ALTMAN INVESTMENT MANAGEMENT

# EQUITY STRATEGY FOCUS

JULY 2013

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## IN VIEW: The Economic Landscape

- **This month, the Bureau of Economic Analysis (BEA) estimated that real gross domestic product increased at an annual rate of 1.7% in the second quarter for the U.S. economy.** The BEA is in the process of a comprehensive revision of its economic statistics from 1929 through the first quarter of 2013. The revisions will add to economic growth because such items as intellectual property and research and development expenditures will be included in GDP as "outputs", whereas at present they are counted as production costs.

- **The reported growth number exceeded the consensus growth estimates of economists at 1.5% and compares to the actual reported 1.8% for the first quarter.** We believe that second half growth will be somewhat higher at approximately 2.5%. If growth comes in below the Federal Reserve's estimate of 3-3.5% for the second half, then quantitative easing might continue at its present rate of $85 billion per month.

- **When Chairman Bernanke made his tapering proposal, it was data dependent, and in our view the Federal Reserve will most likely have to lower its current forecast of second half economic growth down to the 2.5% level.** The intention of the Federal Reserve to drive up asset prices, with regards to bonds, stocks, and real estate since the end of the 2008-2009 recession, has been achieved; however, the unemployment rate at 7.6% is still historically high and only modest employment gains have been achieved.

- **On a positive note, the fiscal deficit has made progress with tax receipts estimated to have increased over 14% and government expenditures to have declined 4.4% in the last three quarters of the current fiscal year.** The nine-month deficit stands at $512 billion and could end the fiscal year at about 4.5% of GDP.

- **The U.S. economy has grown at 1.6% over twelve months through March**, which compares with 0.4% for Japan and -1.1% for the Euro area. The world's second largest economy, China, has recorded growth of 7.5% through the end of June. Economists using alternative measures of growth, besides GDP, suggest much slower growth for China closer to the 3.0% level.

- **China's new government is trying to restructure its economy, steering away from heavy industry that is export-dependent to a more consumption-oriented economy.** Estimates are that domestic consumption in China is only 45% of its GDP, versus 70% for the U.S. This attempt to privatize more of its economy, placing less emphasis on state-controlled enterprises, should help to improve the standard of living of its people. China has been a material engine of growth for the world economy and its recent slowing trend has played an important role in the recent decline in global commodities.

- **Japan is also trying to restructure its economy**, after twenty years of deflation, by implementing an aggressive monetary expansion policy and attempting to open up protected industries to more competition.

- **The European Union is also attempting to reform its economies with austerity programs and labor reforms.** However, it still remains in recession. The British economy in contrast has grown over twelve months through March, and has seen some improvement in manufacturing. Overall consensus estimates that the Euro economy will grow 1.0% in 2013 versus -0.6%. Global growth is forecasted at about 3.3% for 2013, down modestly from 2012.

- **The U.S. economic strength has been centered on autos, construction spending, housing, durable goods, industrial production, and retail sales.** This has had the effect of pushing the leading indicators up 2.8% year over year. Additionally, inflation has been modest (with the CPI up only 1.8) and the fiscal deficit has been improving.

- **The result of these ongoing improvements, consumer confidence is at a post-recession high as measured by the Conference Board.** However, weaknesses in modest employment gains against a backdrop of high unemployment (7.6%), weak wage growth, and weak exports keep the Fed accommodative. High consumer borrowing and a low savings rate suggest that the economy is neither a strong recovery nor a recession but moderate growth of about 2.5%.

- **In 2013 we expect the CPI to rise to 2.0% and a gain in corporate profits for the year of 5%.** At present, we would forecast U.S. GDP to grow 2.7% in 2014, with CPI inflation of 2.5% and a gain in corporate profits of 7%.

- **In July, bond markets rallied, with the exception of the municipal market which was negatively impacted with the Detroit bankruptcy.** 10-year Treasury yields, which had reached 2.75% after Chairman Bernanke's tapering remarks, are currently 2.57% after a return to more "dovish" comments. Long-term high quality corporate bonds are at 5.45% down from 5.62% a month ago, and 30-year mortgage bonds yield 4.40% down from 4.55% a month ago. Municipal bonds fell significantly and now yield 4.79%, as compared to 4.58% a month ago. Outflows from municipal bond funds are in their tenth week. It is rare to find municipal bonds selling at such wide discounts to Treasury bonds.

- **The main negative in the municipal market is the under-financing of pensions in some states**, such as Illinois, which has the highest level of under-funding. In most states, responsible government legislatures are in the process of bringing their state pension plans to higher funding levels now that tax receipts are again growing.

- **Overall, bonds have rallied for thirty-two years (since 1981 when 10-year Treasury bonds actually yielded slightly over 15%) and are now in the process of reversing this trend and quite possibly entering a long-term bear market in bonds.** Despite the interest rate headwinds, we would continue to favor low duration corporate and municipal securities over Treasury bonds.

