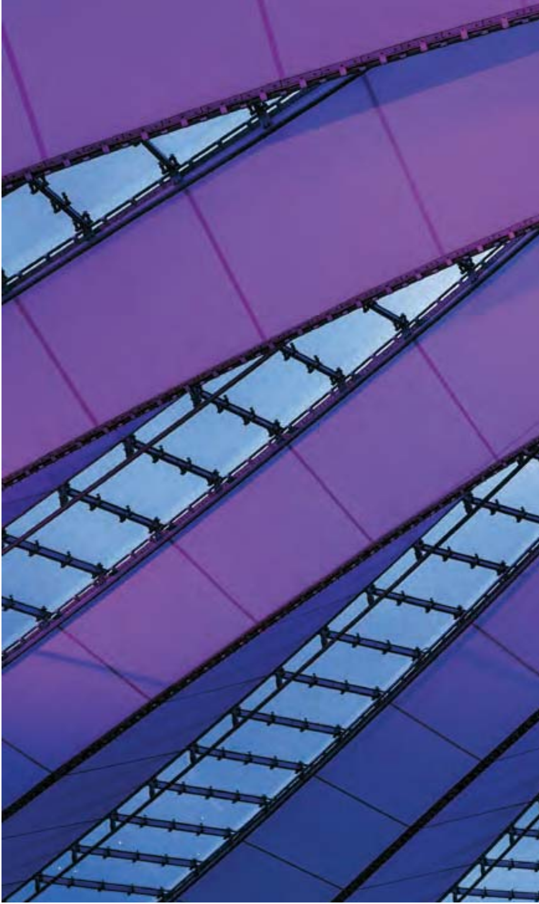

The Case for Active U.S. Large Cap Value Equities

Attractive valuations and renewed fundamentals signal a turning point

By

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Executive Summary

Investment professionals from The Boston Company Asset Management, LLC argue that a combination of factors beyond a favorable market cycle point is creating a positive environment for investing in U.S. large cap value stocks, after the asset class was out of favor for the past few years. As one of the largest, highest-quality, and most-liquid asset classes, U.S. large cap value stocks suffered sizable outflows amid negative headlines, most notably within financial services, its largest sector. However, the Boston Company team believes that trend is in the process of reversing, amid attractive valuations and improving fundamentals for many of the companies in the asset class, particularly financials. They look at the favorable economic and balance sheet conditions for U.S. large cap companies to support their case, arguing that ongoing market volatility and uncertainty make active management a more appropriate approach to the asset class.

Why U.S. Equities?

We believe the U.S. equity market is relatively more attractive than other equity markets around the world. For example, some emerging markets are facing inflationary pressures and investor concerns about whether they can successfully get inflation under control without overreaching and stifling growth. Recent uprisings in the Middle East and Northern Africa have also highlighted the geopolitical instability and "shock" risks often associated with emerging markets. At the same time, investors looking at Europe are concerned about the possibility of rising interest rates and continuing sovereign debt problems that are complicated by divergent economies sharing a common currency and monetary policy.

By contrast, we believe the U.S. economy is benefiting from favorable tailwinds. In our view, the rhetoric out of Washington is becoming increasingly pro-business and pro-jobs; the Federal Reserve has renewed its commitment to lower rates for longer; inflation remains subdued given housing and labor slack; and fundamentals for large companies are improving. Moreover, given that about 40% of the S&P 500 revenues come from overseas,[1] we believe U.S. multinationals are well positioned to benefit from fast growing non-U.S. economies and can do so with less sovereign, political, and currency risk.

