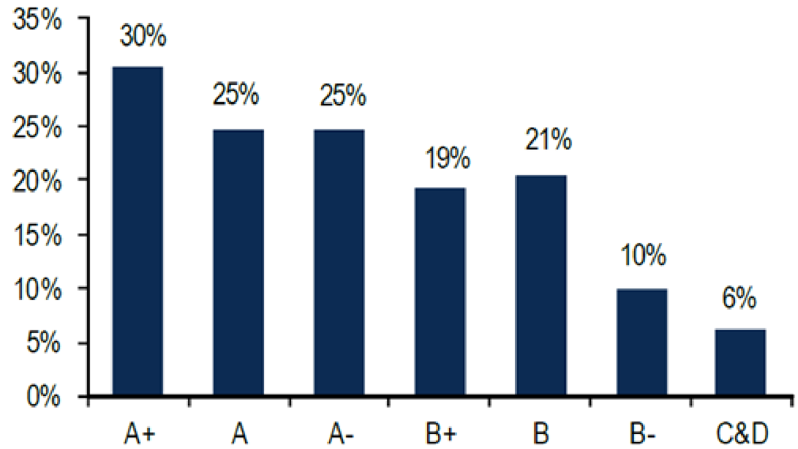
Average performance by S&P 500 Quality Ranks when the profits cycle decelerated (last seven cycles, 1988-present)



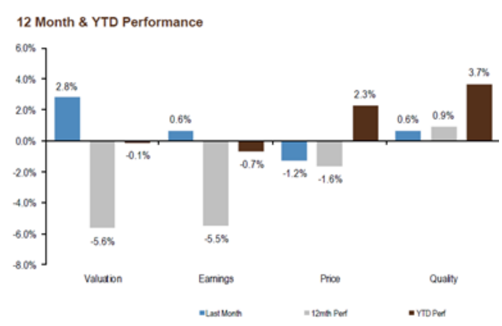
Source: BofA Merrill Lynch US Equity and Quant Strategy, S&P

It Doesn't Get Much Better Than This – Redux

While it may be true that the Virginia Cavalier fans in the office are still riding high from this year's national championship(s), we are referring to the title of the investor communication our group penned 16 years ago that started with, "investors are smiling again." The time was similar to today where the S&P 500 was up over 26% for the year as "a surprisingly strong economy, surging corporate profits, and a beginning valuation that was depressed" provided a favorable backdrop for investors. The same index closed up a fraction below 20% at the end of last month, and we are only six months into the year.

The Benefits of Quality

This past weekend we celebrated not only Independence Day but also breaking the record in the U.S. for the longest economic expansion in the nation's history. Starting in June of 2009, the economy has grown for over 120 months. Now that we are 10 years into the economic expansion, pundits are discussing slowing manufacturing growth, the flattening yield curve, and negative interest rates throughout Europe. How does a vigilant investor position an investment portfolio in light of a slowing macroeconomic environment? Historically, investing in quality companies has provided better returns in such an environment according to Merrill Lynch's analysis of stock performance (as shown above). The challenge for investors is that as J.P. Morgan notes, over the past 12 months and year-to-date, exposure to quality has been an acknowledged winning strategy for stocks in the MSCI All World Index, as investors were willing to "pay up" for sustainable capital returns and earnings growth in the face of a slowing global economy (as seen in the chart below on the far right).



Source: MSCI, Factset,Reuters, J.P. Morgan Macro QDS

Should Higher Returns + Growth = Higher Valuation? A Case is Made

With the Russell 1000 Growth index outperforming its Value cousin by over 5% six months into 2019, it is fair to say investors are hungry for quality growth. Recently a spate of white papers from investment managers have made the case for paying higher valuation multiples for stocks that combine high returns on capital and earnings

Table 1: Fair Value P/E ratios (if $r = 9.5\%$)

		ROIC-Cost of Capital Spread											
		-1%	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
Earnings Growth	8%	3.9	10.5	15.9	20.3	24.0	27.2	29.9	32.3	34.3	36.2	37.8	39.3
	7%	7.1	10.5	13.3	15.7	17.6	19.3	20.7	21.9	23.0	24.0	24.9	25.6
	6%	8.4	10.5	12.2	13.7	14.9	15.9	16.7	17.5	18.2	18.8	19.3	19.8
	5%	9.2	10.5	11.6	12.6	13.3	14.0	14.6	15.1	15.5	15.9	16.2	16.5
	4%	9.6	10.5	11.3	11.9	12.4	12.8	13.2	13.5	13.8	14.0	14.3	14.5
	3%	10.0	10.5	11.0	11.4	11.7	12.0	12.2	12.4	12.6	12.7	12.9	13.0
	2%	10.2	10.5	10.8	11.0	11.2	11.4	11.5	11.6	11.7	11.8	11.9	12.0
	1%	10.4	10.5	10.6	10.7	10.8	10.9	11.0	11.0	11.1	11.1	11.1	11.2
	0%	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5

Source: Epoch Investment Partners

growth. The argument is based on the Gordon Growth Model; companies with higher returns on capital should be rewarded with higher valuations since they require less cash and capital to generate their growth and as a result have more money to give back to shareholders.

Output of this work can be seen in the chart above where the case is made that it is reasonable to pay over 2.3x the multiple for the average stock in the S&P 500 for a company with an 8% earnings growth rate and 20% return on capital. Just as in 2003, many of these stocks can be found today in the technology sector that as a whole trades at 20x next year's earnings. How sustainable are these valuations? We'd prefer to seek out skilled users of technology that can deploy the technology to improve earnings and returns on capital.

We're On the Hunt for Above Average Returns + Growth...At the Right Price

An example that is owned in several portfolios is United Healthcare. United has leveraged its managed care platform and cash flow to invest in technology. Its Optum healthcare information technology unit has grown from 20% of sales 10 years ago to over 33% this year. This unit is growing 25% faster than the rest of the company and helped United increase its returns on equity by close to 50% over this same timeframe. We agree that a company with above average returns on capital and earnings growth should garner an attractive valuation and using the chart above United should be awarded roughly twice its current price-to-earnings multiple. With election politics hanging over most healthcare stocks, we see United as a quality "opportunity" where we believe we have a margin of safety combined with the potential for significant upside opportunity over time.

As always thank you for your interest and trust managing your investments.

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