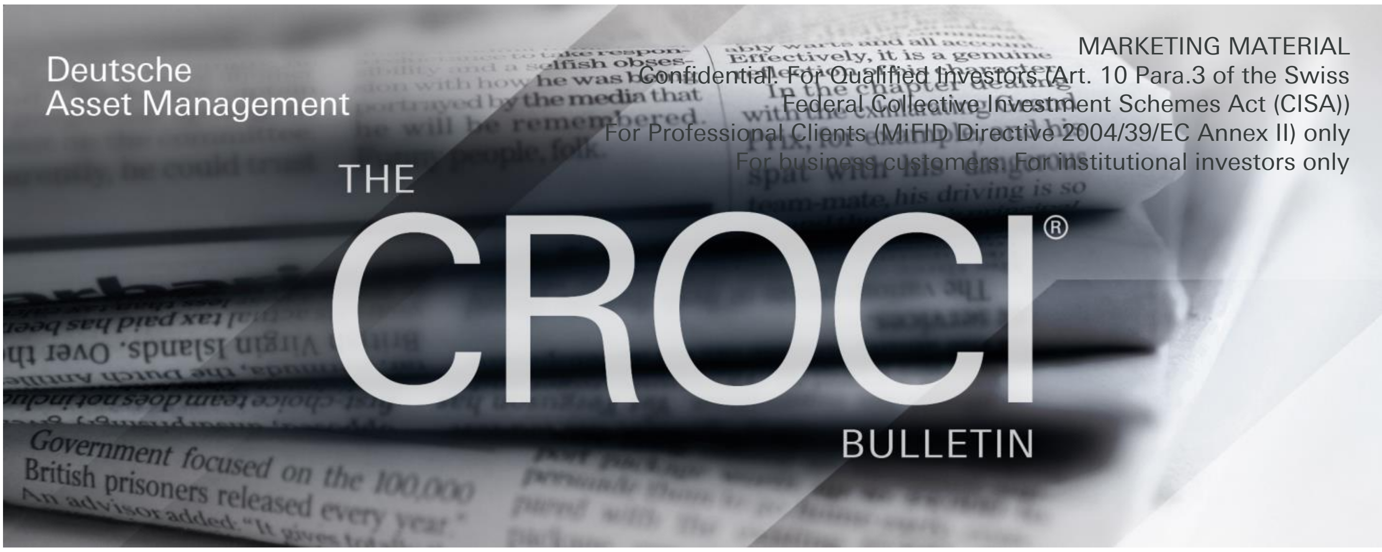

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The Same Old, Same Old

A strong US earnings season is capable of lifting investors' spirits, just as a weak one can dampen them. Following the first quarter results, the revenue of the S&P 500 is expected to have grown by 9% and earnings by 25% over the comparable period last year, according to Bloomberg. Heartening examples include revenue growth of over 20% achieved by both Amazon and Alphabet. Taken alongside promised pro-market measures from the new Trump administration, these results may further fuel optimism. Still, there are some important items to consider:

- Since 2010, the S&P 500 has risen by about 90%[1], but US Economic Earnings have grown by only 24% after adjusting for inflation. This has made equity markets more expensive, as high expectations have become embedded in prices.

- The growth in earnings has been delivered predominantly by three sectors (IT, Healthcare and Consumer Discretionary). The growth in IT has been particularly strong, with Economic Earnings increasing by nearly half—equivalent to an annualised 5.6%—after adjusting for inflation. Consumer Discretionary and Health Care are next best, growing their earnings by an annualised 4.5% and 4.3% respectively. Economic Earnings of both these sectors have increased by more than a third after adjusting for inflation.

- Other sectors have languished. Excluding the earnings-growth triumvirate above, Economic Earnings of our coverage of the S&P 500 has grown by only 5.9%, less than 1% annualised after adjusting for inflation, over this same period.

This leaves out the most intriguing point, though. The best performing sectors year-to-date are exactly the three sectors that we mentioned above. Deeply economically sensitive sectors—Financials and Industrials—have actually underperformed the S&P 500 this year[1].