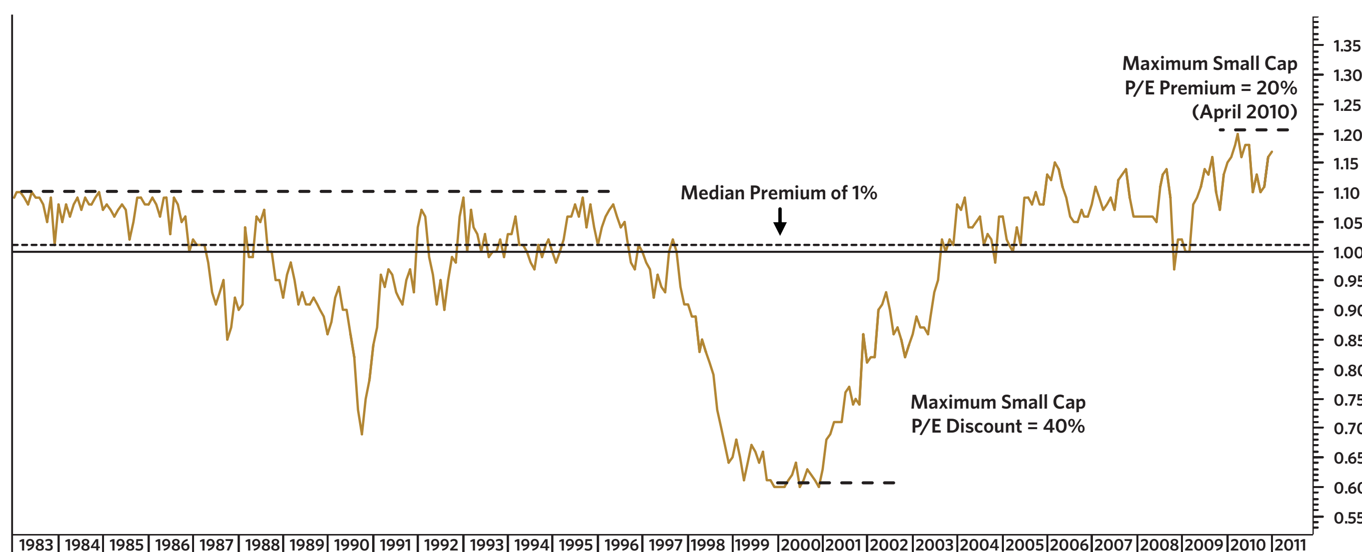
1 "Why Your Domestic Portfolio Isn't," Morningstar, January 6, 2010.

Why Large Cap Equities?

Share prices for U.S. large cap companies are very inexpensive relative both to history and to those of U.S. small caps.

As far as U.S. large cap equities are concerned, we believe valuations and fundamentals are compelling. Share prices for U.S. large cap companies are very inexpensive relative both to history and to those of U.S. small caps. As we have transitioned into a more expansionary phase of the economic cycle, we believe it is not surprising that U.S. small cap stocks have outpaced U.S. Large Caps recently and now trade at a premium. Even more noteworthy, however, is the magnitude of that premium. The current price-to-earnings (P/E) ratio for U.S. large cap stocks is 13.4 times, whereas U.S. mid and small cap stocks trade at 15.1 times and 15.6 times, respectively. As a result, the U.S. small cap premium relative to U.S. large caps is roughly 17%.[2] As illustrated in Exhibit 1, this represents one of the most extreme valuation premiums since 1983. In our opinion, this sizable divergence will resolve itself through an expansion of U.S. large cap multiples, in the face of improving fundamentals for large cap companies, remaining support from quantitative easing, and improving economic data.

Exhibit 1 – Ratio of Small Cap to Large Cap P/E Ratios, 1983 – 2011
Large Cap Valuations Hover Near Long-Term Attractive Levels



Source: The Leuthold Group, April 2011.
*Median P/E of Leuthold Small Cap Universe divided by median P/E of Leuthold Large Cap Universe; P/Es based on non-normalized estimated operating earnings.

2 The Leuthold Group, April 2011.

We believe the near-term underperformance of value stocks bodes well for a mean reversion opportunity. U.S. large cap value stocks have outperformed their U.S. large cap growth counterparts over time with measurably lower risk.