- **When Federal Reserve officials rushed to minimize Ben Bernanke's tapering comments, commodities had a significant rally led by oil.** A weaker dollar will tend to strengthen commodities. In our asset allocation process, we have taken into consideration that corporations have historically high profit margins and strong balance sheets.

**Exhibit I**

*DXY: Dollar Index Spot Price*

## EQUITY OUTLOOK:

- **Equities still remain the best value among various asset classes over the longer term.**

- **The S&P 500 Stock Index (1685 at month end) rallied 6.4% and the Morgan Stanley EAFE Index, a measure of foreign stock performance, increased by 8.5% over the past four weeks** after Fed accommodation on monetary policy was reaffirmed. We believe foreign markets strengthened recently because they had fallen earlier in the year when in most instances the U.S. market was rallying. At this juncture we believe that the contracting spread was not based on a fundamental change in the prospects for foreign markets.

- **The S&P, however, is now at 15.3 times our $110 per share estimate for 2013, and at 14.9 times our $117 per share estimate,** assuming another 7% gain in earnings. While these valuations are not excessive, they have to be measured against a rising interest rate environment. Inflation is still modest at 1.8% over the past twelve months which at present doesn't pressure P/E ratios. Despite robust reported earnings, we remain cautious keeping growth rates at 7.0%.

## IN FOCUS: Opportunities in the "Higher Profitability" Companies

- **The anticipated market rally over the past year placed a greater burden on companies to deliver earnings growth, and has resulted in greater volatility during this earnings season.** We discovered that in the absence of clear growth trends and elevated profitability, investors tended to reward companies that focused on a disciplined approach to capital use as a proxy for margin stability.

- **We have focused our analysis on investment opportunities among higher ROE (return on equity) companies which could benefit from rerating valuations or superior relative growth.** We have found that many opportunities among the higher ROE companies are concentrated in the Healthcare, Technology and Industrial sectors. High ROE tends to correlate with low capital spending, and in the past high ROE and capital discipline has been a driver of stock outperformance.

- **Although returns related to dividend yield and buyback strategies have been highly correlated to higher profitability, relative valuations in this group of stocks have recently become stretched.** Hence, low payout ratios and high ROE are potentially more attractive as the higher dividend yielding stocks face negative reversion and incumbent high risk. Industries within the Materials, Utilities and Energy sectors face potentially the greatest operating margin headwinds, while Defense and Technology are well poised as beneficiaries.

- **In this environment, we are not expecting an expansion in price earnings multiples in the back half of the year as a catalyst for enhanced performance.** As the economy reaccelerates we are, however, expecting a margin recovery in the Financial sector.

# IN BRIEF: Equity Investment Strategy

## BENCHMARK PERFORMANCE HIGHLIGHTS

**Exhibit II**

***S&P 500 Index – 2nd QTR and YTD Sector Performance***

| | Sector Wgt. As % of S&P as of 6/30/13 | 2nd QTR Return 3/31/13 - 6/30/13 | 2nd QTR Sector Contribution of S&P 500 | YTD Return 12/31/11 -6/30/13 | YTD Sector Contributin of S&P 500 |
|---|---|---|---|---|---|
| **S&P Index** | | 2.93 | | 13.87 | |
| **Consumer Discretionary** | 12.2 | 6.80 | 0.79 | 19.79 | 2.24 |
| **Consumer Staples** | 10.5 | 0.48 | 0.08 | 15.13 | 1.64 |
| **Energy** | 10.5 | -0.38 | -0.04 | 9.75 | 1.10 |
| **Financials** | 16.7 | 7.43 | 1.14 | 19.71 | 3.03 |
| **Health Care** | 12.7 | 3.86 | 0.49 | 20.34 | 2.43 |
| **Industrials** | 10.2 | 2.81 | 0.27 | 13.79 | 1.39 |
| **Information Technology** | 17.8 | 1.72 | 0.29 | 6.47 | 1.22 |
| **Materials** | 3.3 | -1.80 | -0.06 | 2.91 | 0.12 |
| **Telecommunication Services** | 2.8 | 1.02 | 0.04 | 10..57 | 0.34 |
| **Utilities** | 3.3 | -2.73 | -0.08 | 9.93 | 0.36 |

**S&P 500 Index – 2nd Qtr Sector Performance Summary**

- The S&P 500 returned 2.93% for the second quarter. Once again, value stocks outpaced growth stocks by 90 basis points. Small cap stocks beat large caps, albeit by a much smaller margin of 16 basis points.
- During the second quarter, Consumer Discretionary and Financials pulled ahead of Healthcare and Consumer Staples sectors by a wide margin. But overall results were mixed - with positive, but lagging, returns in Industrials and Information Technology - and negative returns in Utilities.
- Energy stocks lost ground after a strong first quarter, specifically in the Energy Equipment/Services sector which lost -1.77%.
- Apple, the largest stock in the S&P 500 during the quarter was down -9.8%.

