

Earnings Will Set You Free

A closer look at why business results, not investor sentiment, determine long-term returns.

Executive Summary

Over the long run, earnings growth and dividends, not changes in investor sentiment, are the primary drivers of equity returns. While narratives can cause valuations to diverge from fundamentals for extended periods, durable businesses ultimately earn their way through market skepticism as business results reassert themselves. Through the experiences of Mastercard and Microsoft, this paper illustrates how investors who focus on owning high-quality businesses can benefit from long-term compounding while avoiding the need to forecast the market's next mood swing.

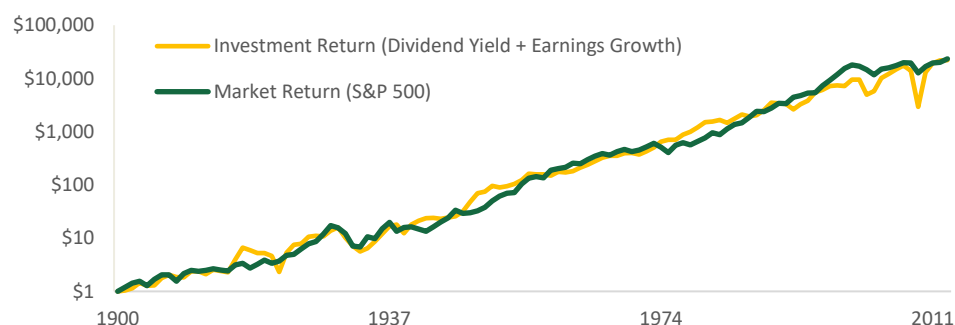
Owners and Renters

Before assessing an investment opportunity, it is essential to understand the mechanisms that drive its returns. John Bogle, the founder of Vanguard, offered one of the simplest and most enduring frameworks for public equities. It decomposes a stock's total return into three components: dividend yield, earnings growth, and the change in valuation multiple applied to those earnings (i.e., price-to-earnings ratio).^[1] The business itself generates the first two. The market's opinion of the business generates the third.

Whether an investor's expected return is anchored to the business results or the market's opinion of it marks the philosophical divide between investors that see themselves as partial business owners and those that are renting the stock. A stock renter's return depends on whether the next buyer will pay a higher multiple, whereas an owner's return is tied to the business's ability to grow earnings over time. In effect, stock renters are forecasting the future sentiment of other investors while business owners underwrite the durability of the company's earnings power. The owner does not need the next buyer to be more optimistic than the last; the owner needs the business to expand earnings, trusting that the market will eventually recognize the power of that growth.

Over shorter time windows, particularly early in a new investment cycle, speculation surrounding a company's valuation multiple can dominate the stock's performance. The evidence over longer periods tells a different story. Eleven decades of U.S. stock market returns reveal that dividend yield and earnings growth do most of the heavy lifting while changes in the valuation multiple contribute almost nothing to the total return (Exhibit 1).

Exhibit 1: Investment Return Versus Market Return
Growth of \$1: 1900-2012



Source: Chilton Investment Company calculations using data from Robert J. Shiller, *U.S. Stock Markets 1871–Present*.^[2] Figures reflect annual S&P Composite price, trailing 12-month price-to-earnings ratio, and dividend yield from January 1, 1900 to January 1, 2013, representing 113 years of returns. Return decomposition follows the framework in John C. Bogle, "Thinking About What Lies Ahead For Investors," Remarks to the CFA Society of Washington, June 13, 2012.^[1]

This does not imply that valuation is irrelevant. Rather, it suggests that even if stock valuations go up, down or sideways, long-term performance ultimately rests on a business's ability to grow earnings. Over time, the market's role shifts from expressing opinions to measuring results.

As Warren Buffett, echoing his mentor Benjamin Graham, often reminds investors, *"in the short run, the market is a voting machine...but in the long run, it is a weighing machine."* [2]

When the Market Looks Away from Earnings

Although earnings and dividends drive long-term returns, stock prices often diverge from them over shorter windows. Markets continuously reassess future cash flows in response to a myriad of factors: elections, interest rate changes, competitive developments, and geopolitical events. Because no one can know with certainty how these forces will ultimately affect a business, today's stock price reflects expectations about the future rather than observable reality.

The resulting uncertainty creates a vacuum that narratives rush to fill. As Durability in the Face of Disruption highlighted with the 2017 grocery and auto-parts panics, when a narrative takes hold, the market paints with broad brushstrokes and tends to classify entire industries as the presumptive winners or losers before the evidence is fully available. Because narratives form before the facts are settled, they typically overshoot in both directions, pricing in outcomes well before there is evidence to support them. When optimism outpaces evidence, multiples expand; when fears exceed reality, multiples contract. In both extremes, what changes is not the business itself, but rather the market's assessment of it.

Yet every narrative eventually meets the same test in public markets: earnings season. Every quarter, companies report results that either confirm or challenge the expectations embedded in their valuations. As those results accumulate, market expectations and business reality are pulled back into alignment. Given enough time, the narrative may shape the path of returns but earnings determine where they end up.