Although the earnings strength of U.S. large cap companies initially came from cost cutting following the financial crisis and economic recession, revenue growth has become an increasing source of upside surprises. In 2010, revenue growth accelerated, finishing the year in excess of 10%.[3] Moreover, U.S. companies have a record amount of cash available, and given the low yield environment, it is much easier for that capital to be deployed. That record level of cash is disproportionately held on the balance sheets of the largest cap companies. For example, the top 10 companies in the S&P account for 59% of all cash in the S&P 500, a ratio which is also above the 33-year average of 49%.[4]

Why Value Equities?

We believe the near-term underperformance of value stocks bodes well for a mean reversion opportunity. U.S. large cap value stocks have outperformed their U.S. large cap growth counterparts over time with measurably lower risk. The Russell 1000 Value Index has generated annualized returns of 12.2%, representing 1.5% of annualized excess return relative to the Russell 1000 Growth Index, from 1979, the inception date of the two benchmarks, through to the end of 2010 (See Exhibit 2). That excess return has been achieved with 2.8% less annualized standard deviation compared with the growth index over the same time span.

Exhibit 2

The Long-Term Performance of Value and Growth

	10 years		20 years		Since Inception	
	Return	Risk	Return	Risk	Return	Risk
Russell 1000 Value	3.3%	16.3%	10.1%	14.8%	12.2%	15.0%
Russell 1000 Growth	0.0%	18.3%	8.3%	17.5%	10.7%	17.8%

Source: Zephyr StyleAdvisor. As of December 2010 Note: Inception date of both benchmarks is January 1979.

Despite long-term trends, there have been times when value has lagged growth, and the most recent period (calendar years 2009 and 2010) is one such example. Still, this kind of consecutive calendar-year growth outperformance has been rare; in fact, the last time it happened was in 1998 and 1999, after which value outperformed growth for the subsequent seven years by 12% per year on average.

3 Brown Brothers Harriman, 2011.

4 Ned Davis Research, Inc., 2011.

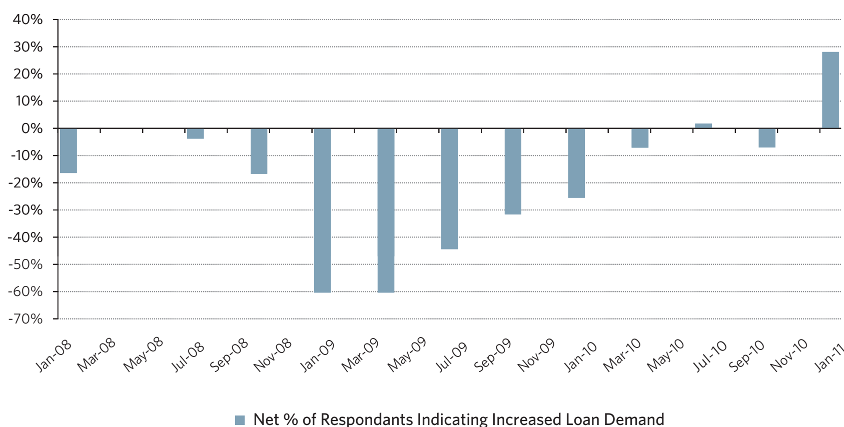
In our view financials are cheap on normalized earnings, normalized dividend yields, and trade near or below book value.

Why Financial Services?

We believe financials' outperformance will drive U.S. large cap value outperformance. In our view, from both an absolute and relative standpoint, it is critical to recognize the relationship of the financials sector to the U.S. large cap value asset class as a whole. The financials sector accounts for almost 28% of the Russell 1000 Value Index (versus roughly 5% for the Russell 1000 Growth Index). Given the importance of the sector to the global economy, we believe there are strong interests in helping the sector to recover. Financials were front and center as equity markets teetered on the verge of collapse in 2008/2009. Today, by many measures, financial stocks remain remarkably inexpensive. In our view financials are cheap on normalized earnings, normalized dividend yields, and trade near or below book value. Still, banks in particular have remained unloved by investors for some time now, and so for us the critical question is what will cause these depressed valuations to appreciate? We think there are four new and important catalysts on the horizon:

1) **Loan activity is improving**. Commercial and industrial loan demand has recently turned positive after declining steadily (see Exhibit 3). By the end of 2010, the Federal Reserve Board reported that banks were becoming more willing to make consumer installment loans. After the lessons learned from the last credit cycle, these loans are well collateralized and are generating high returns.

