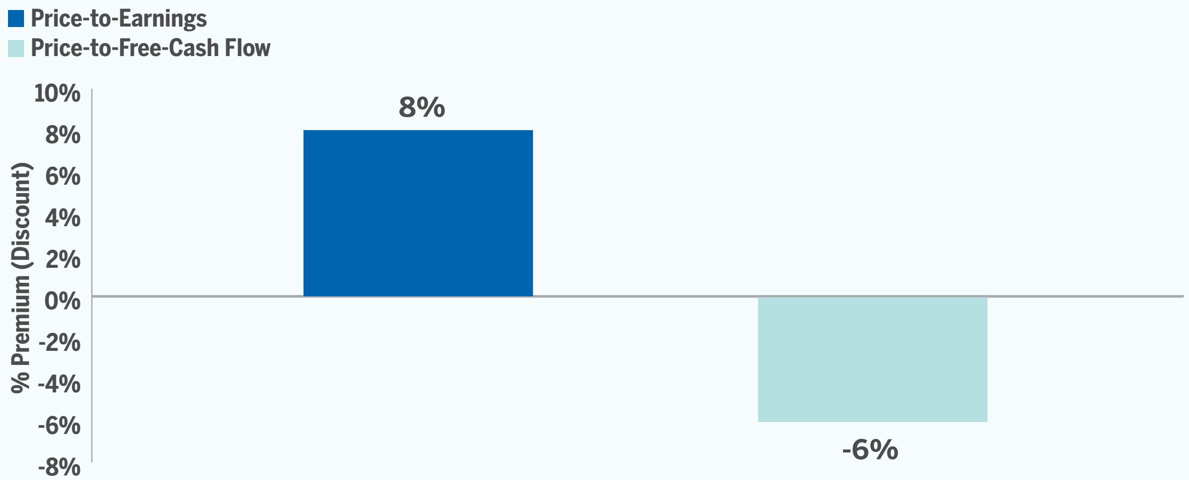
Evaluating Valuations

U.S. equity price-to-earnings (P/E) multiples are higher than their historical average. However, an examination of the changing nature of business models suggests that valuations may be more attractive than they appear.

Expensive or Cheap?

Current S&P 500 Valuation Relative to Past 25-Year Median



Source: FactSet as of 6/30/19.

Note: Price-to-earnings is the current market price of a company divided by its last 12 months of earnings. Price-to-free cash flow is the current market price of a company divided by its last 12 months of free cash flow.

- P/E multiples for U.S. equities are higher than they have been historically but free cash flow multiples are actually lower than they have been historically. How is this possible?
- As the economy has changed over the years so too have business models. New, knowledge-based businesses are able to convert more of their net income to cash because they are less capital intensive and much of their "investment" is recorded on the income statement (e.g., R&D) rather than the cash flow statement (e.g., capital expenditures).
- The software industry, for example, has free cash flow margins that are several hundred basis points higher than its net income margins. By contrast the machinery industry has much lower free cash flow margins as compared to its net income margins.
- Investors should be careful not to simply compare valuation multiples across history given the changing face of the U.S. economy. Stronger free cash flow margins (along with lower interest rates) may justify higher P/Es and indicate stocks are more attractive than P/Es suggest.