**S&P 500 Index – YTD Sector Performance Summary**

- The benchmark S&P 500 index produced a total return for the first half of the year of 13.9%. This compares to total returns in the bond market of -4.6% and -3.4% for 10-year Treasuries and Corporates, respectively.
- The top performing sectors in the first half of 2013 were Healthcare, Financials, Consumer Discretionary, and Consumer Staples; thus representing a mixed bag of defensive and cyclical sectors.
- Materials and Technology, although in positive territory for the year, had the weakest performance.
- Apple, the largest stock in the S&P 500 during the first half was down -24.6%.

**AIM's ATTRIBUTION HIGHLIGHTS**

**Exhibit III**

***AIM LLC Composite – 2nd QTR and YTD Sector Performance***

| | Sector Wgt. As % of Portfolio as of 6/30/13 | Relative Wgt. versus S&P 500 Index | 2nd QTR Total Return of AIM Composite | 2nd QTR Total Attribution of AIM Composite | YTD Total Return of AIM Composite | YTD Total Attribution of AIM Composite |
|---|---|---|---|---|---|---|
| AIM Composite | | | 3.86 | | 15.48 | |
| Consumer Discretionary | 9.4 | -2.1 | 1.95 | -0.53 | 9.94 | -1.00 |
| Consumer Staples | 9.5 | -1.1 | -0.81 | -0.08 | 20.92 | 0.53 |
| Energy | 13.7 | 2.7 | 1.82 | 0.24 | 12.46 | 0.30 |
| Financials | 17.9 | 2.3 | 6.65 | -0.03 | 19.18 | 0.01 |
| Health Care | 13.4 | 1.4 | 3.32 | -0.04 | 17.16 | -0.27 |
| Industrials | 10.8 | 0.7 | 4.49 | 0.20 | 13.13 | 0.43 |
| Information Technology | 16.8 | -2.2 | 8.72 | 1.15 | 17.97 | 2.10 |
| Materials | 2.1 | -1.5 | 7.75 | 0.26 | 18.86 | 0.50 |
| Telecommunication Services | 2.6 | -0.5 | -2.23 | -0.09 | 7.85 | -0.07 |
| Utilities | 2.0 | -1.4 | -4.29 | 0.06 | 7.35 | 0.01 |

Source: Bloomberg

**Second Quarter Sector Performance Summary**

- The AIM composite outperformed the S&P 500 benchmark by 93 basis points during the 2nd quarter.
- Contributing most to relative performance on a sector basis was Technology, adding 115 basis points. Credit is due to strong performance in Cisco, Microsoft, Applied Materials, and Intel. Other cyclical sectors, such as Materials, Energy, and Industrials, added a combined 70 basis points.
- The Consumer Discretionary sector detracted from relative performance, as McDonald's, Philips Electronics, and Johnson Controls each underperformed the sector.
- The best performing stocks this quarter were Microsoft (+21.6%), Metlife (21.2%), and Northrop Grumman (+18.9%). Worst performers for the quarter were Devon, Transocean, and Mondelez, down -7.7%. -6.7% and -6.4% respectively.

**YTD Sector Performance Summary**

- The AIM composite closed the first half of 2013 beating the benchmark S&P 500 by 161 basis points. The Technology sector led the markets in YTD relative performance, carried by Cisco, Microsoft, Applied Materials, and Intel.
- Four of the five Consumer Staples companies within our composite outperformed the sector index by greater than 500 basis points.
- The top five performers in the portfolio on an absolute basis were Metlife, Applied Materials, Microsoft, Honeywell, and Archer Daniels. These stocks increased by 40.6%, 32.1%, 31.3%, 26.4%, and 25.2% respectively during the first half.
- Bottom five performers thus far have been Goodyear (-10.1%), Oracle (-7.8%), Deere (-4.8%), Devon (+0.45%), and Johnson Controls (+3.41%).