For the business owner, periods of narrative-driven volatility create opportunity. While the market focuses on changing sentiment, the owner focuses on whether the company's earnings power remains intact. Mastercard and Microsoft illustrate how, despite periods of significant narrative pressure, earnings ultimately reassert themselves as the primary determinant of long-term value.

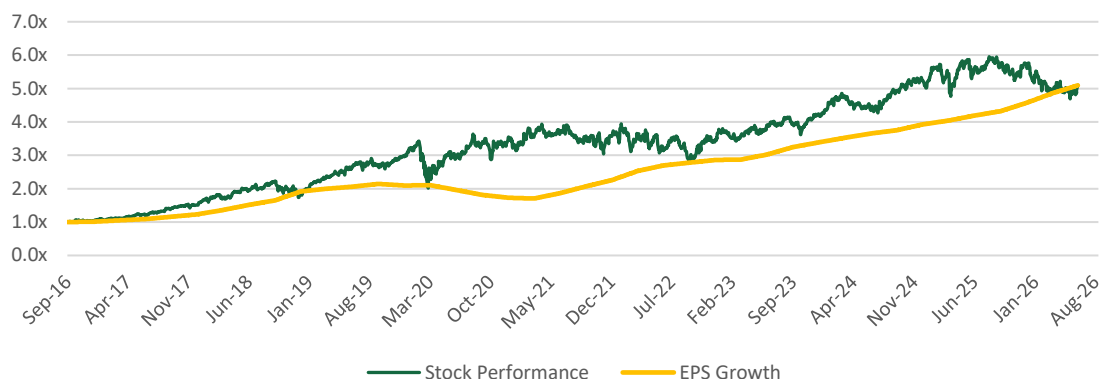
Complaining in Plain Sight

We chose these two companies deliberately. Mastercard compounded quietly, with earnings and share price moving in close step, while Microsoft compounded loudly, with earnings reasserting themselves after a period of severe narrative pressure.

Mastercard

Over the last ten years, Mastercard compounded earnings per share at 18.1% a year while its shares returned 19.2% annually. The minuscule gap between the two figures represents the entire contribution of multiple change in the stock's total return (Exhibit 2).

Exhibit 2: Mastercard Stock Performance vs EPS Growth Indexed



Source: Bloomberg. Figures reflect daily share prices and trailing 12-month EPS growth from August 19, 2016 to September 10, 2026

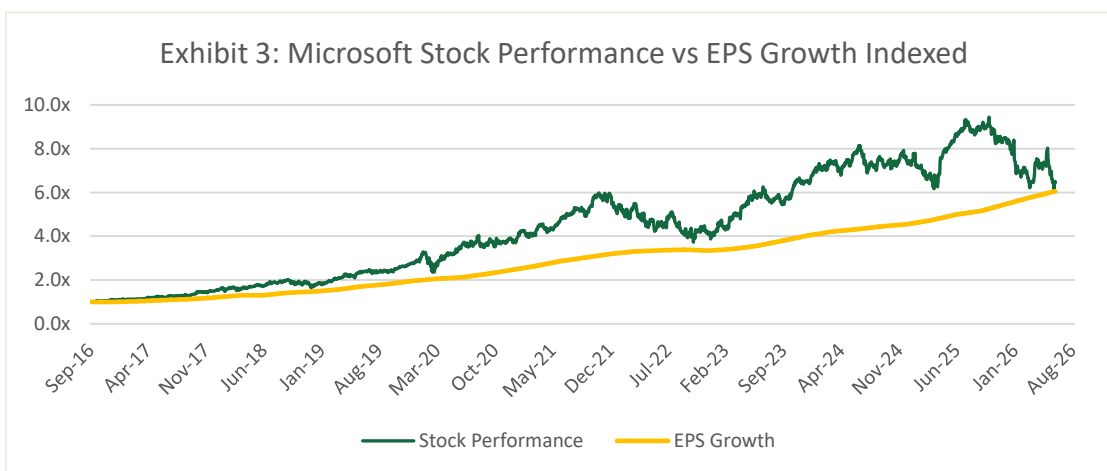
Earnings per share and share price oscillated closely throughout the decade. Enthusiasm for digital payments lifted the multiple above fundamentals and anxiety over emerging fintech competitors dragged it below. Each divergence proved temporary as the share price kept returning to a line set by earnings rather than sentiment. The investor who held through those stretches captured the compounding returns while the one who traded around them just captured the price action. Microsoft faced the same test under considerably harsher conditions.

Microsoft

Through the first half of 2026, Microsoft was the market's preferred vehicle for expressing skepticism on whether the advent of AI and new models from Anthropic and OpenAI would lead to disruption in Microsoft's business model and position as a key provider of productivity solutions and cloud infrastructure services. Even as Microsoft beat consensus estimates, the 'AI loser' label overpowered the structural advantages we described in The Value of Trust in the Age of AI, where Microsoft's decades of institutional trust and deep enterprise integration ranked among its most durable competitive advantages.

