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❖ Contrarian Views and Ideas ❖

Studies in Absurdity

Subject: The Value Milestone

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The Value Milestone

John Maynard Keynes is said to have asserted that no economic idea is really ever dead. One of the most immortal of investment ideas is the notion that value is of little importance in the determination of equity returns. The subject is at least somewhat topical inasmuch as the equity market appears to have recently passed an awful milestone. It would appear that aggregate equity valuations now surpass those recorded in 1972. This latter year, it will be recalled, had once been regarded as a symbol of mass investment hysteria only possibly surpassed by the year 1929.

It should be observed that this writing is very careful to make use of the words "it would appear." This is not because valuations are not very high. It is merely because, as will be seen presently, the artful use of "adjustments" can serve to support a contrary point of view.

In the case of the present study, 134 large capitalization, well known companies were selected from the currently prevailing indexes and their price earnings ratios noted upon a table. This table will be found at the end of this essay where long tables of lugubrious data should be located. There are three columns. The first column notes the individual p/e ratio based upon estimated 2003 earnings. The average is then computed. This average is now 23.7x. The third column merely notes the individual price earnings ratios as these existed in 1972. This is the reason that only 134 equities were selected. In order to be meaningful the equities must also have existed in 1972. The average p/e recorded in 1972 was 22.4x. Therefore, it would appear that the p/e ratio is, on average, greater than was the case in 1972.

Appear must be an operative word since it will be instantly objected that the comparison is without meaning, since the equity market will be discounting the anticipated profits in 2004. If these are considered in relation to current prices, the p/e ratios are actually far lower. This can be readily seen in the table in column two. The average p/e is 18.2x. In order to achieve a p/e of 18.2 in 2004, it would be arithmetically necessary for the average firm to increase profits by 22.6% in 2004 versus 2003. Although aggressive, one must confess that this result is at least theoretically possible. However, it must also be observed that the average profit increase in the post World War II time period is not far from 5.6% per annum.

Of course, the question of average p/e ratio is powerfully influenced by the presence of outliers. For example, Avon, Automatic Data Processing, Disney, Eastman Kodak, Hewlett Packard, McDonalds and Xerox had 1972 p/e ratios of 54.1x, 75.3x, 63.8x, 35.8x, 47.9x, 60.8x and 46.3x. If only these seven were excluded, the average p/e in 1972 would decline to a mere 20.6x. The 2004 average p/e ratio computation has no comparable p/e ratios such as these among its constituent parts. The reason is that no sensible human being believes that Avon, Automatic Data Processing, Disney, Eastman Kodak, Hewlett Packard, McDonalds and Xerox are capable of the hyperbolic growth necessary to sustain p/e ratios of such magnitude.

In the contemporary era a sensible person believes that hyperbolic growth will be achieved by companies such as Yahoo, EBAY, Amazon.com, Cisco Systems, Dell Computer, Amgen, Medimmune, Qualcomm, Pixar, Nvidia, Monster Worldwide, Applied Materials and Bed Bath & Beyond, among others. The p/e ratios of these firms, based upon estimated 2004 earnings, are as follows:

	P/E Ratio	**Market Capitalization**
Yahoo	87.4x	$26.7 billion
EBAY	54.3x	35.9 billion
Amazon	61.1x	23.8 billion
Cisco	28.7x	145.6 billion
Dell	30.3x	92.3 billion
Amgen	25.9x	79.7 billion
Medimmune	23.2x	6.6 billion
Qualcomm	34.2x	37.7 billion
Pixar	52.5x	3.8 billion
Monster Worldwide	43.9x	2.9 billion
Nvidia	25.6x	2.8 billion
Applied Materials	53.0x	38.8 billion
Bed Bath & Beyond	28.0x	12.5 billion
Jet Blue	34.1x	4.8 billion

It is perhaps needless to assert that this list could be made as long as desired and would include firms as large as the average in the list appended to this essay. These do not appear on that list, since these newer firms did not exist in 1972 and hence there is no basis for comparison.