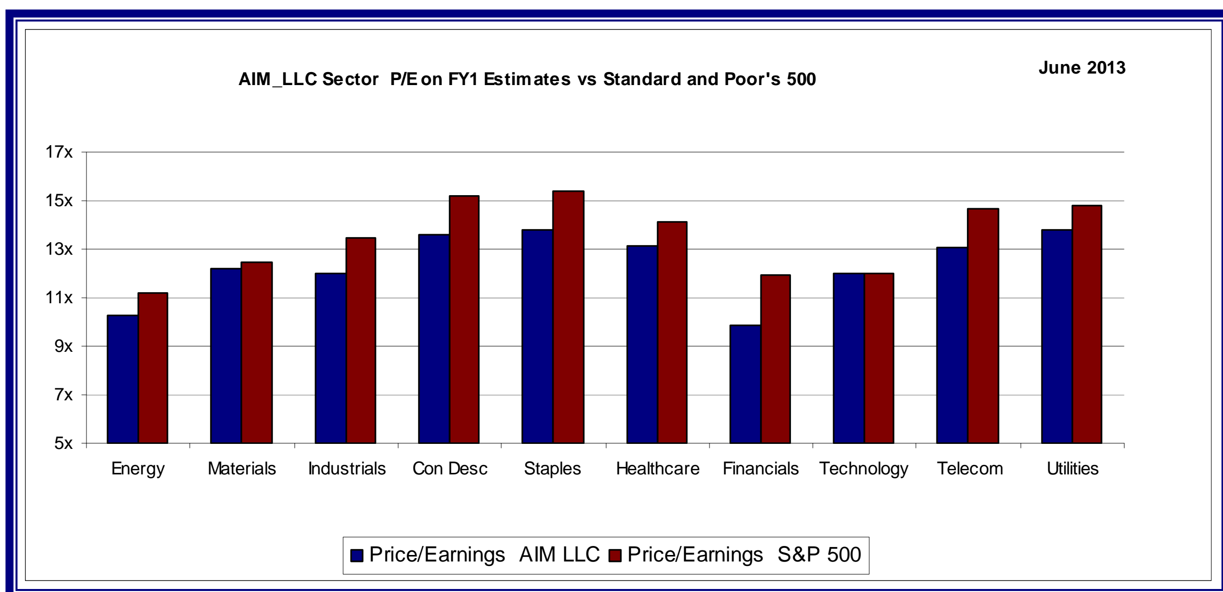
## S&P 500 –SECTOR VALUATION CHARACTERISTICS

### Exhibit IV

| | SPX | Energy | Materials | Industrials | Con Desc | Staples | Healthcare | Fincl | Tech | Telecom | Utilities |
|---|---|---|---|---|---|---|---|---|---|---|---|
| # holdings | 500 | 43 | 30 | 61 | 83 | 40 | 54 | 86 | 70 | 7 | 31 |
| Beta | 1.00 | 1.23 | 1.28 | 1.15 | 1.04 | 0.51 | 0.72 | 1.34 | 1.05 | 0.63 | 0.46 |
| P/B | 2.40 | 1.88 | 2.65 | 3.01 | 4.04 | 4.31 | 3.20 | 1.22 | 3.21 | 2.65 | 1.59 |
| TTM P/E | 15.44 | 12.05 | 15.73 | 15.85 | 18.29 | 17.90 | 17.64 | 13.95 | 14.94 | 18.25 | 13.79 |
| P/E cur | 14.52 | 12.23 | 14.64 | 15.02 | 17.75 | 16.92 | 15.41 | 13.09 | 13.29 | 16.20 | 15.47 |
| P/E FY1 | 13.10 | 11.20 | 12.48 | 13.45 | 15.18 | 15.38 | 14.11 | 11.93 | 12.02 | 14.67 | 14.79 |
| P/S TTM | 1.45 | 1.05 | 1.27 | 1.35 | 1.24 | 1.09 | 1.60 | 1.79 | 2.39 | 1.34 | 1.40 |
| Div yield | 2.19% | 2.36% | 2.47% | 2.27% | 1.50% | 2.78% | 1.96% | 1.85% | 1.91% | 4.39% | 4.02% |
| P/CF | 9.28 | 6.98 | 10.49 | 11.08 | 11.84 | 12.96 | 15.45 | 6.66 | 9.96 | 4.89 | 5.99 |

