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THE IMPORTANCE OF MULTIPLE EXPANSION TO OUTSIDED RETURNS

Nearly every solid value-based fund manager with a decent amount of dough to invest that we like to follow has become quite bullish on U.S. large cap stocks. The refrain goes something like this, “The greatest companies in the world [U.S. Large Caps] are cheaper than they have been in 10 years and one does not get the chance to own these types of high quality companies at such low prices very often.” Managers go on to point out that large caps have done nothing but go down over the last 6 years even as their revenues, earnings, and dividends have increased quite substantially. Whereas in March of 2000, small caps were clearly much cheaper than larger caps, the ensuing six years of small cap outperformance have made large caps more attractive. We are also told that the mainstream public’s disgust for large cap U.S. stocks is near an all-time high. The fact that we have heard this from nearly every fund manager has made the contrarians in us wonder if the earnings multiples in these large cap stocks still reflect too much institutional optimism, even if the little guy has soured on the stocks.

We will submit that the U.S. is home to some of the greatest, branded, high quality blue chip companies in the world. We will also submit that large caps in aggregate are cheaper than small caps in aggregate. But do keep in mind that small caps have on average outperformed large caps by 180 to 190 bps per annum for the last 85 years – a huge amount in compounding as we have chronicled before. With all that said, we think it might make a lot of sense to dig into the bull case for the U.S. large caps to see if an unmistakable investment opportunity truly exists.

What has troubled us about all of these managers’ summations on cheap large caps is that their wonderful arguments about the true value existing in large cap land have been punctuated by a guilty admission at the end of each of their respective bull cases. The admission they are loathe to dwell on goes something like this, “oh, by the way, despite so and so large cap’s stock having declined for 8 years while earnings increased, the P/E multiple is still 15 or 16 or 17 or even 18 times, but we can justify that because interest rates are so low!” No one then mentions that rates are still well below historic averages and likely to have nowhere to go over time except upwards, barring some sort of large U.S. housing debacle that likely wouldn’t be very bullish for stocks anyways.

Over the last 85 years, according to the stock market chart on our wall supplied by *Value Line*, the average Dow Jones Industrial Average P/E (excluding the money-losing years of 1931-1933) has been 14.5x earnings and the average dividend yield has been 4.2%. So as we run through a couple of the popular “cheap” large cap stocks, keep in mind that 14.5x earnings and 4.2% dividend yield is simply average for a large cap U.S. stock’s P/E. Also, keep in mind that for something to be really cheap, one



would need the P/E to be substantially below average (to allow for earnings multiple expansion) or the long-term earnings growth rate to be substantially above the average of 7 to 8%. We will go ahead and throw out the earnings growth rate being substantially above average given the already historically high net margins being enjoyed by U.S. corporations currently (how much higher can things go for a ratio which has long shown mean regression tendencies whenever earnings margins have ventured towards the tails?).

A mentality that we heard Buffett talk about at his annual meeting and which we think is creeping into most fund managers' minds is a "buy at 90% of X" approach. In a world of low returns on cash, it could in theory be advisable to pay slightly below intrinsic, say 90% for large caps (as Buffett talked about in his Budweiser and Wal-Mart buys) and in this process lock-in 7 or 8% returns at best in great businesses. However, to expect significantly more returns than this is foolish and Buffett has said as much. This "90% of X" mentality, while not a favorite of ours, may make some sense when you have tens of billions to invest and the prospect of allocating a huge portion of this cash anytime soon seems unlikely. But for the poorer investors (the non-billionaires) like your authors, who can look at a wider range of companies as we have no size restrictions, it makes no sense to pay anywhere close to 90% of intrinsic simply to put money to work when clearly better opportunities exist in the world for those willing to roll up their sleeves.

Investment returns in stocks usually come in two forms. The first being an increase in earnings and the second being an increase in the multiple of earnings people are willing to pay for the company. To keep this as simple as possible let's first assume that the earnings multiple doesn't change. If a company generates long-term earnings growth of 10%, then an investor can only reasonably expect his return from holding that stock to be 10% as well. For example, earnings were \$1.00 per share last year and the P/E multiple was 10x, implying a \$10 stock. If earnings grow 10% in the year to \$1.10 per share and the multiple stays at 10x, then the stock price will rise an identical 10% to \$11.