In fact, if one were to view the Moody's Handbook of Common Stocks for 1972 or 1973, it is impossible to find anything comparable to the Nasdaq 100 both in terms of the size of the companies and in terms of valuation. Consequently, viewed from this perspective, 2003 is rather unique. In any case, it should be arithmetically evident that it would be no problem to devise a list of companies inclusive of the larger elements of the Nasdaq 100 such that the average p/e ratio is far higher than that recorded in 1972.

In 1972, it seems that only Avon, Disney and Automatic Data Processing were examples of companies with the level of egregious price earnings ratios commonly recorded on the Nasdaq in the contemporary era. In order that this not be noticed, no little effort is required. Nonetheless, it has been successfully accomplished. It would seem that the contemporary notion of value is much more in accord with the valuations recorded on the major stock exchanges then those values are in accord with any traditional notion of value.

If the historical study of valuation teaches anything it is that valuations can assume widely varying ranges. These have never been higher. It is astonishing the degree to which these can be lower. In this connection, the Moody's Handbook of Common Stocks 1981 edition is far more instructive than the 1972 or 1973 editions.

For instance, Avon traded at a p/e of 9.0x in 1980. Automatic Data Processing traded at 16.4x in that year. This is despite the fact that its earnings advanced with great consistency from 1972-1980. Disney maintained a p/e ratio of 19.8x. Eastman Kodak could only attain a p/e of 8.3x. Hewlett Packard managed to keep a somewhat respectable 16.6x p/e ratio. McDonald's, despite the consistent growth in demand for unwholesome, caloric cuisine, could only sustain a p/e of 8x. Xerox, which had been regarded as a technological marvel, also supported a p/e of 8x in 1980. Of course, its holders would never have believed that a mere two decades hence, this company would have been in serious danger of bankruptcy.

Thus, if Keynes is right, the traditional notion of value is not dead. It is merely dormant. If another notion of value other than the contemporary notion should ever prevail, there appears to be much scope for loss of capital.

Recent P/E Ratios of 134 Securities vs. 1972

	2003	2004	1972
Air Products & Chemicals	18.1	15.5	21.6
Alberto Culver	21.1	18.4	20.2
Albertson's	11.6	11.5	11.0
Alcan	25.4	16.2	12.0
Alcoa	27.4	19.1	10.4
American Electric Power	12.9	12.5	11.0
American Express	20.5	18.1	31.3
Wyeth (formerly Amer. Home Prods.)	17.8	16.0	32.1
AT&T	7.9	10.6	10.9
Anheuser Busch	19.9	17.8	35.4
Archer Daniels	15.8	13.5	15.5
Automatic Data	24.3	21.9	75.3
Avon	25.5	22.6	54.1
Avnet	29.4	19.4	11.3
Bank of America	10.9	10.6	15.6
Bank of New York	18.6	16.2	9.6
Becton Dickinson	17.1	15.4	33.8
Boeing	43.2	20.9	16.3
Boise Cascade	133.6	19.9	19.0
Bristol Myers	15.3	15.3	24.8
British Petroleum	12.6	15.2	31.8
Burlington Northern	14.1	12.2	11.7
Campbell Soup	16.2	15.0	16.9
Caterpillar	23.6	17.9	16.1
Citigroup	13.9	12.4	16.9
Clorox	18.2	16.5	35.5
Coca Cola	24.2	22.4	41.1
Colgate Palmolive	21.7	19.6	23.7
Consolidated Edison	14.2	14.2	12.4
Conagra	14.7	13.8	11.2
Conoco	9.2	11.5	9.7
Cooper Tire	18.0	13.7	9.0
Corning	109.8	52.3	30.2
Deere	24.6	18.1	9.6
Diebold	23.9	21.5	23.4
Disney	36.5	27.6	63.8
Donnelley RR	19.4	17.6	17.0
Dover	27.7	21.6	17.2
Dow Chemical	33.4	20.0	22.3
Dow Jones	55.3	38.2	34.3
Duke Energy	14.9	14.2	13.6
Dun & Bradstreet	18.5	16.3	27.5
Du Pont	25.1	18.7	19.3
Eastman Kodak	11.9	11.3	35.8
Emerson Electric	22.8	21.3	32.9

