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Historical Earnings, P/E Ratios and Sector Valuations in Today's Markets: Active Value Investing by Vitaliy N. Katsenelson

Vitaliy Katsenelson, CFA is a portfolio manager with Investment Management Associates in Denver, CO. He teaches finance at the University of Colorado and most recently is the author of *Active Value Investing* (above), where he describes his strategy of investing in range-bound markets. He is a frequent contributor to the *Financial Times, Dow Jones MarketWatch, has written for Barron's and Business Week*, and maintains a website ActiveValueInvesting. We interviewed Katsenelson on February 14, 2008.

Your central thesis is that we are now in a range-bound market and not a bear market. For the benefit of our readers, can you define a range-bound market and why you are so confident we are not in a bear market?

Markets have long term secular cycles and short-term cycles, and it is the former that I will focus on in this discussion. Traditionally we have been trained to look at long-term cycles from a bull and bear perspective. But half of the secular markets in the last 200 years have been going up, and the other half going up and down and not really going anywhere. I define these long-term sideways markets as range-bound. We assume when markets are not going up they were going down, but really these are periods of prolonged sideways movement.

A secular bull market begins with very low P/E ratios and average economic growth. P/E ratios expand, adding to earnings growth, and P/E ratios serve as a tailwind producing supersize returns.

But when P/E ratios expand to very high levels they become a headwind. At end of a bull market we can have a range-bound or a bear market. The only difference is what happens to the economy in long run. If the economy is growing - even if that growth isn't spectacular (average will do) - we will have a range-bound market. If the economy is contracting we will have a bear market. Either way, we will have P/E compression.

In a range-bound market, the slope (overall direction) of the market is flat, but the market is volatile.

The best recent case of a bear market was Japan in late 1980s. Japan had both a long-term contracting economy and contracting P/E levels. Economic contraction added fuel to the fire.

"There has been only one secular bear market in the last century, and that was the Great Depression."

I don't know what the economy will do in the next six months or the next two or three years. But, if the economy remains healthy in the long run, we are in a range-bound market – one which started in 2000.

There is some probability of a severe or long recession, in which case a bear market results. There has been only one secular bear market in the last century, and that was the Great Depression.

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You argue persuasively (see Down to the Last Drop of Profit Growth) that today's P/E multiples are inflated, primarily because earnings (the denominator) is above historical averages. Currently pre-tax margins are at 11.9%, but have averaged only 8.5% since 1980. Is this based on the S&P 500 or a broader market? You argue that shifting to a service-based economy might improve baseline margins to between 8.9% and 9.2%, but this still implies a 30% drop in the market. If we are about to see a contraction in earnings, shouldn't the market have already discounted this into prices, and reflected this in current P/E ratios?

Today's margins (measured as pre-tax operating earnings across all US corporations as well as across the S&P 500) are almost 40% above historical averages. Our economy is more service-oriented than in the past, adding 40 to 70 basis points to historical profit margins.

To normalize the broad market's earnings, I look at them over more than just the trailing 12 months. I use 3, 5, 10 and 12 year historical averages, to insure earnings are not artificially skewed by one or two year's worth of exceptional (good or bad) results. This is consistent with the approach advocated by Robert Shiller of Yale [Ed. Note: see our article on this subject].

Today's P/E ratio (based on 2007 earnings) is about 17, but if you normalize the earnings, the P/E goes up to 22 or 24.

The market is not cheap, and today's market levels do not reflect lower earnings. If it did, P/E ratios would be lower. Also, investors love drawing straight lines to illustrate market trends, and thus most expect the above average earnings growth we observed in the recent past to continue (in part because we came out of the 2001 recession and in part because of margin expansion). Unfortunately, they'll be negatively surprised.

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Just because profit margins are high and will contract does not forebode a 30% drop in the market, at least not in the short run. Depending on the presence or severity of a recession, profit margins will decline and earnings will either lag GDP growth or decline.

This profit margin analysis does not forecast the (cyclical) short-term direction of the market, which would be market timing – a loser's game. I am trying to identify risks. (As a side note: in my book I argue against market timing, instead urging investors to focus on timing individual stocks – buying them when they are cheap and selling them when they are fairly valued. I provide a detailed strategy of how to do just that.)

