Robeco BostonPartners

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U.S. Equities at a Crossroads?

The economic climate looks better

Nearly five years after the panic of March 2009, when stock prices dropped to the lowest levels in recent history, the U.S. equity markets have returned to the range of fair value. At around 1,800 the S&P 500 Index is trading at about 16.5 times estimated 2013 earnings, priced for a fair rate of return in the long run of between 7 and 9% - in line with historical averages. As such, the equity markets look neither cheap nor overvalued.

This poses a quandary for those investors – institutional as well as retail – who missed the massive rally off that 2009 low (the "Fat Pitch," to use a baseball analogy) and with it a whole generation of investment gains. "If we buy U.S. equities now, are we setting ourselves up to buy at the top?" they may be asking themselves. "And if we don't get in, will we miss yet another Fat Pitch?"

In attempting to answer that question we start with the premise that the investment landscape around the world is in much better shape than it was in the dark days of 2008 and 2009. As bottom-up stock pickers we do not attempt to make macroeconomic and geopolitical forecasts. But we do believe that the U.S. economy is relatively well placed when compared to the rest of the world. Consider:

- House prices have recovered sharply from their dramatic decline six or seven years ago.
- Gas prices continue to fall as crude oil drops further below its recent peak.
- The employment situation is improving even if the upward trend remains sluggish.
- The Fed's injection of liquidity into the system through quantitative easing has clearly benefitted major financial institutions. They have been able to boost their capital while at the same time credit quality has improved and non-performing loans are falling.

Further, we do not believe the U.S. equity market has formed a bubble as it did between 1998 and 2000, with the exception of a few highly priced small and mid cap stocks. (We define a bubble as a material disconnect between asset prices and fundamentals, usually driven by extreme sentiment). The U.S. bond market, on the other hand, does look to be artificially inflated as the likelihood of higher rates increases.

"Three Circles": An attractive valuation, strong business fundamentals, and positive business momentum.

Set against these favorable factors is the continuing disagreement in Washington over U.S. fiscal policy which has done significant damage to business confidence. Rather than increase capital expenditure on plant and equipment, and research and development, major corporations are opting to return cash to shareholders by way of buybacks and dividends. This lack of expenditure is one reason why GDP growth in the U.S. is running below trend.

Finding investment opportunities

Against this backdrop we continue to use our "Three Circles" approach to investing, selecting stocks that have three key characteristics: an attractive valuation, strong business fundamentals, and positive business momentum.

Beginning with valuation, as we stated at the outset U.S. equities look fairly valued. Table 1 (below) uses a discounted cash flow methodology to show a range of fair values for the S&P 500 Index, given a set of possible assumptions for 2013 and 2014 earnings per share, long-term real and nominal EPS growth rates, as well as a 6.2% equity risk premium added to the current 2.7% 10-year Treasury risk-free rate of return (which combined implies an approximate 9% discount rate on equity earnings).

Table 1: S&P 500 Fair Value

Earnings per Share (EPS), Earnings Growth Equity Risk Premium and 10-Year Treasury Note Yield

Fair Value S&P 500 Earnings Growth Sensitivity ** @ 6.21% Equity Risk Premium

	ROE		EPS	Real EPS Growth 1.0%	1.5%	2.0%	2.5%	3.0%
	15.3%	$	**104.00**	1,504	1,590	1,697	1,831	2,007
	15.5%	$	**105.00**	1,523	1,611	1,720	1,858	2,038
	15.6%	$	**106.00**	1,542	1,632	1,743	1,884	2,068
	15.8%	$	**107.00**	1,560	1,653	1,767	1,911	2,099
2013 (F)	**15.9%**	$	**108.00**	1,579	1,674	1,790	1,937	2,129
	16.2%	$	**109.75**	1,613	1,710	1,831	1,983	2,182
	15.4%	$	**111.50**	1,615	1,708	1,823	1,969	2,158
	15.7%	$	**113.25**	1,648	1,745	1,864	2,015	2,212
2014 (F)	**15.9%**	$	**115.00**	1,681	1,781	1,905	2,061	2,265
	16.1%	$	**116.75**	1,714	1,818	1,946	2,107	2,319
	16.4%	$	**118.50**	1,747	1,854	1,987	2,154	2,372
			Nominal EPS Growth	3.6%	4.1%	4.6%	5.1%	5.6%

** Assumes : 6.21% Equity Risk premium & 2.70% 10 yr Yld

Source: Robeco Boston Partners. Data as of December 2013.
Please refer to the back page of this booklet for other important information.

The bottom line is that the current value of the S&P 500 Index at 1,800 implies a very high equity risk premium and very modest long-term earnings growth expectations, both of which indicate upside for the market if the economy strengthens from this point onward.

Looking at the fundamentals, one key element we seek is high generation of free cash flow. The current trend towards share buybacks and dividend increases is clearly working to the benefit of shareholders. It is worth noting that a number of large, activist investors seem to be targeting high cash generating businesses, pressuring managements to return more capital to shareholders.

As for momentum, it is possible that investors might be pleasantly surprised by an end to the budget impasse early in 2014. While dysfunction has been the hallmark of Washington politics this year, any move towards a consensus might persuade the corporate sector to open its purse-strings and step up capital expenditure. That in turn would spur more growth in the U.S. economy.

Be wary of high-flying stocks

Overall we still detect a mood of caution and skepticism on the part of investors who missed the Fat Pitch early in 2009. However there are signs in certain parts of the market that sentiment is beginning to move away from fear and pessimism towards greed and optimism. We see evidence of this in the sky-high valuations of certain small and mid cap stocks whose prices reflect totally unrealistic expectations for the future.

By our nature, developments such as these make us wary. As active managers we do not spend time on future predictions, often based on non-financial metrics. We focus on what we know and understand in the present. We put more emphasis on analyzing the available information on a stock rather than gathering as many details as possible about the business and suffering information overload. Most importantly, we also look for the “genetic signature,” or the common features of a good investment: inexpensive, of high quality, and showing positive momentum. The high-flying stocks we just mentioned do not meet those criteria.

In conclusion, we believe that the bias remains towards higher equity prices over the long term. This is based on current valuations as well as the catalysts of a gradually improving economy and, once the budget situation is resolved, increased business spending. It is true that corporate earnings growth will present more of a challenge in 2014 but we think that is already fully priced to market expectations.

About Robeco Boston Partners

Robeco Boston Partners specializes in traditional value investing, with an investment process and philosophy that was established more than 25 years ago. The source of our investment returns is security selection achieved through bottom-up fundamental analysis guided by quantitative methods. The team's process systematically blends fundamental research with quantitative screening to identify undervalued stocks throughout the capitalization spectrum.

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Mr. Feeney is Co-Chief Executive Officer and Chief Investment Officer for Robeco Boston Partners. He is responsible for the firm's strategic, financial and operating decisions, and all aspects of investment management including the firm's fundamental and quantitative research groups. He was one of the original partners of Boston Partners Asset Management in 1995. Prior to assuming these roles, he was Director of Research. Mr. Feeney joined the firm upon its inception in 1995 from Putnam Investments where he managed mortgage-backed securities portfolios. He began his career at the Bank of Boston where he was a loan officer specializing on highly leveraged loan portfolios. Mr. Feeney holds a B.S. degree in finance (Summa Cum Laude, Phi Beta Kappa) from the University of New Hampshire and an M.B.A. with High Honors from the University of Chicago. He holds the Chartered Financial Analyst® designation and is past President of the Fixed Income Management Society of Boston. He has twenty-eight years of investment experience.

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