



Finding Value in the S&P 401

October 2016

Today more than ever, there are widely varying opinions about the valuation of U.S. equities. Some believe equities are expensive on a ten-year earnings basis. Others think equities are expensive due to the recent slow earnings growth. Many opine that equities are expensive because earnings estimates are too high. Finally, a group of investors surmises equities are inexpensive because of their dividend yields versus record low interest rates. OPCM believes all four are likely to be correct, however, especially in the present environment, it is dangerous to label an entire index as expensive or inexpensive. Why?

In the present environment, due to the unprecedented activities of global central banks manipulating interest rates lower, many investors are allocating capital to some investments that will likely have higher risk, lower return outcomes. Investors are simply chasing higher investment dividend and income yields. Unfortunately, they are failing to factor in valuation to the equation. History shows this strategy rarely ends well.

OPCM believes this present environment has resulted in a wide spectrum for sector valuations. To our investment team, sectors can now be placed into five distinct categories. The first category contains the “bond proxies”, which are sectors with higher than average dividend yields. These sectors include utilities, telecommunications services, REITs, and consumer staples. Although these four sectors possess relatively high dividend yields versus bonds, the valuation, earnings growth, and debt levels fall somewhere between frightening and obscene. The four sectors trade at an average Price/Earnings ratio of over 21, with average debt/capital ratios of over 55%, and earnings growth averaging only about 5%. These four sectors, which contain 99 companies, reached extremely high to record high valuations over the summer. Coincidentally, these sectors fell 4-7% during the third quarter versus a positive return for the overall S&P 500. Excluding these four sectors, we are left with 401 companies in the S&P 500 that do not fall under the umbrella of very expensive with low earnings growth and high debt. Next we break down the “S&P 401.”

A group we call “expensive with high expectations” is like the 99 companies mentioned above in that it is hard to find attractive opportunities. In this case, stocks are expensive, forward expectations are high, and we feel the probability of a future disappointment is high. We are generally not interested in this group. Many industrial companies fall in this group.

The investment team is, however, finding value in the next group of companies that appear to be expensive on the surface, but earnings are inflecting higher, and should deliver higher than market earnings growth rates. These sectors include energy and materials, both of which we increased our allocation to in early 2016.

Also on the positive side, there are three sectors with overall inexpensive valuations, where sentiment is extremely negative due to the upcoming election, the level of interest rates, or overly negative earnings estimates. The sectors that fit in this group are healthcare (election fears), financials (fear of low interest rates forever), and consumer discretionary (overly negative earnings estimates and poor sentiment). Over half of the potential new purchases on our team’s watch list fall under one of these three sectors, as many of these issues may be transitory or over exaggerated.



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Finally, there is the technology sector where higher earnings growth companies trade at astronomical valuations, while slower growth companies trade near market valuations. As you know, this is a very diverse sector for OPCM with holdings that span every type of technology industry. Our potential future purchases are also diverse with reasonable valuations versus earnings growth.

To summarize, we believe making a blanket call on valuation for the broad S&P 500 in this environment is a mistake. Within the S&P 500, there are a few sectors that are extremely overvalued and risky due to investors chasing investment yields. Excluding these situations, a disciplined investor is left with an S&P universe of 401 companies. Within that universe, our investment team is mainly finding the most value in companies that:

First, appear to be expensive, but earnings growth may surprise to the upside, thus eliminating the perceived expensive valuation. And second, companies that recently underperformed, and became exceedingly inexpensive due to overly negative sentiment about future earnings, and other fears that may pass in the near or intermediate future.

So today when asked whether U.S. equities are expensive or inexpensive, we say YES.

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