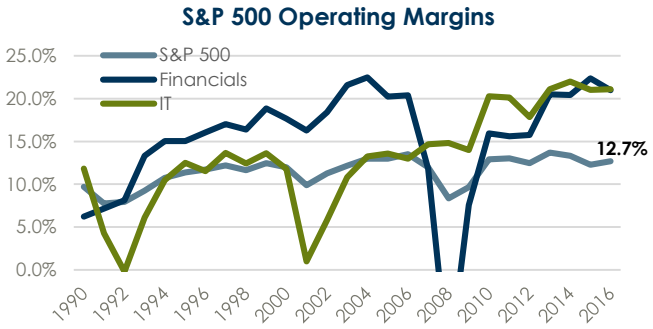
Equity Valuations – Is It Different This Time? September, 2017

BACKGROUND

- **The current bull-market has lasted 101 months, the second longest in the post WWII era.**
- **The longest bull-market was 113 months from 10/90-3/00 and the average post WWII bull market was 58 months.**
- **The S&P 500 has appreciated 265% since 3/09, compared with 417% from 10/90-3/00 (the average bull market was 148%).**
- **Recently, the PE multiple for the S&P 500 Index was 21x trailing 12-month earnings, a 21% premium to the post WWII average.**
- **Other valuation metrics, including Shiller's Cyclically Adjusted PE, point to high valuations as well, with a recent multiple of 29.9x compared to an average since 1948 of 19.0x, a 57% premium.**
- **Given current valuations, should investors reduce equity exposure or look to other asset classes?**

A brief review of earnings multiples – The PE multiple is a widely used valuation metric and can be calculated several ways including trailing or forward earnings, reported (including non-recurring items) or operating (ongoing business) earnings. If the methodology is consistent over time, either approach can provide a benchmark for current valuations. The recent trailing 12-month PE (operating) of 20.8x appears elevated when compared to the longer-term average, however today's level is well below the PE reached during the Tech Bubble of 29.8x. S&P 500 earnings are expected to grow ~18% over the next 12 months resulting in a more reasonable forward PE of 17.8x. Additionally, one can argue that the overall Index PE might be lower if the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) that trade at an average trailing PE of 70x, are excluded.

Operating margins – Along with elevated PE multiples, operating margins for the S&P 500 have also been expanding. The operating margin for the index was 12.7% at the end of 2016, compared to 9.7% in 1990, and an average over that timeframe of 11.5%. Why? Margins have benefitted from a few secular trends that include, declining interest rates (reduced borrowing costs), lower wage growth and lower effective corporate tax rates (more deductions).

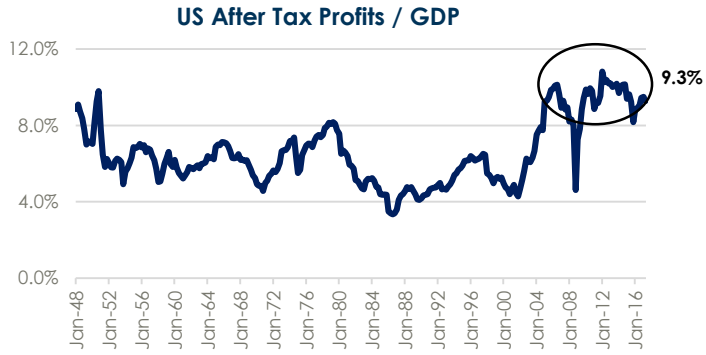


Source: Bloomberg, ACG.

Composition of the S&P 500 Index – Since 1990, notable changes in the sector composition of the index have also occurred. In 1990, Information Technology (IT) was just 6.3% of the index and IT operating margins were 11.8%. By 2Q17, IT represented 22.3% of the index and operating margins improved to 21%. Similarly, since 1990, the weight of Financials nearly doubled from 7.5% to 14.8% and margins have more than tripled from 6.2% to 21%. This changing sector dynamic reflects certain structural and cyclical shifts in the US economy.

Understanding the changing composition of the index might suggest that margins can sustain current levels and avoid a near-term mean reversion.

Corporate Profitability – The ratio of Corporate After-Tax Profits to GDP has also moved higher in recent years. Most recently, the ratio was at 9.3%, compared to the long-term average going back to 1948 of 6.5%. Notwithstanding the structural changes in the economy over time, the observations leading up to and following the financial crisis are elevated relative to anytime prior.



Source: Federal Reserve Bank of St. Louis, ACG

ACG'S POSITION

US large cap equity valuations appear elevated based on several metrics. However, other asset classes don't necessarily offer better opportunities. Fixed income assets are expensive (interest rates remain near historic lows and corporate spreads have tightened dramatically) and real estate valuations are stretched.

Equities can still be supported in the near-term if earnings continue to grow. Current data shows consumer spending remains supportive, interest rates are not likely to increase materially in the short-term, and potential tax reform could extend the current earnings cycle. On a relative valuation basis, Non-US/EM equities look more attractive compared with US equities. Investors should consider rebalancing back to target allocations.