The current range-bound market started in 2000 when valuations were 50-60% higher than the starting valuations of previous range-bound markets. Seven years later, after plenty excitement and volatility, we are at the same level as where previous range-bound markets started. Whether you value this market with current or historical earnings, you'll get the same result – it is not cheap!

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You argue that competitive pressure erodes the earnings of strong companies. Do you see any sectors as particularly vulnerable? Do you see any industries or sectors where earnings contraction is happening now?

Changes taking place industry-wide get competed away. For example, one might argue industrials have benefited from decreased power among labor unions. But these benefits are transitory and do not allow companies across an industry to sustain higher margins. Price competition ultimately destroys above average margins; it is just a matter of time.

I analyzed historical margins in each of the ten sectors comprising the S&P 500. Six of these sectors are severely inflated. Three (energy, materials, and industrials) are 50% higher than their 1988-2006 historical average margins, even though industries in these sectors haven't changed much structurally. A slowdown in the global economy will be a great deflator in those sectors. Financials are 33% above historical averages – we are already seeing profit margins contract here as banks are taking write offs and defaults are going up. Information Technology and Telecommunications Services are 135% and 25% above historical levels, respectively, although I don't attach as much significance to this because of the enormous structural changes which have affected these sectors. It will probably take the longest for profit margins to adjust in these sectors.

	Pretax Profit Margins		
S&P 500 Sectors	2006	Average (1988-2006)	Above Average by:
Energy	18.3%	11.6%	58%
Materials	14.4%	8.0%	82%
Industrials	11.2%	6.2%	80%
Consumer Discretionary	4.3%	4.1%	3%
Consumer Staples	8.9%	7.9%	12%
Health Care	11.1%	10.4%	6%
Financials	17.4%	13.5%	29%
Information Technology	10.3%	4.4%	135%
Telecommunication Services	12.0%	9.6%	25%
Utilities	11.4%	10.1%	12%
Average:	11.9%	8.6%	**39%**

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Data Source: Standard & Poor's Compustat

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A lot less margin expansion has occurred in Consumer Discretionary, Consumer Staples, Health Care, and Utilities. It comes down to competitive advantage and industry structure. You want to own companies that create a large moat around their business and will be able to defend their position and maintain their margins.

The S&P 500 P/E was at 18.92 as of 1/31/08, versus a historical 25-year average of 20.72 and a historical 50-year average of 17.60. Shouldn't we feel pretty comfortable with today's P/E ratio, compared to historical levels?

If you look at P/E levels over last 100 years, the average is about 15. The higher number over last 25 years encapsulates a very strong 1982-2000 secular bull market.

You need to look at a period including full secular bull and range-bound markets, which together last 30 years or longer. That is what I did in the book. P/Es over the last 25 years include a full blown bull market and only a small portion (seven years) of a range-bound market.

P/E ratios have actually spent very little time at the average level of 15. Only 27% of time have P/E ratios been between 13 and 17. P/Es are at average levels only when they go from one extreme to another.

Shiller argues that P/E ratios should reflect historical (e.g., 10-year) trailing earnings, rather than just the trailing 12 months. His data also suggests that P/E ratios are inflated. How much emphasis do you place on historical data, such as Shiller suggests, versus contemporary ratio values?

I agree with Shiller. Historical data helps to understand the environment and helps to make better decisions. In the book I took a fairly detailed look at P/Es based on 10, 5, 3, and 1 year trailing earnings.

I'd like to ask about non-US markets. The MSCI World Index P/E ratio is currently below its 20 year average. Have overseas profit margins expanded to the same degree as in the US? Should overseas investors be worried about P/E contraction? Earnings contraction? Which regions do you see as currently over- or undervalued?

Unfortunately, I don't have a good answer. It is difficult to get good data on these markets for the type of analysis I require. The math works the same way. Returns come from price appreciation (due to earnings growth and/or P/E expansion) and dividends.

We stay away from hot markets. China has been bid up, and the returns that follow will be low. We have 25% of our portfolio in ADRs, all in companies we determined are undervalued and meet our stringent Quality, Valuation and Growth criteria. Mostly these are European, as this is where we find most opportunities (i.e. cheap high quality stocks). We also own plenty of global companies with a significant portion of their revenue from overseas markets. They should benefit from faster growth in international markets.