Ultimately, if economic growth is sustainably accelerating, then investors might expect to see a more robust performance in cyclical sectors. In reality, however, it has just been a classic case of the same old, same old.

Perhaps it is still too early to judge the real impact of Trump's economic policies, and the market may still be adjusting its expectations following the sharp speculative Q4 rally[2]. Either way, this is a clear reminder of the principal theme in our CROCI 2017 Outlook (*A Happy Odyssey*)—that it will take time and patience to reach a new economic equilibrium. Much more than good Q1 earnings are needed to undo the work of a whole decade over which market valuations have run ahead of fundamentals.

Where does this leave investors? Whilst investors attempt to decipher the impact of Trumpian economics, we note (a) that the earnings-growth triumvirate of sectors have no evident valuation premium despite their outperformance, thanks to their strong growth, (b) 46% of US companies[3] now have demanding valuations, potentially even in bubble territory. This is the highest proportion since 1999, based on our long-standing "bubble"[4] analysis. In a market ripe with speculation, we believe it makes sense to focus on fundamentals and on the most attractive and undervalued stocks, which is what CROCI is all about.

[1] The Economic Earnings data used throughout this newsletter is from CROCI. The performance data is from Bloomberg Finance L.P. Data as on 5th May 2017.

[2] See CROCI March 2017 Bulletin, "Sustainability of optimism"
[3] Source: CROCI, Deutsche Bank. Data as on 5th May 2017.
[4] See CROCI Focus: Catching Bubbles, July 2015.

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Introduction to CROCI

Cash Return on Capital Invested (CROCI) is a cash-flow-based analysis which, by making a series of economic adjustments to traditional accounting data, aims to make non-financial companies comparable - regardless of industry or domicile. The main areas where CROCI "economic data" differ from accounting data are as follows:

- Accounting for "hidden" liabilities – CROCI Enterprise Value (EV) includes not only financial liabilities (such as debt) but also operational liabilities (such as operating lease commitments, warranties, pension funding, specific provisions etc).
- Depreciating similar assets in a similar manner - Adjusting depreciation to reflect "economic depreciation" and effective useful economic life.
- Replacement value of assets – Inflating the value of net assets using the relevant inflator (based on the real age of assets).
- Unreported assets – Systematically capitalizing real cash-generative assets that are left off the balance sheet. Research and development costs and advertising are examples of such assets.

Economic PE (Ec.PE): is the CROCI version of the PE ratio and is calculated as EV/(CROCI * NCI) or (EV/NCI)/CROCI

CROCI & Real Value

Real Value Economic value as calculated by the CROCI process via the adjustments to and normalisations of reported financial statements, conducted by CROCI's team of company analysts.

Notes: The CROCI process seeks to make company financial data more consistent, comparable and economically meaningful through a series of reviews and adjustments. This contrasts with more conventional definitions of "Value" that tend to be based on accounting measures such as equity or profits.

The term Real Value can be used attributively to refer to companies with the lowest CROCI Economic P/E.

Real Investor An investor whose investments are driven principally by the careful analysis of company fundamentals, including their economic cash returns and their economic valuation. Specifically, a Real Investor has two characteristics:

1. Fundamental: any investment is informed or driven by the interplay between the cash flow generation, the capital intensity and the valuation of that company.

2. Skeptical of reported financial statements as a guide to investing: Real Investors believe that the income statement and balance sheet in a company's accounts are not necessarily designed to be helpful to equity investors, and that a synthesis of all the notes to the accounts and diligent restatement of the accounts must happen in order to render valuations comparable and meaningful; and

Real Investors look to economic value to inform investment, and believe that the reported financial statement data may not be representative of the economic reality of a company.

Since CROCI makes adjustments to financial statements in order to include all relevant information in the notes to the accounts, and to restate the accounts in order to render economic valuations, which are meaningful and comparable, CROCI may be one valuable approach.

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