RGA INVESTMENT ADVISORS LLC

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Get Your Heavy Duty Staple Remover Ready

On August 25, 2014 the S&P crossed 2000 for the first time. We are nearly two-years past that milestone (now 21 months), yet the S&P continues to wrestle with the round-number level. In essence, very little has happened in the broader markets over this time. Yet, on the sector level the story is very different.

Below is a table showing the performance and delta in the P/E ratio for each of the GICS Sectors, the S&P 500 and the Russell 2000 since the market's first move above 2000:

Sector	Return Since 8/25/2014	P/E Start	P/E End	Change in P/E
Energy	-30.03%	15.8406	42.7616	169.95%
Materials	-7.27%	20.3683	18.1935	-10.68%
Industrials	3.57%	18.6788	17.3815	-6.95%
Consumer Discretionary	15.35%	20.5095	18.1815	-11.35%
Consumer Staples	16.34%	19.2253	22.143	15.18%
Health Care	12.25%	22.5415	20.7527	-7.94%
Financials	1.90%	14.4317	15.4367	6.96%
Information Technology	10.60%	19.5075	19.6072	0.51%
Telecommunications Services	5.29%	14.9902	15.0718	0.54%
Utilities	14.84%	16.5248	18.3118	10.81%
S&P	**4.96%**	**17.991**	**19.4189**	**7.94%**
Russell 2000	**-0.90%**	**53.6637**	**36.9853**	**-31.08%**

Source: Bloomberg LP (Note that all changes are from the period starting at 8/25/2015 and through 5/31/2016)

A few points stand out right away:

1) **Energy's P/E has risen substantially despite a 30+% drop in price.** This is due to the collapse in energy shares and underlying earnings of the companies who operate in energy. Since the P/E we included here excludes extraordinary one-time items (charges against earnings that are non-recurring in nature), it is clear that markets are pricing in some kind of cyclical improvement for energy.
2) **After Energy, Consumer Staples and Utilities are the only other sectors for which P/E ratios have risen since the S&P first crossed 2000**. This is not because earnings growth has been robust in

either sector. In fact, with staples, nearly the entire 16.34% return since 8/25/14 can be attributed to the change in its P/E and not to growth. This is a result of the sector's historically robust and sustainable dividends being used as bond proxies in this era of low interest rates.

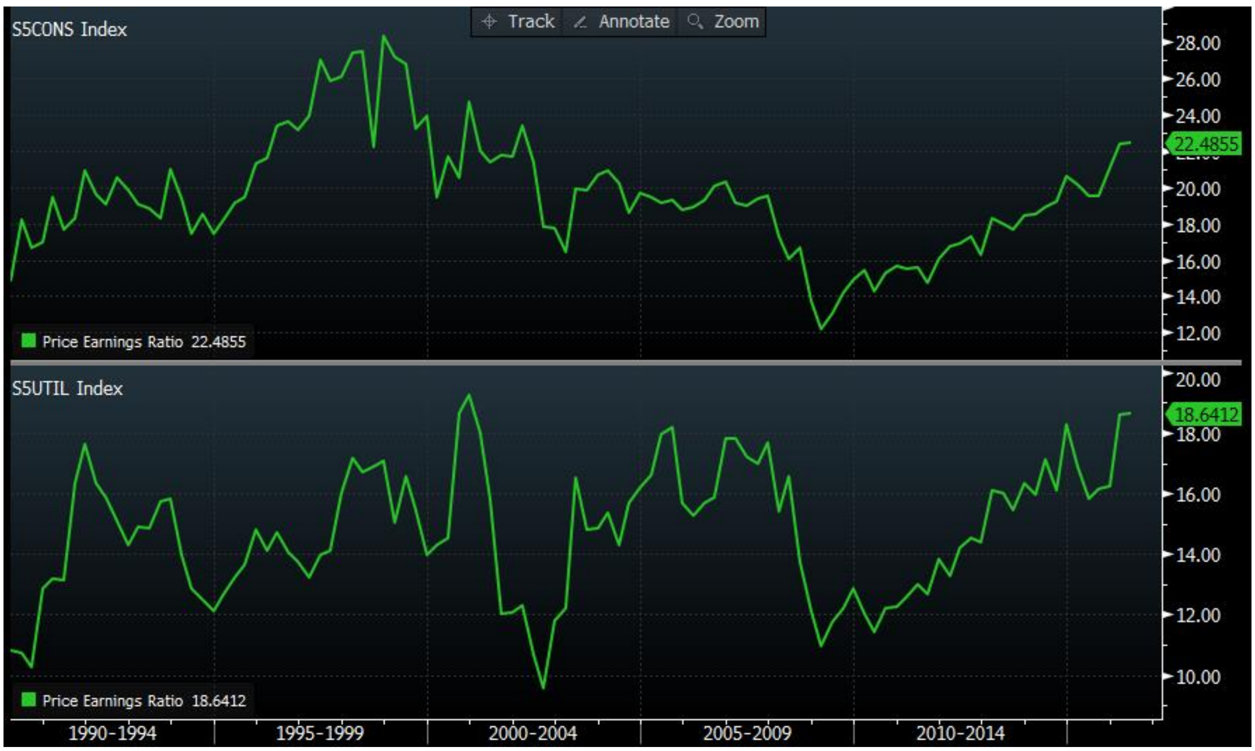
3) **Health care and Consumer Discretionary each had their multiples contract while earning double-digit price returns**. Both sectors benefited from robust earnings growth; however, the multiple contraction indicates that the markets anticipated this healthy growth and priced at least some of it in.
4) **The S&P's multiple expanded by nearly 8% despite generating less than a 5% return**. In other words, for this time period, all of the market's return and then some can be explained by multiple expansion rather than growth. We went through the sectoral components of growth in our September 2015 Commentary which further explains how and why this has happened.[1]
5) **The Russell 2000 has had a huge amount of multiple compression**. The Russell 2000 has been essentially flat (down less than 1%) since the S&P first crossed 2000, yet its multiple has dropped by an extreme 31%. What this means is that earnings at the Russell 2000 companies have grown tremendously while price has gone nowhere.