On January 28, 2026 shares fell by 10% in a single session, erasing \$357 billion in market value, the largest single-day dollar loss in the company's history to that point.[3] Microsoft beat expectations again the following quarter and yet, the share price slid further.[4,5] The disagreement was never about whether Microsoft could grow earnings; it was whether spending at that scale would earn a return above its cost. That question could only be settled by the tangible results in the forthcoming earnings report (Exhibit 3).

Exhibit 3: Microsoft Stock Performance vs EPS Growth Indexed

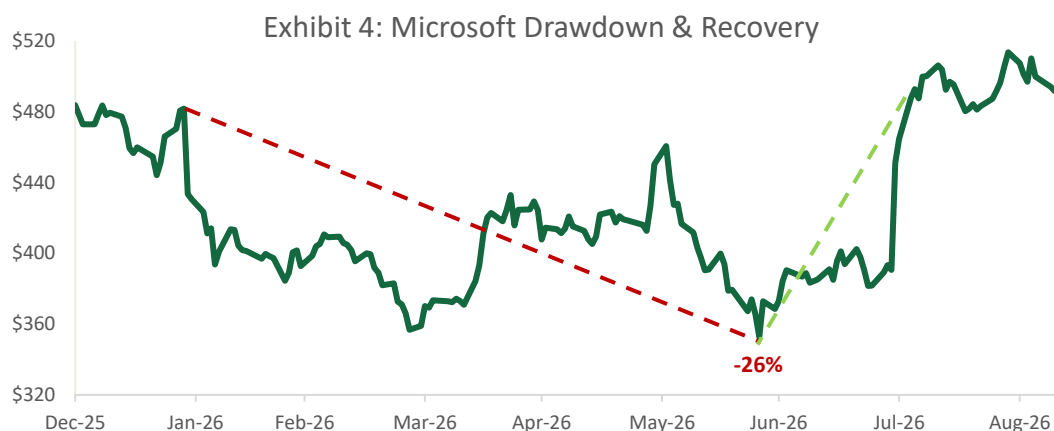


Source: Bloomberg. Figures reflect daily share prices and trailing 12-month EPS growth from August 19, 2016 to September 10, 2026

The evidence, when it arrived, resolved the question in the business's favor: the company's next quarterly report decisively beat expectations, with growth in its cloud and AI businesses accelerating rather than slowing.[6] The share price soared as a result, adding roughly \$450 billion in market value, the largest single-day gain on record for any company up to this point (Exhibit 4).[7]

Those who had sold on the prior narrative were obliged to buy the same business back at a higher price once the earnings report flipped the perception from an 'AI loser' to an 'AI winner'.

This is the cost of renting a great company.



Source: Bloomberg. Figures reflect daily stock prices from December 31, 2025 to September 10, 2026

One quarter does not settle the debate. Spending at this scale will continue to be questioned and tested, as it should be. For business owners, the longer record is the more useful one. Across a decade that included skepticism about mobile displacement, cloud economics, and now AI infrastructure returns, Microsoft's share price has tracked its rolling forward earnings estimates with a consistency that persevered throughout the narrative noise. Reported earnings have functioned less as a single verdict than as a recurring test a durable business keeps passing.

Final Thoughts

A company's ability to grow earnings and dividends, not the market's shifting opinion, determines an equity investor's return over the long run. The implication extends beyond simply identifying the sources of return; it changes what an investor has to pay attention to.

The renter's task is primarily a forecasting exercise, not of future business results, but of other investors' opinions of them. This approach is speculative by nature and requires continuous attention to political developments, media commentary and competitor announcements. These transient factors shape sentiment, which may drive daily price movements without materially changing the long-term earnings power of a quality business. The owner, by contrast, is free to look beyond the market's changing opinions and focus on the business's long-term earning power.

Freedom, in this context, is not freedom from risk. An owner still bears the risk that a business's earnings power erodes, that its competitive advantages narrow, or that its capital is poorly allocated; no amount of patience insulates an investor from underwriting the wrong business. Freedom, rather, is freedom from the need to anticipate the market's mood.

The ownership approach is neither automatic nor costless. It requires underwriting discipline at the outset: a genuine assessment of whether a business's earnings power is durable enough to reward the patience this approach demands. It also requires tolerance for the periods in which the market disagrees, as it did with Mastercard and during Microsoft's punishing first half of 2026. Importantly, it does not require correctly predicting when sentiment will turn, what headline will trigger it, or how the market will read next quarter's results before those results exist. Time and accumulated earnings do that work instead.

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Sources:

- [1] John C. Bogle - Thinking About What Lies Ahead For Investors
- [2] Warren Buffett - Chairman's 1993 Letter to Shareholders of Berkshire Hathaway
- [3] Geekwire - Microsoft's Historic Plunge
- [4] Microsoft Corporation, FY2026 Second Quarter Earnings Press Release
- [5] Microsoft Corporation, FY2026 Third Quarter Earnings Press Release
- [6] CNBC, "Stock market news for July 30, 2026" (Microsoft FY2026 Q4 results)
- [7] Reuters, "Microsoft Sets Record With Near \$450 Billion Single-Day Gain in Market Value," July 30, 2026

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