Exxon	14.8	17.5	11.5
Fannie Mae	9.9	8.9	10.3
Federated Dept Stores	14.3	12.9	20.8
Ford	11.4	10.7	8.3
Gannett	18.9	17.2	30.5
General Dynamics	16.8	15.1	12.7
General Electric	18.7	17.4	21.7
General Mills	15.1	13.6	18.3
General Motors	8.2	8.3	10.4
Genuine Parts	15.3	15.1	37.7
Georgia Pacific	22.1	11.8	17.5
Gillette	24.9	22.5	20.3
Halliburton	28.1	17.4	27.8
Harns Corp	23.1	19.9	25.6
Heinz	16.0	14.8	13.8
Hercules	13.6	11.0	18.2
Hershey Foods	21.7	19.7	15.8
Hewlett Packard	19.4	15.7	47.9
Honeywell	19.6	18.8	32.7
Imperial Oil	11.2	14.1	34.6
Inco	73.7	14.8	22.4
Intel	42.2	29.4	50.6
IBM	20.9	18.4	34.4
Intl. Flavors & Fragrances	15.8	14.4	56.8
International Paper	51.1	22.4	16.4
Interpublic Group	37.2	19.6	12.3
Jefferson Pilot	13.4	12.4	15.9
Johnson & Johnson	19.1	17.1	52.8
Kellogg	17.4	15.9	16.9
Kerr McGee	11.0	15.4	24.4
Kimberley Clark	15.9	14.8	14.3
Knight Ridder	20.1	18.4	23.1
Kraft	14.5	14.5	12.7
Kroger	11.5	10.7	15.2
Lilly	25.9	22.7	36.5
Lockheed Martin	19.7	17.7	10.5
Lowe's	25.7	22.4	14.2
Marsh McLennan	15.2	13.4	29.9
May Dept. Stores	15.9	14.2	15.0
McDonalds	17.7	16.6	60.8
McGraw Hill	20.9	19.2	18.5
Merck	14.5	13.6	38.2
Meridith	23.4	19.6	15.2
Merrill Lynch	15.9	15.0	19.7
MMM	25.8	22.9	35.0
Monsanto	16.6	14.2	14.8
JP Morgan Chase	11.7	11.7	14.2
Motorola	67.7	33.0	38.0

National Semiconductor	40.6	29.2	27.5
Newmont Mining	46.1	33.2	16.2
New York Times	24.6	22.0	17.3
Northrop Grumman	21.0	18.1	9.5
JC Penney	18.5	14.5	27.8
Pepsico	21.6	19.4	25.9
Pfizer	18.4	15.2	27.5
Phelps Dodge	NM	23.5	9.8
Altria (formerly Phillip Morris)	10.0	9.5	19.9
Pitney Bowes	17.0	15.9	21.5
PPG	19.2	15.8	10.8
Procter & Gamble	21.6	19.7	27.9
Raytheon	19.6	16.9	14.4
RJ Reynolds	11.9	10.4	11.8
Rockwell	27.7	22.6	11.0
Rohm & Haas	23.8	19.5	20.2
Royal Dutch Petroleum	11.9	14.3	12.2
Safeway	10.3	10.3	11.0
Schering Plough	40.2	40.0	38.4
Schlumberger	31.7	23.7	36.8
Sears	10.7	11.0	27.1
Sony	73.3	51.0	34.3
Southern Company	15.7	15.2	11.0
Stanley Works	15.5	13.2	15.3
Sunoco	10.2	10.6	12.7
Tektronix	35.2	25.7	25.6
Texas Instruments	70.5	37.1	35.4
Textron	18.9	18.2	14.4
Texas Utilities	11.5	11.1	15.8
Time Warner	30.0	27.8	15.8
Tootsie Roll	26.8	25.0	13.0
Unilever	13.8	13.0	7.8
United Technologies	18.2	16.6	9.3
Vulcan Materials	21.5	18.5	8.9
Wachovia	13.9	12.6	17.5
Walgreen	27.0	23.4	12.9
Washington Post	32.1	23.9	9.4
Wells Fargo	15.4	13.8	11.6
Weyerhauser	37.4	20.7	21.4
Wrigley	27.9	25.3	14.8
Xerox	22.3	14.4	46.3
Average	**23.7**	**18.2**	**22.4**