Reaves Asset Management

Today's Relative Valuation of Utilities – Our View

From time to time we field questions about today's relative valuation of utilities; we've also seen the financial press examine the issue. To be sure, though the premium reached a high point at the end of last year, utilities remain near an historic valuation relative to the broad stock market. While it is helpful to note the disparity between utilities' dividend yields and the yields of corporate and treasury bonds, we think a somewhat more rigorous examination of utilities' present relationship to the broad equity market reveals that the market is acting fairly efficiently.

The average regulated utility company has a P/E of approximately 15.0x next year's earnings. It has a dividend yield of about 4.2% and can be reasonably expected to grow earnings in the 3-5% range. By comparison the S&P 500[1] yields about 2% and trades at 13.5x, with the assumption that the index has a 2013 earnings power of $108.50, or 7% higher than expected for the current year. If we hold all of these variables steady, it appears that the outlook for total return (dividend plus earnings growth) for both indices are roughly the same. We believe that there are two critical differences: the outlook for volatility and the appetite for income. The opportunity lies therein.

Volatility for the S&P Utilities[2] relative to the S&P 500 has come down meaningfully since the financial crisis. Currently, the S&P Utilities 24-month rolling average of standard deviation[3] is about half of that of the S&P 500 – 9.1% vs. 18.8%. We believe that the relatively lower risk by itself could easily explain much of the Utilities' 14% P/E premium, when one thinks of a simple efficient frontier chart. Further, we think that today's low volatility should be durable. Companies with protected franchises in what are fundamentally non-discretionary products should have a lower volatility of earnings which should continue to translate into relatively lower volatility of stock market returns. An above average and rising dividend yield should help.

The other significant theme has been the demand for income in today's low interest-rate environment. Current demographic trends, constrained economic activity and extremely accommodative monetary policy from the Federal Reserve have all conspired, as we are all familiar, to create a situation in which investors have been forced into equities in order to generate real income. The situation has become so acute that, as many have observed, the market for U. S. Treasuries has become the venue of choice for investors wishing to bet on the business cycle, while investors looking for income have to look to the equity market. Among the S&P 500 companies, utilities (and telecommunications stocks, for that matter) offer the highest level of income.

We think all of these factors contribute to the current relative valuation of utilities and we do not see much that interferes with the relationship. We continue to believe that under the status quo incremental investors will continue to find utilities attractive. Should the economic picture deteriorate, we believe that utilities will become more attractive. Conversely, a return to strong economic and (by extension) earnings growth for the broad market could cause the broad market to pull away, particularly if accompanied by a major change to the interest rate picture. Our focus on companies that have the ability to raise their dividends, not to mention our investment in energy stocks, should help in such a climate to moderate the impact. As long as expectations remain for earnings-per-share growth for the S&P 500 in the single digits and for low interest rates, we believe that utilities and telecommunications stocks will be well-positioned.

1 The S&P 500 Index is a capitalization-weighted, composite index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

2 The S&P Utilities Index is a capitalization-weighted index containing 33 Electric and Gas Utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities.

3 Standard deviation is a measure of the variability of returns-the higher the standard deviation, the greater the range of performance (i.e. volatility). The data shown reflects the deduction of investment management fees and/or transactions costs. Standard deviation is based on quarterly data. The risk/return data shown are based on historical annualized rates of return and standard deviations of the Reaves ERISA Composite.


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