

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

July 3, 2009

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## **P/E Valuation 101: Beauty is in The Eye of the Beholder**

### **Is This Stock Market Fully Valued?**

Every night we seem to hear that the market might be cheap, fully valued or expensive. Sometimes we hear all of those views in the same evening by different pundits. When this happens, how's the average person to know what to believe?

In this article, I won't tell you who to believe and why. However, I can give you some direction with how you might you might hazard a guess on your own.

Let me start with the concept of valuation. Traditional valuation analysis starts with the premise that the value of any asset should be equivalent to the present value of that asset's **expected future returns** or cash flows. In practice, there are a number of methods and processes by which one can estimate valuations – some are quite involved and some less. A rigorous approach would involve seeking to value an asset from multiple vantage points. Yet, the average investor is often not trained or patient enough to go through such a process.

Among the simpler and more commonly used valuation measures is the Price to Earnings or P/E Ratio. At its essence, it represents the share value investors are willing to pay for a share of a company's common stock based upon that company's expected annualized earnings. For example, if a company is earning \$4 per share, how much would you be willing to pay for a share?

The P/E Ratio might just serve as a useful tool in answering this question and it helps if you know one of the more useful ways to view it.

### **A Very Basic P/E Ratio Relationship**

When much younger and less informed, I tried perusing financial newspapers to compare the P/E Ratio's of the stocks I was interested in to that of others. Often, I applied my comparisons quite indiscriminately. And, the result was not very consistent or effective. At the same time, I wasn't really forming much appreciation for how the ratio could be used or its significance.

What I didn't know, was that the P/E Ratio could be converted into an expected rate of return yield. Let's take a look at the equation to elaborate:

$$\text{Share Price} / \text{Annualized Earnings per Share} = \text{P/E Ratio}$$

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For those of you who are mathematically inclined, you shouldn't have a problem following this. So, if

**Annualized Earnings per Share / Share Price = Earnings Yield**

Then, you should be able to obtain the same result from this equation:

**1 / P/E Ratio = Earnings Yield**

Now, when you convert this ratio into a yield, you have a result that might look easier to evaluate versus other investment opportunities. You might even be able to compare the result to something like - bond yields. Which leads me to introduce you to a theory called the "Fed Model". By the way, you would only go through this trouble of converting the P/E ratio to an earnings yield if you didn't have historical or forecasted EPS data readily available.

The Fed Model theory asserts that the yield on 10 Year US Treasury Bonds should be relatively similar to the S&P 500 expected earnings yield. This, in theory, is a method that can provide you an indication whether equities are cheap, fully valued, or expensive. Under this theory, if the 10 Yr UST yield is greater than the forward earnings yield of the S&P 500, then stocks are expensive relative to bonds and vice-versa. The theory is not perfect, but should give you a basis for developing your own thoughts on the subject. Just note that stocks are far less comparable to US Treasury bonds when it comes to risk and that needs to be considered as well.

**The More Important P/E Ratio Consideration**

First, expected future earnings are more valuable than historical data. And, if working with forward-looking earnings, how optimistic or pessimistic are the forecasts you're getting?

Keep in mind that we invest today with the hope that we will realize greater value in the future. Like driving a car, unless you desire to go backwards, it is safer to keep your eyes forward rather than peering through the rear window.

Once you are comfortable that you are working with forward-looking data, you have to develop an opinion as to whether you think the forecasted data makes sense. After coming off of one of the worst market declines in a lifetime and comparable economic conditions, do you think stocks are expensive? I know, I know – the market is up more than 30% from the mid-March lows. But the market is also still more than 40% lower than the October 2007 highs. Also, I don't get the impression that the consensus earnings estimates are overly optimistic either. What's your take?

**Market Update**

While the second quarter of 2009 has treated us well, it now seems like the market might, I say might, stall for a little while. I don't expect a free fall like we saw last March and in October, however, I'm not entirely afraid to take some profits here and there and jump back into the market on dips.

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Many people were sufficiently scared by the stock market's actions over the past year and many missed this quarter's run up in prices. My own feeling was that the markets had factored in a much harsher outcome for the economy last March, and when it looked like a continued downward spiral was less of a threat, the markets abruptly changed direction and rallied. This caught many professional and personal investors off guard and they missed the bulk of this rally. As a result, don't be surprised to hear many in the media try to talk down the market as doing so may be the only way they can reclaim a market opportunity to buy at lower prices.

I don't think that the economy will make a rapid rebound from here as credit remains tight, unemployment hasn't seemed to peak yet and home prices continue to fall. On the other hand, I think that the economy is at the early stages of stabilizing and consumers and business are just beginning work through having to rebuild their finances in this new environment. Don't get me wrong. I do see "green shoots" and, yet, it seems like more than 75% of the "field" remains barren and the buzzards are still circling. I am optimistic. Still cautious, but optimistic nonetheless.

Our portfolios continued to move higher through June, and we finished the 2<sup>nd</sup> quarter strongly. As such, I am happy to report that – taken as a whole – our portfolios under management were UP 1.96% for the month of June. On a year-to-date basis, we're looking pretty good right now as well. Here are some comparative numbers for you to review:

	<b>Jun 2009</b>	<b>3 Month</b>	<b>Y-T-D</b>	<b>1 Year</b>
<b>ELF's ETF Strategy (net)</b>	1.96%	30.86%	14.04%	-20.75%
<b>S&amp;P 500</b>	0.02%	15.22%	1.78%	-28.18%
<b>Russell 2000</b>	1.34%	20.23%	1.77%	-26.30%
<b>MSCI EAFE Index</b>	-0.77%	23.76%	5.64%	-33.55%
<b>MSCI All County World</b>	-0.73%	21.22%	7.56%	-31.09%

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The ELF ETF Strategy returns presented herein represents a composite of actual results from all client portfolios managed by ELF. Currently, it is the only composite presented by ELF and separate client account portfolio positions are substantially similar, except as may be modified for retirement plan accounts and accounts with net equity of \$60,000 or less. There is no minimum account size for inclusion into ELF's ETF Strategy composite and accounts with net equity of \$60,000 or less have a tendency to downwardly skew the combined results.

The performance data presented herein includes the reinvestment of dividends and capital gains; as well, ELF's ETF Strategy composite returns are presented after deducting actual management fees, transaction costs or other expenses, if any. ELF charges an annual investment management fee as follows: 1.25% on the first \$250,000; 1.00% on the next \$750,000; 0.95% on the next \$4,000,000; and, 0.75% thereafter.

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