The effect of multiple expansion/contraction has and always will have a profound effect in over/underperformance by investors. Consider again our example of a company earning \$1.00 per share that sees earnings grow 10% during the year to \$1.10. With no multiple expansion the return on the stock movement from \$10 to \$11 is the same as earnings growth - 10%. But if the market sees 10x earnings as a below average multiple and see fits to increase multiple ever so slightly, to say 11x, then all of the sudden \$1.10 in earnings is then multiplied by 11x, which translates to a \$12.10 stock price. This transforms a 10% return into a 21% return. An ordinary return is transformed into a great return. Hopefully this example underscores the importance of buying stocks where earnings multiple expansion is possible and dare we even say likely.

So absent multiple expansion (contraction) all a stockholder can hope to receive in investment return is the earnings growth the company generates. Few companies can generate long term earnings growth north of 10-15%. Most companies fall woefully short of 10-15% and this has resulted in long-term stock returns more in the neighborhood of 9-10%. This is also why multiple earnings expansion is so critical to outsized returns. Without earnings multiple expansion, generating the 15-25% returns that we all dream of is nearly impossible. Stocks at or around the long-term average P/E of 14-15x, especially large caps that cannot grow that fast given their size do not offer the prospect of outsized returns based on



earnings growth. You have to believe they will expand their P/E and we think it's silly to expect P/Es to expand from average to well above average in a dangerous market environment such as this.

Interest rates are not a valid excuse in our opinion to pay such high multiples for supposedly cheap large cap U.S. stocks. Just because the 10-year U.S. treasury is at 4.75% doesn't mean that the new "cheap" standard has permanently gravitated from 7 or 8x earnings to 15 or 16x earnings. The most recent 45-year average interest rate on the 10-year treasury is roughly 7%. We don't make interest rate projections, but let's just assume a reasonable scenario is to imagine that the 10-year treasury yield eventually migrates to back to a 7% yield so as to return to its long run average. Then, would a stock purchased today at 15x earnings really experience any multiple expansion if a 10-year treasury in such a scenario now yielded more (7% vs. 6.67% (1/15)) than the large cap stock? Why would anyone logically take business risk to get a substantially lower earnings yield? Well, in the long run, few would. A large cap P/E at 15x in such a scenario would do well just to maintain such a multiple. This means that an investor would in a best case scenario only receive the earnings growth in terms of annual stock appreciation. A return of 7 or 8% would likely be as good as it gets as the law of large numbers prevents most U.S. large caps from racking up long-term earnings growth rates much higher than 8%. An eight percent return is decent and in-line with historic market returns, but is not going to set the compounding tables on fire.

On the other hand, let's walk through the math of a large cap stock purchased at 7x earnings in a scenario where the 10-year treasury backs up 225 bps to the historic average of a 7% yield to maturity. At 7x earnings, the large cap would in a steady state be generating an earnings yield north of 14% (1/7). The 7x earnings large cap assuming it followed a fairly standard 25% dividend payout ratio would also be yielding nearly 3.6% in dividends per annum. So should a 10-year treasury see its yield back up from 4.75% to 7%, it would appear very unlikely that investors would be tempted to switch investment allocations to the 10-year as its yield (whether it be 4.75% or 7%) still pales in comparison to a 14% yield where 25% of it returned to shareholder pockets each year in dividends. Buying at 7x sustainable earnings or a 14% earnings yield affords an investor a great margin of safety. Interest rate swings (even if they should be up a great deal) in most cases will not depress the earnings multiple further, in fact, one can see how at a 14% earnings yield (absent a late 70s or early 80s huge spike in inflation) that the possibility of multiple expansion even in a modestly increasing rate environment seems very high. A 7x earnings stock yielding 14% can levitate to a 10x P/E or 10% earnings yield and still provide investors over 300 bps incremental yield over the 45-year average of the 10-year treasury at 7%. That is why buying high quality businesses at truly low earnings multiples has been such a wonderfully steady return provider for guys like Warren Buffett and John Templeton.