Exhibit 3 – Federal Reserve Loan Officer Survey Results
Loan Demand Has Turned Postitive

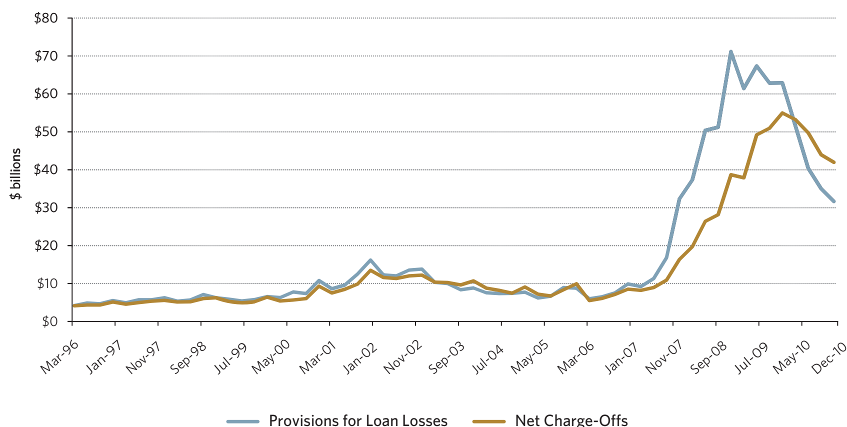


Source: Bloomberg.

2) Credit is strengthening. Delinquency rates on loans at commercial banks have reached an inflection point. As of the end of December 2010, the delinquency rate of 6.3% is much improved versus the 7% rate from 2009. Additionally, provisions for loan losses and net charge-offs have also positively declined from their peaks in 2009 (see Exhibit 4).

Delinquency rates on loans at commercial banks have reached an inflection point.

Exhibit 4 – Provisions for Loan Losses and Net Charge-Offs
Negative Loan Activity on the Decline



Source: Ned Davis Research, Inc., 2011.

3) The regulatory climate is improving. Deliberations over the Dodd-Frank bill, Basel III provisions and the Durbin amendment created great uncertainty for the financial sector. As clarity is achieved, that uncertainty is diminishing. We believe the ultimate impact is likely to be less bad than initially feared. Importantly, the expected impact has already been factored into consensus estimates. Furthermore, the U.S. government is allowing well capitalized financial companies to raise dividends. In our view, this is a powerful signal from both management and regulators about the strength and stability of these institutions.

4) The yield curve is steepening. At the beginning of 2011, the 10-year minus 2-year U.S. Treasury yield curve, which measures the difference between long-term and short-term interest rates, had a spread of 275 bps.[5] We expect that this yield curve spread will help financials companies enhance returns on their deposits. It also signifies that the market believes the economy is improving.

5 Ned Davis Research, Inc.

Why Active Management?

We believe that active management has the potential to deliver value during periods of market uncertainty and heightened volatility. Given high market correlations and strong upward trending equity markets before 2008, we understand why some investors were attracted to passive investing. However, in 2008 when it was clear that financials were leading markets lower, active managers were able to underweight the sector in a way that passive investors could not.

Given where we are in the economic cycle and both the attractive valuations and improving fundamentals for important financial stocks, we believe U.S. large cap value stocks are poised for outperformance.

We compare active managers to airline pilots. In our view, pilots are not highly valued because they set a plane on autopilot for much of a transatlantic flight. Rather, they are highly compensated because of the skill set required to navigate a take-off, landing, and unexpected turbulence encountered along the way. In our view, while passive investing may be an appropriate part of the investment "journey," there are unpredictable turbulent periods when it might not be, which might be very disruptive to reaching your investment destination as safely and as quickly as desired.[6]

Given where we are in the economic cycle and both the attractive valuations and improving fundamentals for important financial stocks, we believe U.S. large cap value stocks are poised for outperformance.