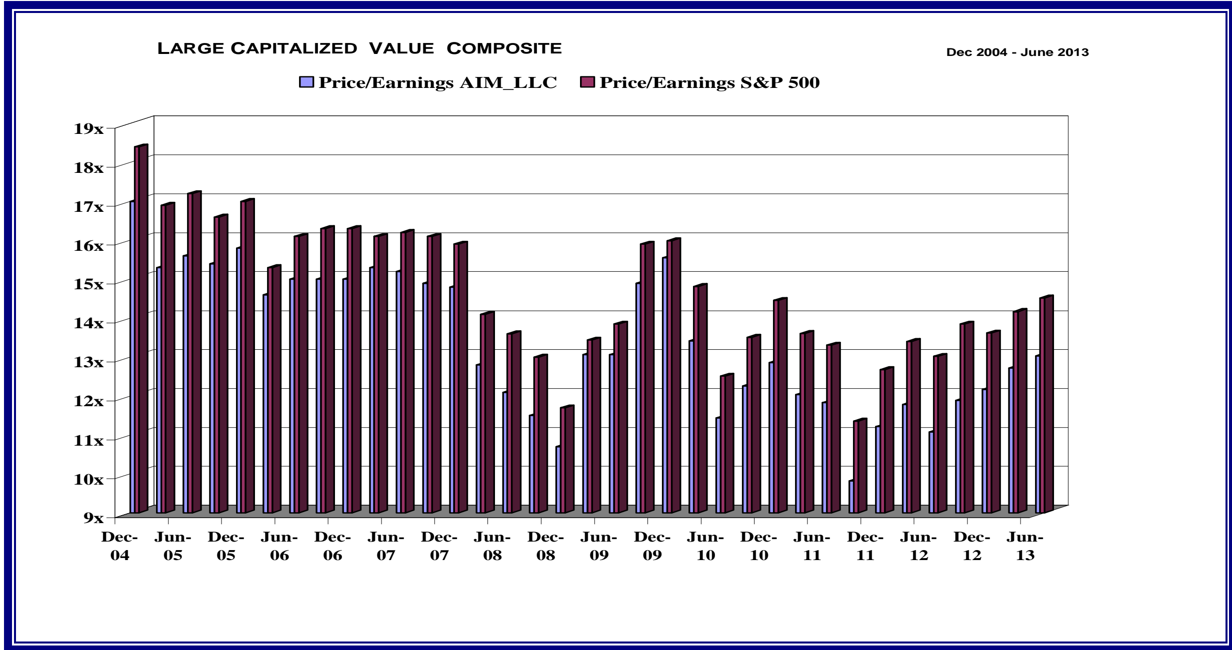
Source: Bloomberg

### Exhibit V




Source: Bloomberg and Altman Research

## Exhibit VI

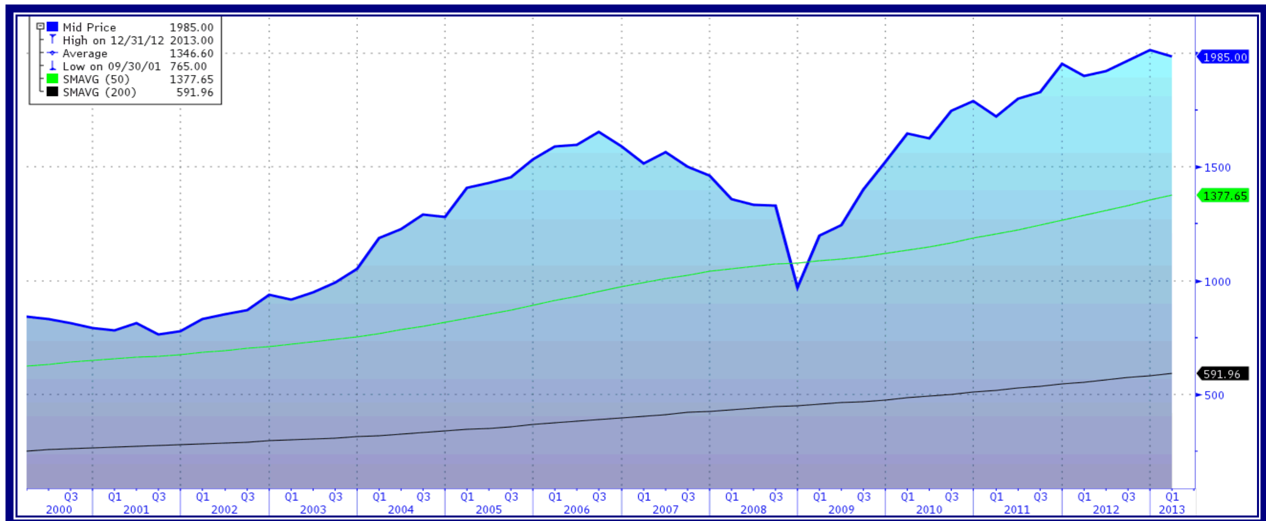



Source: Bloomberg and Altman Research

## THE FIRST QUARTERLY COMPANY PERFORMANCE RECORD

## Exhibit VII

### *Corporate Profit Levels*

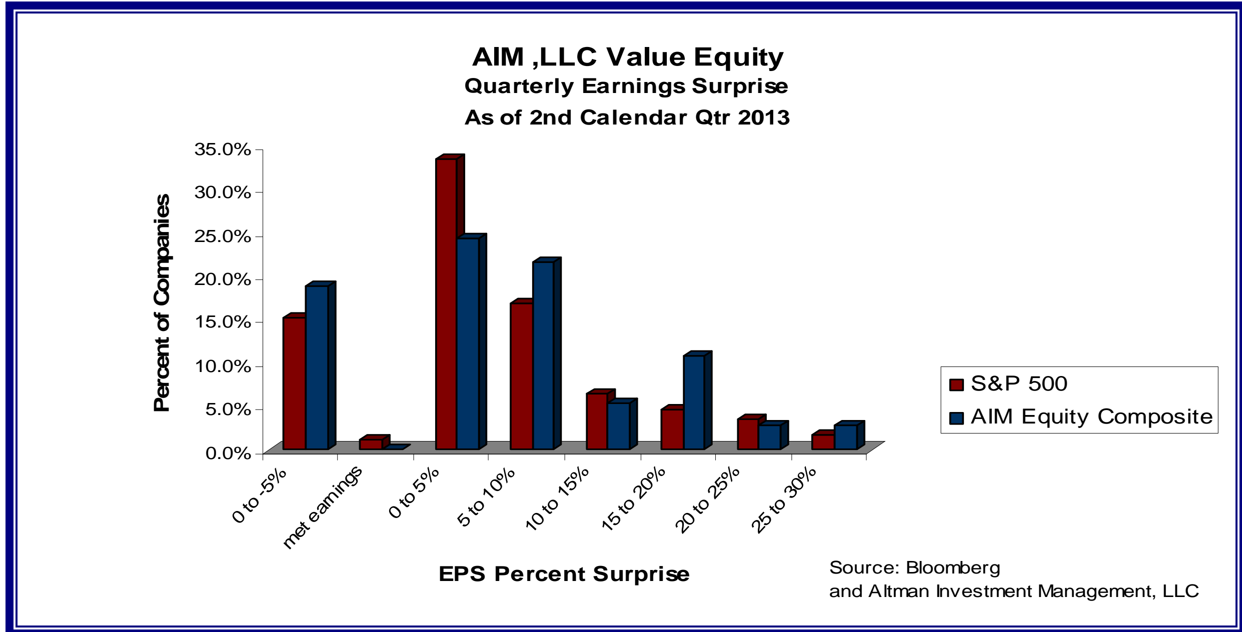



Source: Bloomberg and Altman Research

The second quarter was a 'decent quarter' with revenues and earnings beating street expectation by .02% and 3.0% respectively and on track to exceed $27.00 in aggregate for the Standard and Poor's 500 or ~$110 annualized. Overall sales beat expectation with Staples and Materials being the only real "misses". Overall earnings were up 3% with Energy being the major drag versus estimates.