Below we have laid out the abbreviated bull case for 4 stocks below. We have dispensed with company descriptions and the like as everyone knows what they do; we have simply attacked the quantitative metrics of purchase that so many managers are raving about:

Wal-Mart (ticker: WMT)

Stock Price: \$48.97	Dividend Yield: 1.40%
Trailing P/E: 18.92x	TTM Earnings Yield: 5.27% (1/18.92)
Forward P/E: 14.79x	FWD Earnings Yield: 6.76% (1/14.79)



At its current price Wal-Mart offers a paltry 1.40% dividend yield. This low yield is in part because they have been so successful at re-investing earnings at a very high rate, though that rate is invariably coming down as the company's huge size (\$1 billion in sales a day) limits growth. On a trailing earnings basis Wal-Mart offers a 5.27% earnings yield and on a forward earnings basis, which looks a bit optimistic in our view given the state of the low-end consumer, WMT stock offers a 6.76% earnings yield. Both earnings yields are nothing to write home about and we think the stock will be lucky to maintain a 15-19x earnings multiple going forward. This means that at best Wal-Mart investors returns with no earnings multiple expansion in the offering will be simply the EPS that Wal-Mart can organically deliver. Over the long-term would anyone really want to take "the over" on 10% earnings growth for Wal-Mart? Likely not, which means a 10% return or perhaps less is what to be expected. Ten percent is nothing to sneeze at, but not anything to be jumping up and down about. In fact, it speaks to just how utterly expensive WMT's stock got that, after trading water for so many years, it is still not unmistakably cheap.

Col-gate (ticker: CL)

Stock Price: \$61.78	Dividend Yield: 2.10%
Trailing P/E: 25.91x	TTM Earnings Yield: 3.86% (1/25.91)
Forward P/E: 19.13x	FWD Earnings Yield: 5.23% (1/19.13)

Colgate has a wonderful collection of brands but a 2.10% dividend yield and a 3.86% trailing earnings yield is not going to deliver anyone blockbuster returns. The forward earnings yield isn't much better at 5.23%. If one were to hold the stock for a long period of time it is unlikely that he or she would lose money, but it's also unlikely that returns could crack more than high single digits. There is really no logical room for multiple expansion long-term and earnings growth of more than 10-12% seems very unlikely.

3M (ticker: MMM)

Stock Price: \$73.53	Dividend Yield: 2.50%
Trailing P/E: 16.34x	TTM Earnings Yield: 6.12% (1/16.34)
Forward P/E: 14.71x	FWD Earnings Yield: 6.80% (1/14.71)

MMM appears to be in slightly better shape quantitatively than Colgate. The dividend yield is slightly higher at 2.50% and the trailing earnings yield is also higher at 6.12%. The forward earnings yield of 6.8% is perhaps at best fairly valued meaning the P/E multiple may have found its long term equilibrium if they deliver on next year's earnings. However, none of the metrics approach being truly cheap on an absolute basis and once again returns in the high single to low double digits will have to come entirely from earnings growth. Keep in mind that it ain't that easy growing a \$22 billion revenue base like MMM's.

DELL (ticker: DELL)

Stock Price: \$21.62	Dividend Yield: 0.00%
Trailing P/E: 17.61x	TTM Earnings Yield: 5.68% (1/17.61)
Forward P/E: 17.43x	FWD Earnings Yield: 5.74% (1/17.43)



We are perhaps most appalled at the Dell recommendation as grouping it in with wonderful companies like Wal-Mart, Colgate, and 3M is a large stretch in our opinion. True, Dell has created a great deal of shareholder value over the last two decades, but the business is not one of strong brands or a sustainable cost advantage in our minds. The continually shrinking ASPs in tech have made Dell's direct percentage cost advantage less and less of a factor in absolute dollar terms. This has eroded Dell's direct model advantage in our minds. Don't believe us? Go and price some corporate Dell workstations and compare with similar workstations at CDW or other competitors and you will find negligible pricing differences. Dell's move into consumer electronics is a sign of weakness in our minds as all of their products have become ultra commoditized. An unbranded tech-oriented business trading at 17.5x times trailing and forward earnings does nothing for us. A sub-6% earnings yield also does nothing for us. Dell's supposed \$ 9 billion cash hoard is also not something we would back out of the enterprise value as some of that is in foreign jurisdictions with large tax implications and Dell is buying back overpriced stock to stem large option dilution. Likewise, given the unpredictable nature of tech and electronics businesses, they almost always need to stockpile cash for a rainy day. With the SEC looking at Dell's accounting coupled with questionable customer financings, it appears clear to us that the rain clouds are going to linger over Dell's Round Rock, Texas headquarters for quite sometime. Multiple expansion seems quite unlikely, all stock price appreciation will likely come from Dell's earnings growth and arriving at a long term growth number is anyone's guess - we certainly wouldn't choose a high one.

Sadly not a one in the bunch would seem to meet a discriminating investor's test for true value. If you have billions upon billions to invest or are content with an 8% or so return at best, then all except Dell may fit your bill. We are quite content to wait for juicier opportunities.

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