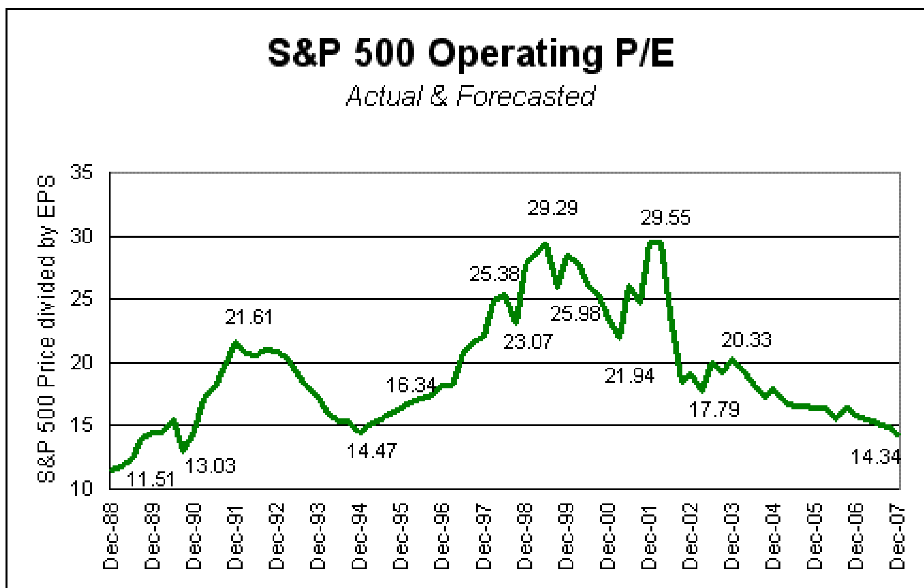
November 8, 2006

The Issue

P/Es, Characteristics & Circumstances

Context & Perspective

Based on $84 in earnings and a price of 1380 the S&P 500's P/E is 16.4x times trailing twelve-month earnings per share, down significantly from where it was before the current bull market began in October 2002[1]. According to Birinyi Associates Inc., it's the first time since 1960 that the price-earnings (P/E) ratio has declined in a bull market[2]. Moreover, the multiple-compression that has taken place over the past few years is among the steepest ever as earnings have soared, while stock prices have risen only moderately. Indeed, when the S&P 500 was first priced at the present level, back in mid-1999, S&P500 earnings were just $47, whereas they are now $84[3]. Additionally, the forward P/E, based on Standard & Poor's estimates for September 2007 EPS, is 14.8x[4].



Source: Standard & Poors, 11.08.06

Both the 16.4x trailing P/E and 14.8x forward P/E are below the average of the past 15 years[5]. The current P/E metrics suggest to many that the market is presently undervalued, some say by as much as twenty or twenty-five percent. Many expect

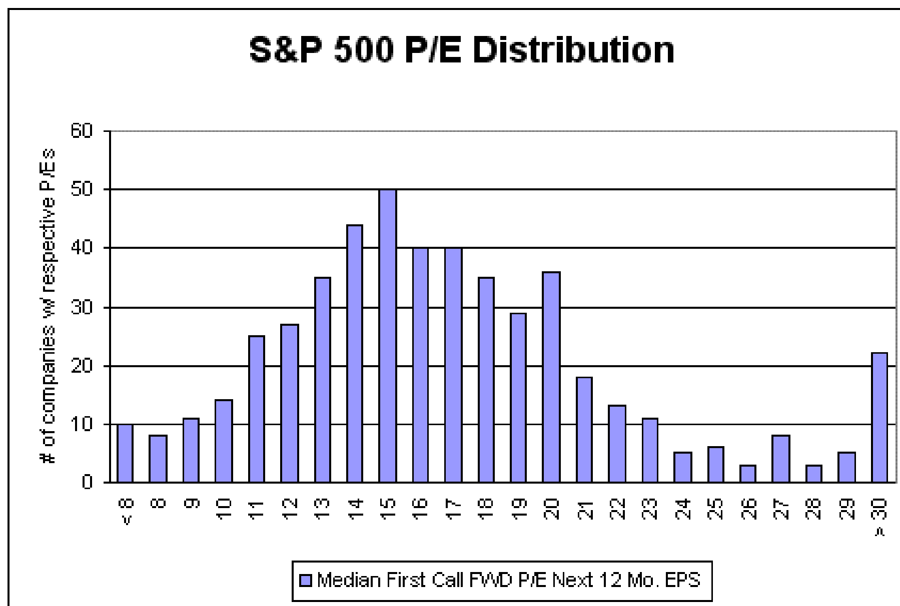
multiple-expansion in the year ahead now that the Federal Reserve has paused and perhaps ended its latest interest rate tightening campaign. The analysts at International Strategy & Investment (ISI) Group believe that economy is entering a mid-cycle slowdown where growth will be below potential for a while, but will not enter recession. They note that during the three prior U.S. mid-cycle slowdowns (1967, 1985, 1995) S&P 500 P/Es expanded on average 2.6 points[6].

