Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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NET ASSESMENT

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*I*n a recent article in the Financial Times: "Rate rises erode investors incentive to hold US companies' shares", the Chief Strategist of Pictet Asset Management was quoted saying: "For the first time ever the yield on cash, bonds and equities is the same, … If you are a US investor you should probably buy bonds because, in risk-adjusted terms, they give you more."

*O*f course, using earnings yield (and, by extension, price-to-earnings (PE) ratios) is often misleading despite its popularity since the PE ratio on its own does not tell us much about a company's or market's fundamentals and hence its likely future financial performance. Although predicting the future movements of equity markets over the short term is an exercise in futility, an informative exercise based upon M. Mauboussin's article (M&M on Valuation, Jan 2005) that can help us understand the fundamental economic constituents and expectations embedded in the markets PE multiple and its overall valuation.

*I*n his paper, Mauboussin cited Miller and Modigliani's valuation formula, where a company's valuation is separated into two parts: 1) steady-state value and 2) a future value. The steady-state value can be thought of as "… a business's worth if it doesn't create additional value and maintains its normalized earnings." Assuming an 8% cost of capital (COC) (a reasonable assumption for a hurdle rate), the steady-state PE is 12.5. He notes: "The market expects any company with a PE multiple above 12.5 to create future value. If a company has a PE multiple at or below 12.5, the market either assumes no value creation or anticipates that future value creation will not offset a decline in the current base business. We can also think of the steady state P/E as a commodity multiple, the level all companies reach at the end of their life cycle…" as their Returns to Invested Capital (ROIC) tend towards their COC due to competition.

*T*o justify a PE ratio of 25 (the current ratio of the S&P 500) MM showed two scenarios: 1) 8% earnings growth and 24% ROIC; or 2) 10% growth and 16% ROIC that would be necessary to support the valuation. What this implies is that an investor who buys the market at a PE of 25, in theory, would earn an annualized rate of 8% p.a., assuming that in the aggregate, the market achieves a ROIC of 16% and incremental capital growth at 10%.

"Investing, however, is more than just a case of understanding those dynamics but also assessing where there may be a deviation from those embedded expectations."

Investors should note that as interest rates rise, so too does the COC and hence the PE multiple will fall. Although the current PE multiple of 25 does not scream overvaluation, it should be noted that both the growth and ROIC expectations to support the valuation are on the higher side. Given the near-term global economic headwinds, it is more likely that actual results will be on the lower side.

*T*he holy grail in investing is finding that business that earns a high ROIC, can reinvest its retained earnings at those high ROIC, can also sustain that dynamic over a long period of time and be bought at a reasonable price. Given that the bulk of the returns of the S&P 500 over the last half-year was primarily due to a handful of stocks, there will be opportunities for just such businesses where valuation fundamentals are more favourable.

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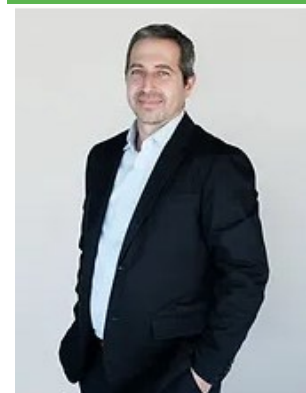
Strong Roots, Sustainable Growth

Eleon Capital Management Ltd.

1 Arch. Makarios III Avenue
Office 105, Lakatameia,
2324,Nicosia, Cyprus



Panagiotis Ververis,
Portfolio Manager,
Eleon Capital Management

Phone: +357 22 021 634
Fax: +357 22 021 635
Email: info@eleoncapital.com
Website: www.eleoncapital.com

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