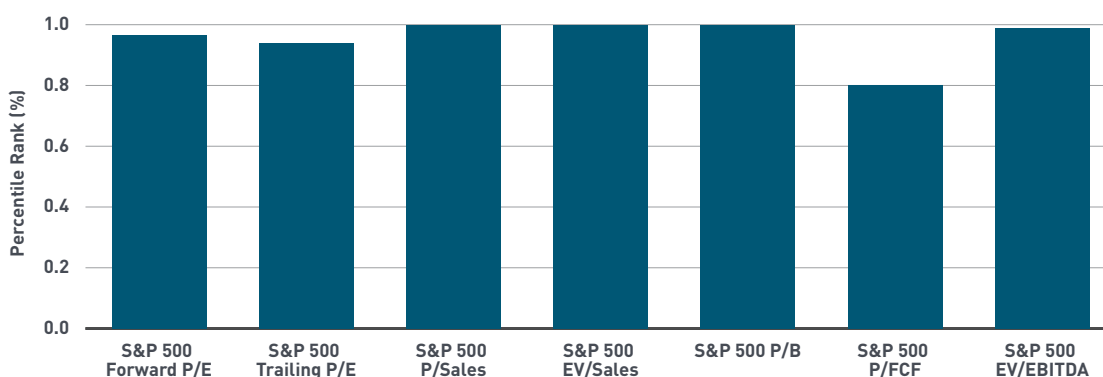


Source: BNP Paribas

It's worth noting that S&P 500 valuations, across a range of metrics, are within 10% of their most expensive levels since the early 1990s, as shown in Exhibit 3. In part, some of this increase may be due to structural changes in the US economy over the past 30 years, with many companies less capital intensive and generating higher profit margins, but it is hard to argue that the entire market should be trading close to all-time highs.

Exhibit 3: Across most fundamental valuation metrics, US large cap equities are near the most expensive they have been since the 90s

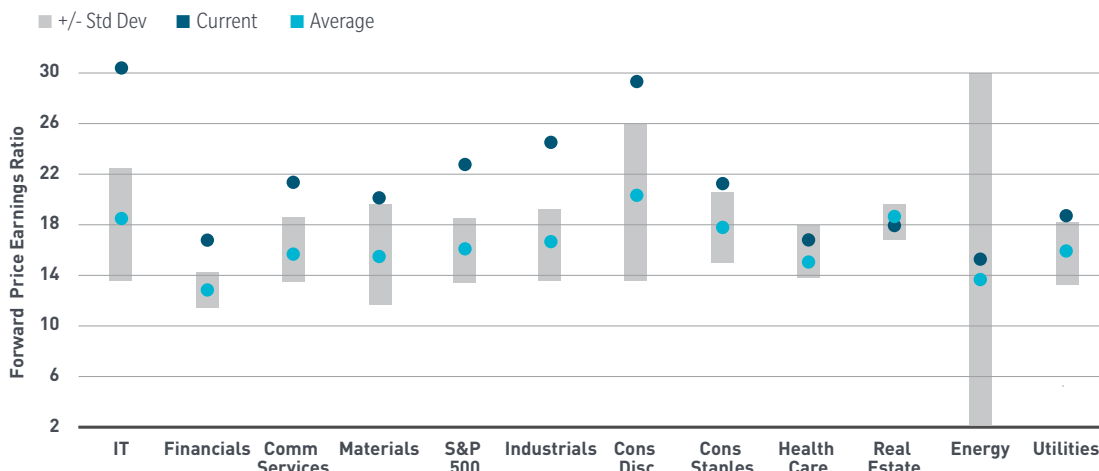
■ Current S&P 500 Valuation Relative to History (100% = Most Expensive, 0% = Least Expensive)



Source: FactSet. Horizontal axis labels represent the starting points of the time periods used determined by data availability. (Forward PE 1993, P/FCF 1991 all other metrics since 1990) Percent ranks are based on valuation metrics as of 30 September 2025. Forward = next-12-months. If not labeled "Forward," all other multiples are based on last-12-months data.

When broken down by sector, current valuations remain elevated (Exhibit 4), underscoring the importance of being selective and mindful of how earnings might evolve to meet these valuations.

Exhibit 4: Valuations are elevated across sectors; it is not just technology driving S&P 500 valuation levels



Source: Monthly data from 30 September 2005 through 30 September 2025. Due to data availability, real estate data is from 30 September 2016 through 30 September 2025. FWD = Next 12 months forward P/E ratio.

Investing is inherently about taking risks, but the key is to take risks that are likely to be rewarded. Valuation, at its core, is investors' collective view of the future. When valuations expand to the levels we are seeing now, they reflect optimistic expectations, but even good news can disappoint if those expectations are set too high. As valuations rise, the margin for error narrows, and risk can become asymmetrical, with downside risk outweighing upside potential. It is therefore essential to carefully assess potential risks in a forward-looking context. A company's ability to deliver earnings and cash flow growth over time is what ultimately determines its value, and investors must remain grounded in this principle.

What Should Investors Consider?

For long-term investors focused on both growth and capital preservation, attaching greater importance to valuations becomes increasingly prudent as they continue to rise. This doesn't mean avoiding all high-growth opportunities, but rather taking a discerning and disciplined approach. Lean into quality and resilience, and don't rely solely on naïve metrics or blanket assessments. A holistic perspective is essential, combining both quantitative factors and qualitative insights to separate genuine value from mere price momentum.

A successful outcome requires more than hope; it demands strategy. While momentum and exuberance can be powerful forces, investors must remain vigilant about what needs to happen to future earnings to justify elevated valuations. Missing out on some near-term upside may be the price of maintaining discipline, but it is a small tradeoff for avoiding unrewarded risks.

Conclusion: Active and Selective Investing Anchored in Valuation

Valuation remains the foundation of long-term returns and effective risk management. While today's elevated market valuations and favorable conditions — such as easy money and technological breakthroughs — may suggest a shifting paradigm, history demonstrates that prices cannot rise indefinitely without being supported by earnings. Valuation always matters because it reflects the sustainability of returns and the risks inherent in achieving them.

Although the current environment shows hallmarks of a bubble, we are not stating that one is imminent. Instead, we emphasize that the conditions for caution are present, as high valuations naturally narrow the margin for error. This makes discipline and selectivity essential for navigating today's markets. Investors must carefully assess whether lofty valuations are justified by realistic expectations of future earnings and cash flows.

It is also critical to recognize that valuation is not a straightforward mathematical formula. Traditional metrics like price-to-earnings (P/E) or price-to-book (P/B) ratios are useful but incomplete. True valuation requires a forward-looking analysis of risks and opportunities, many of which are inherently uncertain and difficult to quantify. A company that appears expensive on traditional metrics may still represent strong value if its long-term potential outweighs its risks.

By focusing on quality, resilience, and a holistic evaluation of future risks and growth potential, investors can better manage uncertainty and position themselves for sustainable long-term returns in today's challenging environment.

The message is clear: ignoring valuation is not a “new paradigm” — it's a gamble.

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