If, as you say, "real GDP growth has been one of the most consistent economic statistics throughout the past 100 years," why do you object to a buy-and-hold strategy on the S&P 500?

If you hold a traditional index fund, like the S&P 500, and the market remains range-bound – a very high probability at this point - you'll likely experience the range-bound

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market hell: plenty of volatility and no returns (miniscule dividends and zero price appreciation). I believe you can do a lot better in the current environment.

Given your preference (in range-bound markets) for high dividend yield, high cash flow, lower P/E stocks, what US funds or fund categories are best positioned for the current market?

As I note above, it is important to look at normalized earnings at the sector and company level. I believe Energy, Materials, and Industrials face a very real threat of operating margins contraction. If you believe the global economy will slow down, Materials and Industrials will get hit very hard. Unfortunately, this risk is not priced into stock valuations. I would underweight these sectors.

In the last range-bound market, from 1966-1982, value stocks (those with low P/E ratios) outperformed growth (high P/E) stocks. Their P/Es were lower so they experienced less P/E compression. They also have higher dividends, and this is responsible for a large portion of their return.

If you decide to take a passive investing route, at least pick index funds with a value bias and above average dividend yield, and you'll do better than a broad market index that has a high valuation and pays a skimpy dividend.

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One fund family offering a value and high dividend yield strategy is Wisdom Tree. You can take this strategy further and buy value-tilted ETFs of sectors which are likely to face less profit margin pressure.

In October of last year, you argued the Fed should hold interest rates steady, and let free market forces work out the liquidity problems on their own. Do you still hold to this opinion? What is your view of the fiscal stimulus package just passed by Congress? Are there other government actions that should be taken to stimulate the economy?

The Fed is equipped to fight cyclical problems. The problems we face are structural. Risk was underpriced for a long time, so investors became risk seekers. The risk of the system and the financial markets as a whole increased. It is now unwinding. The market should work itself out on its own. Fed intervention lessens pain in short run but increases pain in the long run.

In Japan they had a structural problem in late 1980s. The government intervened, and did not let companies go bankrupt. The problem did not work itself out - their economy went into a prolonged recession as a consequence. In the past, in the U.S., we let the free markets do their magic even if it caused us more pain the in short run. However, this all changed in 2001, when the Fed intervened and kept rates at extremely low levels for a long time. It led to housing bubble and the problems we have today.

The further we postpone the recession the longer it is going to last. Fed actions may create bubbles in other (often unexpected) asset classes. Stimulus package make for great political speeches but do not

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accomplish much. I told my mother-in-law she should deposit the check she'll get from the government in my kids' accounts. After all, they'll be the ones paying for it.

Lastly, you are forecasting the range-bound market (which started in 2000) will last until 2020. What overall asset allocation recommendations would you make now?

Assuming you are a long term investor, there are two things I recommend.

First, the traditional wisdom that 90% of returns come from asset allocation is only true for secular bull markets, when stocks outperform bonds and T-bills by a great margin. However, in range-bound markets returns from stocks don't differ substantially from bonds or T-bills. I approach this question by asking another question -"What is cost of being wrong?" I would err by overweighting stocks (and underweighting bonds), in case inflation picks up (or the market offers returns higher than I expect). Stocks are a better asset class than bonds. But you must be in the right stocks.

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Instead of buying a broad market index, investors should be in a portfolio of individual stocks that meets the Quality, Valuation and Growth criteria I describe in the second part of my book. This is the approach we use at Investment Management Associates.

Choose funds with a value bias. Value may come in and out of favor, but it does better in range-bound and bull markets.

Second, it is very important to look at what I am saying about range-bound markets, even if you disagree. If history is a guide, there is a high (80%) probability (which you should not dismiss) we will be in a range-bound market and a 20% probability we will be in a bear market. (By the way, Active Value Investing will do better in a bear market, too, because you own high quality companies paying above average dividends, or growing earnings with attractive valuations.) Active Value Investing has the lowest possibility doing harm if you are wrong, which is how you should evaluate any strategy. If the stars are perfectly aligned in a weird way and we experience a spectacular bull market, you might slightly underperform. It is like taking out a very small insurance policy.

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