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Marketing Material

HIGH S&P 500 FREE-CASH-FLOW YIELD REFLECTS WEAK CAPITAL EXPENDITURE, NOT ATTRACTIVE VALUATIONS

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IN A NUTSHELL

- S&P 500 earnings-per-share yield is 20% below history, free-cash-flow yield is 35% higher due to low capital expenditure
- Free-cash-flow traps?: Beware of sectors where free-cash-flow yield is cheap, but earnings-per-share yield is expensive
- S&P 500 net margins recovered in the second and third quarter of 2019 after slipping in the fourth quarter of 2018 until the first quarter of 2019
- S&P 500 earnings quality has been sub-par since 2015, it is 82% in the third quarter of 2019
- S&P 500 buyback slow, but total dividend plus buyback payout remains high

S&P 500 EARNINGS-PER-SHARE YIELD IS 20% BELOW HISTORY, FREE-CASH-FLOW YIELD IS 35% HIGHER DUE TO LOW CAPITAL EXPENDITURE

S&P 500 ex. Financials earnings-per-share (EPS) yield is 4.9% now vs. 5.9% average since 1980, but the free-cash-flow (FCF) yield is 4.6% now vs. 3.4% average since 1980. Thus, some think the S&P 500 is not expensive vs. history, despite a low EPS yield (high price-to-earnings ratio, P/E), arguing FCF yield valuation metrics are better than earnings yield. We disagree. Earnings yield better captures how demanding valuations are across stocks and time or vs. interest rates. FCF yield differs from earnings yield owing to the portion of earnings reinvested for growth. FCF measures calculated as operating cash flow (OCF) less capital expenditures (capex) are problematic for valuation. Here we simply calculate FCF as (non-GAAP net income + depreciation and amortization (D&A) – capex).

Higher S&P 500 FCF yield vs. history is from lower capex vs. D&A. Less opportunities for businesses to expand does not make valuations more attractive. Moreover, any boost to FCF from the extraction of capital, when D&A is larger than capex, is unsustainable. This is why we prefer EPS yields. Also, we can subtract EPS yields from real-cost-of-equity (CoE) estimates to imply market expected long-term value-added growth rates. Similarly, a fair steady state P/E can be estimated as 1/real CoE. An observed P/E above a steady-state P/E reflects a premium for value added growth. Unlevered earnings multiples or yields, such as EV/NOPAT (net operating profit after tax) or NOPAT/EV, are our most preferred single period financial performance based valuation metrics. Otherwise we prefer discounted-cash-flow (DCF) models.

FREE-CASH-FLOW TRAPS?: BEWARE OF SECTORS WHERE FREE-CASH-FLOW YIELD IS CHEAP, BUT EARNINGS-PER-SHARE YIELD IS EXPENSIVE

FCF yields at Materials, Energy and Industrials are 150 to 200 basis points (bps) above history, but because of depressed capex. The EPS yields at Materials, Energy and Industrials are 50 to 150 bps below history. Investors focused on FCF yield might be taking false comfort in unsustainable free cash flows from lack of investment or capital extraction. We think the low EPS yields vs. history show that these sectors are priced for a strong recovery in earnings power, which might not be coming soon.

Financials and Health Care are the only two sectors with EPS yields higher than their average since 1980. Health Care also has the biggest FCF yield premium vs. history at 7.1% vs. 5.0% average. But this high FCF yield is consistent with a high EPS yield vs. history, which is then further boosted by less capex vs. D&A than in the past. But in part because investment now occurs more through expensed Research & Development than capex. It is the combination of an attractive EPS yield and a more intangible investment driven industry further boosting the FCF yield that we find attractive.

S&P 500 NET MARGINS RECOVERED IN THE SECOND AND THIRD QUARTER OF 2019 AFTER SLIPPING IN

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THE FOURTH QUARTER OF 2018 UNTIL THE FIRST QUARTER OF 2019

Since the 1990s, globalization and digitalization boosted S&P 500 profit margins to new highs, which were boosted even higher by the U.S. corporate-tax-rate cut in 2018. After peaking in the third quarter of 2018 at 12.7%, S&P 500 non-GAAP net margin declined to 11.7% in in the fourth quarter of 2018 until the first quarter of 2019. The two-way tariffs implemented by the United States and China since July 2018, together with a stronger dollar and weaker oil prices, pressured S&P 500 net margins. However, S&P 500 companies demonstrated resilience and their net margin improved to 12.1% in the past two quarters, albeit on a non-GAAP basis as discussed below, suggesting that the cyclical risks of a downward spiral from companies defending margins is contained. However, if this trade war persists and globalization stalls, further pressure will come on margins and how companies respond to protect margins could raise cyclical risks. Our 2020 estimate (E) S&P 500 170 dollars EPS or 4% year-over-year growth assumes 3% to 4% revenue growth, about 1.5% share shrink and slightly down S&P 500 net margins. Even just a slight net margin decline of 0.25% would reduce S&P 500 EPS growth by 2%.

S&P 500 EARNINGS QUALITY HAS BEEN SUB-PAR SINCE 2015, IT IS 82% IN THE THIRD QUARTER OF 2019

The S&P 500 GAAP EPS to non-GAAP EPS ratio has been below its norm since 2015. We consider this ratio healthy at 90%, when outside of recessions. We are bothered that rather than recovering, this ratio drifted lower to 82% in the third quarter. We also compare non-GAAP earnings to an adjusted cash flow measure to assess how well non-GAAP EPS represents true earnings. Over the past few years, (non-GAAP net income plus D&A) was 10% to 15% higher than (OCF - option expense) vs. about 5% prior. We advocate a 10% reduction to non-GAAP S&P 500 EPS to account for earnings quality.

S&P 500 BUYBACK SLOW, BUT TOTAL DIVIDEND PLUS BUYBACK PAYOUT REMAINS HIGH

Net dollars spent on buybacks were roughly 150 billion dollars in each of the last two quarters at the S&P 500, compared to a quarterly pace of 200 billion dollars in the third quarter of 2018 until the first quarter of 2019. As of the third quarter, net buybacks as a percentage of market capitalization ran at a 2.5% a.r., in line with the average since 2013. On a four-quarter trailing basis, the dividend yield is 1.9% and buyback yield (net buybacks less stock compensation as percentage of market capitalization) is 2.1% for a combined total yield of 4%. The dividend payout ratio is 35% and 38% from net buybacks for a combined 73%. We expect buybacks to slow further in favor of higher dividend payout ratios.

GLOSSARY

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

One basis point equals 1/100 of a percentage point.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

In relation to currencies, depreciation refers to a loss of value against another currency over time.

Discounted cash flow is a method used to gauge the value of a company by finding the present value of projected future cash flows.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Net operating income (NOI) refers to rent and other revenues minus operating costs.

Operating Cash Flow is an accounting term that measures the amount of cash generated by a company through its usual business activities.

An option is a contract which gives the buyer the option – but not the obligation – to buy or sell an asset in the future at a specified price.

The payout ratio is the proportion of earnings paid our as dividends to shareholders, typically expressed as a percentage.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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