One reason for looking at the sectors in this way is to highlight how many moving parts there are when we talk about "the market." There are significant divergences these days and unique drivers behind the action in market subcomponents. This leads to confusion and indecision. Confusion and indecision often result in sideways, volatile price action. As a result, it is no surprise that the time period encompassing this discussion has been sideways and volatile.

What exactly can we learn from the price action in Consumer Staples and Utilities? Only one simple fact has mattered as far as valuations go for these two sectors: On August 25, 2014, the 10-year yield was at 2.39%; it ended May at 1.84%.

[1] http://www.rgaia.com/a-liquidation-move/

Over this time, the dividend yield for Staples went from 2.71% to 2.61%, while the Utilities yield went from 3.69% to 3.54%. Below are the P/E ratios for these two sectors charted since 1990:



The top of the chart shows the Staples sector, while the bottom is Utilities. Aside for the dot.com bubble period, Staples have never been as richly valued. Meanwhile, Utilities are as expensive as ever.

Of the four best performing sectors (Discretionary, Staples, Healthcare, Utilities), two experienced multiple contraction, while two experienced multiple expansion. We have often discussed the market's multiple as the sentient component of valuation for how it embodies the character and emotion of market participants more so than any other single variable. The multiple is essentially how we measure "Mr. Market's" mood. We can use some fundamental tools to determine a range of appropriate multiples based on several scenarios in an effort to triangulate what "fair value" for an index or security should be. What we can never do (nor will we do) is attempt to predict where a multiple will be any time in the future.

One of the simplest things we can say is that typically (and there are fair exceptions), a rising multiple indicates improving fundamentals, while a falling multiple indicates deteriorating fundamentals. With this heuristic, it would be fair to assume that Staples and Utilities had a much better forward outlook today than they did in the Summer of 2014, while the outlook for Healthcare and Discretionary deteriorated. There is an element of truth to this with respect to Healthcare and Discretionary; however, the opposite is actually the case with Staples and Utilities. In some respects, key components of these sectors are as fundamentally challenged as they ever have been and the truth behind these challenges is even more evident today than it was two summers ago.

In the market practitioner's lexicon, when something in the market is boring and justifying of a low multiple, people call it a "utility." These properties have become synonymous with the Utilities sector for a reason: it has slow growth, with predictably boring fundamentals and a historically high yield (i.e. low valuation). Financials are often labeled today's "utilities" and we can see pretty clearly that they have been near the low-end of the market's P/E for this entire digestive period. In the market practitioner's lexicon, "growth" has been synonymous with high multiples. Meanwhile, today, one of the sectors with the worst growth profile (Staples) has the highest multiple of any sector.

By the end of this year, three of the five platforms we highlighted in our January commentary will have lower P/Es than the Staples, despite their robust growth rates.[2] By the end of 2017, all will have lower P/Es. That could change with our stocks moving higher, Staples moving lower, or a little bit of both. Clearly by virtue of our positions we expect our stocks to move up irrespective of market or sector action. In the meantime, we will continue to search for opportunities in some of the more unloved sectors of the market like Healthcare and Financials, where multiples have either contracted substantially or already were much lower than average.

The strength of Utility and Staples sectors are part of the fallout from the Financial Crisis. While yield alone explains the multiple expansion here, the Financial Crisis itself has created a misguided sense of "buy what's safe" in the retail investment world. This credo has become agnostic to pricing and valuation. As Howard Marks once said, "when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky."[3] Marks is telling us here that at a certain point, price itself becomes the risk. When people become price-agnostic in a given area, smart investors should run the other way every time.

Moments ago we said we would refrain from making predictions about market multiples. Right now we will make a prediction, albeit with a twist. We are not sure when exactly this will happen, but we are

[2] http://www.rgaia.com/robust-networks-for-the-long-term/
[3] https://www.oaktreecapital.com/docs/default-source/memos/2015-09-09-its-not-easy.pdf?sfvrsn=2

confident that Staples will lose their place as the market's most richly valued area with limited likelihood of ever recouping that status.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-1945
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, CFA
Managing Director
O: (516) 665-1945
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com