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Market Analysis: Europe/North America

George Sertl on North America

The US stock market has performed well in recent years as the economy has maintained a steady, albeit subpar, expansion following the 2008 financial crisis.

Equities have benefited from a strong rebound in corporate earnings, first due to cost cutting, and then followed by improved global demand. The positive backdrop for riskier assets has been aided by ample liquidity supplied by the Federal Reserve.

Valuations are clearly not as cheap as they once were, but we still think there are selective opportunities in US stocks, particularly in large-cap equities, which have trailed their more US-centric small cap peers.

Over the past year to 31 August, the Russell 2000 index has returned about 26%, easily outpacing the nearly 19% return of the S&P 500 index. This is no one-year phenomenon, however. Small caps have been outperforming large caps for several years.

Since the market lows of March 2009, small caps have generated three percentage points of excess return per year versus large caps.

However, we think large caps have underperformed and are still attractively valued. Based on data going back to 1995, the whole S&P 500 index has sold for about 18.3x trailing one-year earnings on average, compared to about 17.4x for the Russell 2000. Today, the S&P 500 sells for about 15.4x versus 18.8x for the Russell 2000.

US mutual fund cashflows are a direct reflection of these trends; there have been outflows from large-cap funds in each year from 2008 to 2012. When you have forced selling due to net outflows instead of thoughtful selling driven by investment processes, we think there will be bargains.

The opposite was true back in 2000 at the peak of the tech bubble, an era when small caps were out of favour. Large caps sold for multiples in the high 20s compared to high teens for small caps. That valuation divergence positioned small caps to outperform over the long term, and that is precisely what we have observed over the past 13 years with the Russell 2000 generating roughly 350 basis points of excess annualised return over the S&P 500.

One way to assess relative value across asset classes is to look at a company's free cashflow yield compared to the level at which it can issue ten-year debt. This ratio tells you how well you are being paid to be an owner versus a lender to the same business.

The free cashflow yields of large-cap companies are in some cases two to three times the rate at which they can issue debt. Comparatively, small caps are more expensive as their free cashflow yields are lower, whereas their cost of debt is higher.

So with large-cap stocks, we find investors are able to purchase relatively better businesses at cheaper prices.

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Bull Points

- Large caps have a quality and valuation advantage
- Large cap yields are attractive relative to their cost of debt

Bear Points

- Small-cap stocks look expensive
- Smaller companies have weaker balance sheets

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The Russell 2000® Index is an unmanaged, market-weighted index of about 2,000 small U.S. companies. Its returns include net reinvested dividends but, unlike the Fund's returns, do not reflect the payment of sales commissions or other expenses incurred in the purchase or sale of the securities included in the index. An investment cannot be made directly into an index.

S&P 500 is an index of 500 of the largest U.S. companies.

P/E Ratio: **Price-to-Earnings (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. FCF Yield: **Free Cash Flow** is a measure of financial performance calculated as operating cash flow minus capital expenditures. ROI: **Return on Investment (ROI)** is a performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments.

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