Others argue that the stock market is not really that undervalued because it is correctly pricing a higher inflation future than most currently believe, which might mean more Fed tightening, which could even lead to an earnings contraction if tighter Fed policy causes recession. Interestingly, over the past 130 years P/E multiples have averaged 14x[7].

Still others say that losses taken during the tech-crash were so severe that investors are still just too cautious to get enthusiastic about stocks and are thus unwilling to "pay up" for earnings. Heightened geo-political concerns are also likely undermining investor sentiment, contributing to a higher equity risk premium.

P/Es are clearly a very popular metric used by investors to "determine value." However, it is important to remember that they are not an end-all determinant. Furthermore past P/E trends and averages may not be much use when making decisions for the future. Just because a company's P/E ratio is low does not necessarily mean it's undervalued and just because its P/E ratio is high does not necessarily mean it is overvalued. The future performance of the company will ultimately determine whether it was a value or not.

Additionally, the P/E of an index or a portfolio is an aggregate measure. The characteristics of the individual members can be quite different. For example, 324 S&P 500 members have forward P/E ratios higher than weighted average (see graph below)[8]. During the tech-bubble of 1999-2000 a relatively few companies had extremely high P/Es, which skewed upwardly the P/E of the overall index. Many S&P500 companies were undervalued in 1999-2000. Therefore understanding the characteristics of individual holdings and even how they interact with each other is arguably more important than focusing on an aggregate P/E.



Source: FactSet, 9.30.06

Michael J. Mauboussin, chief investment strategist at Legg Mason Capital Management, notes another weakness of P/E data for analytical purposes. He argues that P/E data is nonstationary. In other words, “the statistical properties of the population change over time,” which means “applying averages to today’s population can lead to misleading conclusions.”[9] Mauboussin says that P/E data is nonstationary because three big drivers of P/E ratios are very unstable. They are (1) taxes and inflation (2) changes in the composition of the economy and (3) shifts in the equity risk premium[10]. “Past-ratio averages are only applicable to the degree that they capture current circumstances,” says Mauboussin[11].

Interestingly, Mauboussin writes: “There is pervasive evidence that the global economy is moving from a reliance on tangible to intangible assets, including market-to-book ratios, workforce allocation, and the rising significance of education. Further, because intangible-reliant businesses have few assets on their balance sheets, they tend to show high returns on capital. With other factors held constant, higher cash-flow-to-net income ratios and returns on capital support higher price-earnings ratios.”[12]

Conclusion

Future conditions, not present characteristics are the ultimate arbiter of present value. While the future will likely possess some characteristics of the past circumstances will not be the same. While P/E analysis is one tool that can help determine value, its capabilities are limited. Legg Mason Capital Management engages in intense multivariate analysis in its search for value. It does not have access to information that others do not, but has an investment approach that is unique. Bill Miller, Chairman & Chief Investment Officer of Legg Mason Capital Management, wrote in his third quarter 2006 commentary to shareholders: “Analytical advantages come from taking publicly available information and processing or weighting it differently from the others.”

1. Standard & Poor’s, 11.08.06
2. Hilary Johnson, *U.S. stocks still look cheap*, Bloomberg, 11.06.06
3. Standard & Poor’s, 11.08.06
4. Ibid
5. Ibid
6. ISI Group, 11.07.06
7. Michael J. Mauboussin, *More Than You Know*, page 139
8. FactSet, 11.08.06
9. Michael J. Mauboussin, *More Than You Know*, page 136
10. Ibid, page 137. The equity risk premium is the excess return that you can expect from the overall market above a risk-free return.
11. Ibid, page 136
12. Ibid, page 139

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