## Exhibit VIII

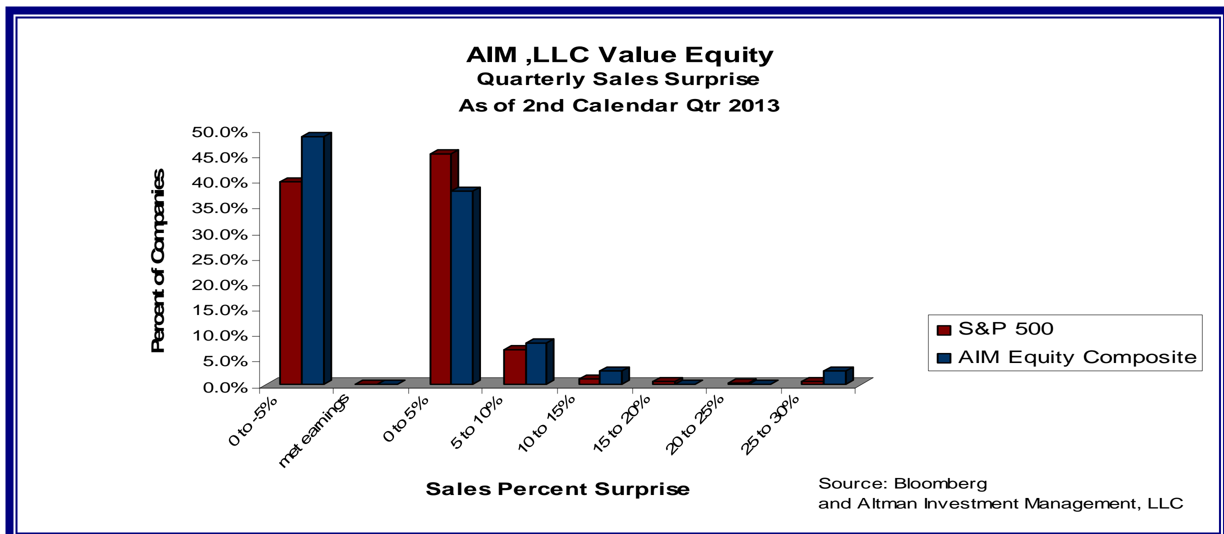
*2nd Quarter Preliminary EPS Report*




Source: Bloomberg and Altman Research

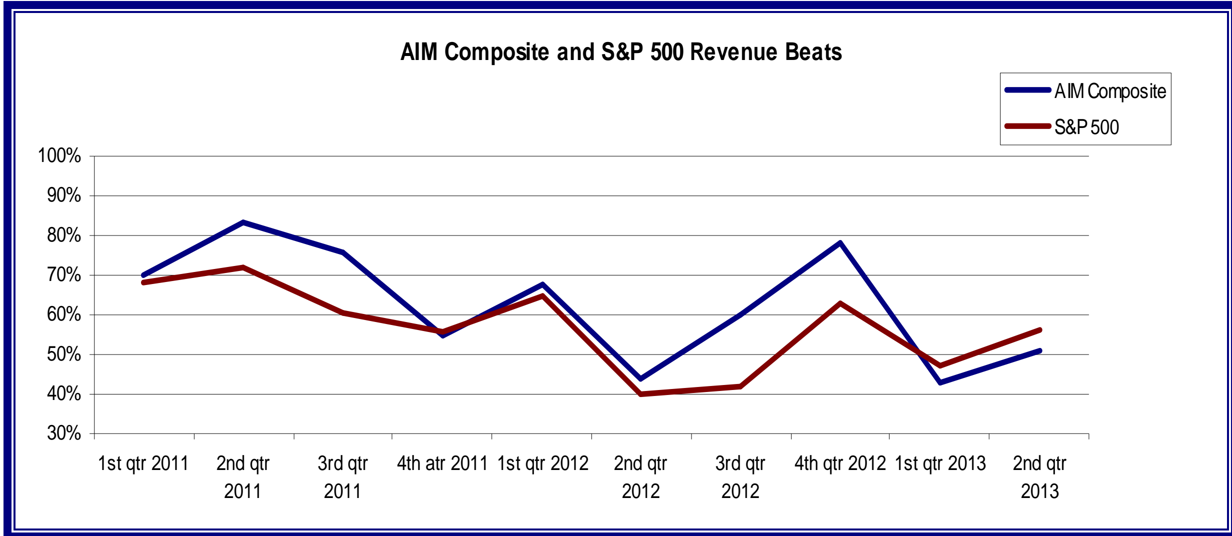
The chart above illustrates the percentage of investment holdings within our value portfolio that exceeded street estimates during the 2nd calendar quarter of 2013. Most notably, 73% of our investments exceeded street estimates and 72% of the companies in the S&P 500 exceeded street estimates. Looking at top line sales, 51% of our investments exceeded street estimates as compared to 55% for the S&P.

## Exhibit IX




Source: Bloomberg and Altman Research

**Exhibit X**

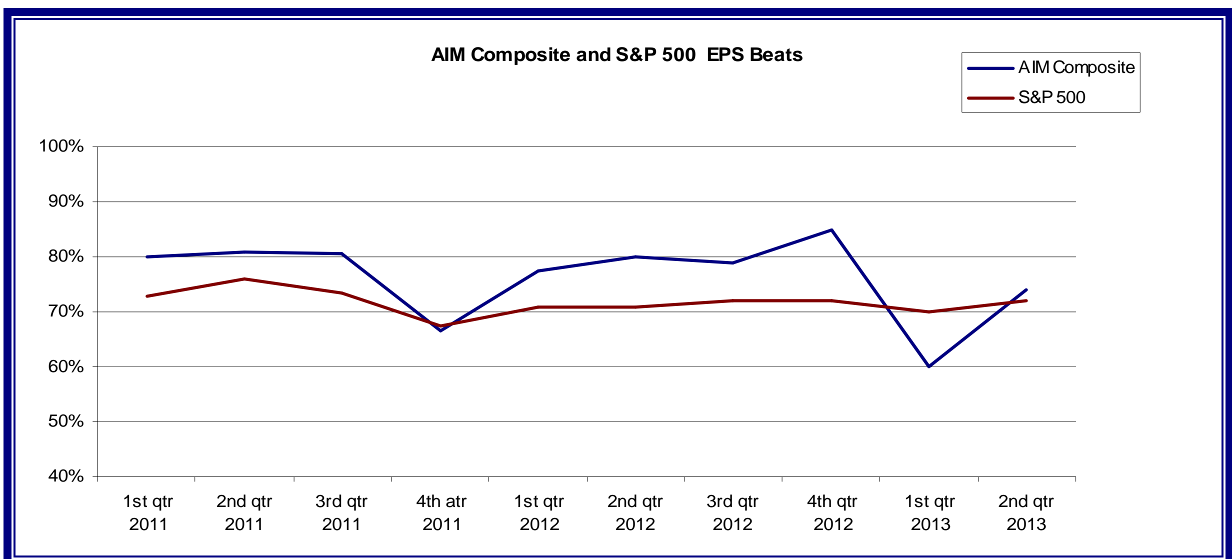



Source: Bloomberg and Altman Research

The number of companies beating expectations seems to have recovered from a brief dip below trend in Q1. Earnings growth in Q2, up 3.7%, picked up from the prior quarter rate of 1.7%. Growth was supported mainly by strength in Financials and Consumer Discretionary sectors. Growth in all other sectors slowed during the quarter. Revenue growth is up 3.3% so far as compared to the prior quarter negative growth of -1.2.

7 of the 10 market sectors experienced a pick-up in revenue growth over the prior quarter. This is the best figure since Q1'12 and argues that Q3'12 was the worst report when only 58% of companies posted gains (-1% y/y total). These year-over-year gains are broad-based across the major sectors. In our view, this is impressive considering the headwinds in 1H13 and suggests that given the easier comparisons in 2H13 (vs. 2H12), plus the anticipated GDP acceleration, our expectations of increased estimates are on track.