6 Morningstar identified U.S. Large Value as the best asset class for active management during the period when financials stocks were at their most turbulent.

Brian C. Ferguson, Senior Managing Director

Brian is The Boston Company's Director of U.S. Large Cap Equities and the Senior Portfolio Manager on the Dynamic Large Cap Value strategy. Moreover, he also functions as the team analyst responsible for the health care and industrials sectors. Brian has 21 years of industry experience and has been with the firm since 1997. He has been associated with the Dynamic Large Cap Value portfolio since 2001 and has been Senior Portfolio Manager since 2003.

Brian joined The Boston Company as an Equity Research Analyst on the U.S. Small and Mid Capitalization Opportunistic Value Team, focusing on financial services and consumer related stocks, and later launched the firm's Mid Capitalization Value strategy. Prior to joining The Boston Company, he was an Analyst on the Vanguard Windsor Fund at Wellington Management.

Brian received a BA in Economics and International Relations from Bucknell University. He received an MBA from Columbia University's Business School with a concentration in Finance; Brian is a member of the Beta Gamma Sigma Honor Society.

John C. Bailer, CFA, Managing Director

John is an Associate Portfolio Manager on the Dynamic Large Cap Value strategy and functions as the team analyst responsible for the consumer, technology and telecommunication sectors. John has 19 years of industry experience and has been with the firm since 1992. He has been associated with the Dynamic Large Cap Value portfolio since 1999 and has been a Portfolio Manager on the strategy since 2003.

Previously at The Boston Company, John was a Portfolio Coordinator responsible for assisting in the asset allocation and client servicing for our domestic value strategies. He began his career in Corporate Finance at Mellon Financial Corporation and was responsible for asset/liability analysis of the bank's balance sheet.

John graduated with distinction from Babson College with a BS in Accounting and Management Information Systems. He received an MS in Finance from Boston College. He holds the Chartered Financial Analyst designation and is a member of CFA Institute and The Boston Security Analysts Society.

S. Joel Mittelman, CFA, CPA, Director

Joel is a Portfolio Strategist on the Dynamic Large Cap Value strategy. Joel has 18 years of industry experience and has been with the firm since 2007, functioning as a Portfolio Strategist on the team since joining.

Immediately prior to joining The Boston Company, Joel was with Fidelity Investments. He has additional experience with Wellington Management and McKinsey & Company.

Joel earned a BS in Business from the University of New Hampshire and an MBA with distinction from Carnegie Mellon University. He holds the Chartered Financial Analyst designation and is a Certified Public Accountant.

Additional Contributors

The other members of the team also contributed to this piece. They include:

Julianne D. McHugh, Director

Julianne is a Research Analyst on the Dynamic Large Cap Value strategy and functions as the team analyst responsible for the financials and retail sectors. Julianne has 19 years of industry experience and has been with the firm since 2004, functioning as a Research Analyst on the team since joining.

Prior to joining The Boston Company, Julianne was an Equity Analyst at State Street Research & Management, where she focused on the non-bank financial and retail sectors. Before that, Julianne served as a Research Analyst at Dalbar, Inc., where she covered the financial industry.

Julianne received a BS with a concentration in Finance from Lehigh University. She received an MBA with a financial management track from MIT Sloan School of Management.

David S. Intoppa, Vice President

Dave is a Research Analyst on the Dynamic Large Cap Value strategy and functions as the team analyst responsible for the materials, energy and utilities sectors. Dave has 11 years of industry experience and has been with the firm since 2006, functioning as a Research Analyst on the team since joining.

Before joining The Boston Company, Dave was a Research Associate at State Street Research & Management Company, covering the energy sector. Prior to this, Dave worked on financial reporting at State Street, where he was responsible for filing all SEC-required reports.

Dave earned a BA in Economics from Tufts University and an MBA in Finance and Accounting from New York University's Stern School of Business.

Index Definitions

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

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