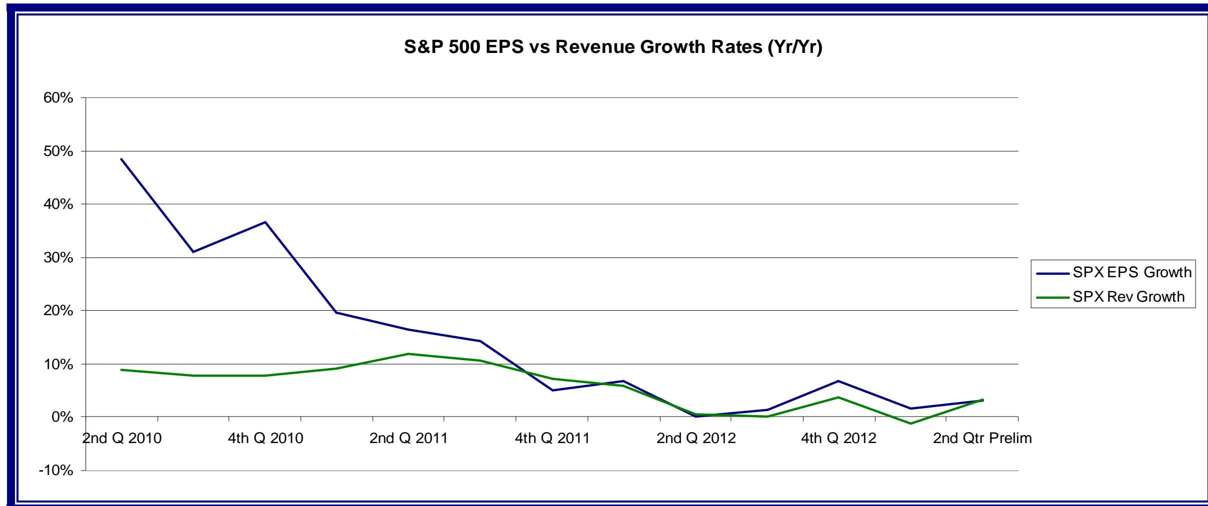
**Exhibit XI**




Source: Bloomberg and Altman Research

The temporary first quarter drop in relative earnings expectations reversed in the second quarter as well. What the market is recognizing, however, is that a majority of stocks (72% of the S&P 500) continue to beat analyst estimates. The rate of revenue beats is back to 56%, up from 47% last quarter. Secondarily, corporate profit levels have nearly doubled despite the slower growth environment. This indicates the success companies have had in strengthening their balance sheets – thus enabling them to run at more efficient levels.

**Exhibit XII**




Source: Bloomberg and Altman Research

## CLOSE UP: The Financial Sector

### *The P&C Cycle - Insurance Stocks Revisited*

Approximately 9% of the portfolio is exposed to the Insurance industry, with about one third of that weight in the property and casualty business. Reflecting on second quarter earnings, we see three key themes as we consider expanding portfolios on recent relative market weakness:

- The second quarter marked an important inflection point for the P&C group, as most firms beat expectations, and demonstrated clear earnings momentum. However, with evidence of pricing beginning to peak, investors demonstrated some disappointment as many stocks in the group trailed the market during the reporting season.
- Driven by improving fundamentals, and with recent pricing momentum, operating earnings are likely to continue to rise through 2014. With solid underlying margins and favorable development continuing to provide a tailwind, commercial lines companies beat estimates by 17-30% in the quarter. Our investment holding in Travelers, for instance, beat estimates by as much as 30%. For many commercial line insurers, pricing has run ahead of trend for over a year leading to improvement in underlying loss ratios. Accident year loss ratios declined by an average of 2% for commercial lines.
- However, the market is forward looking, and as investors focus on the firms' improving profitability in the context of rising post-QE interest rates, the lead indicators of a peak pricing cycle will re-emerge.

**Exhibit XIII**

*S&P Property and Casualty Index vs. the Fed Funds Rate*

Source: Bloomberg and Altman Research

- The portfolios of Property and Casualty Insurers are heavily invested in fixed income securities, and therefore in a rising interest rate environment, one would expect book values to decline. During the 2nd quarter as the 10 year yield rose from 1.85% to 2.49%, book values dropped an average of 2% while ROEs remained at 10%. It is when we begin to see the Fed Funds rate rise that this industry begins to outperform. This is because in the long run, higher interest rates lift ROEs through higher investment income levels. Taking a look at the last two decades in the chart above, we can see that when the Fed Fund's rate was rising, Property and Casualty followed suit.

- On balance, with earnings and pricing still rising, fundamentals still improving and continued capital management likely to support the stocks, we remain constructive that any headwinds will be offset by strong fundamentals.

## IN SUMMARY:

Our last *Market Perspective* touched on evidence of improving economic conditions in both the U.S. and Euro-area which would likely lead to Street estimates rising for 2014. Hence, we have raised our 2013 target for the Standard and Poor's 500 index. We are now concluding that 2014 earnings estimate will approach $120. Recent economic data has been generally encouraging with the ISM surging to 55.4 (the biggest one-month jump since '96) and jobless claims falling to the lowest weekly figures since early '08. We are now closing the second quarter earnings season with encouraging signs that top-line growth is holding – thus confirming that our cyclical bias in portfolios is the winning strategy.

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