To Have and Have Not

Joe and I recently attended the annual Raymond James investor conference in Orlando, Florida. With over 300 companies presenting, the conference is a great opportunity to gauge the operating climate of multiple industries. It also offers a convenient avenue to receive updates on QV holdings as well as kick the tires on potential new ideas. Collectively, we attended over 60 company presentations in addition to meeting with a number of management teams of existing and prospective investments. Below are some observations from the conference.

Despite the S&P 500's low growth prospects, we heard from many companies who continue to report strong results. However, we also found many who are navigating a more difficult environment. Although headline economic data remains unimpressive, the evidence from corporate America suggests that growth continues to be very unevenly distributed. For example, tool and industrial product manufacturer Stanley Black & Decker has grown earnings at a five year compound rate of 14%, and management believes they can achieve organic topline growth of 4-6% and earnings in the low teens over the next few years. Masco Corp., a maker of home improvement products like faucets and cabinets, expects sales to grow at 7% over the next two years. With residential construction spending growing above 10% annually, management's forecast may prove accurate. Among other high quality economically sensitive companies however, the environment is very different. Praxair, a distributor of atmospheric gas to a wide range of industries, has seen sales rise by 1.3% annually over the last five years - below nominal GDP growth. Management expects little improvement in 2016 as commodity related exposure and a weak macro outlook has led them to forecast only 1.5% earnings growth. Expectations from railroad operator Union Pacific are not dissimilar. The company saw car loadings decline 6% in 2015 as all freight categories fell except automotive. Following an 8% decline in Q1, management expects this trend to continue in 2016.

Current valuations provide little support for investment among many of the high quality economically sensitive companies who presented in Orlando. Dividing them into 'haves' and 'have nots' on the basis of growth expectations, neither group appears particularly cheap. Companies in our 'have' basket are expected to grow by 15% on average over the next 12 months based on consensus estimates. However, this group currently trades at a price to earnings (P/E) ratio of 20x - a 22% premium to its 10 year median. Over the same period, the 'have nots' are expected to see their earnings fall by 1.2% on average. This basket trades at 17.4x - a 12.5% premium to the long term median. Although these are small samples, our 'haves' and 'have nots' demonstrate an ongoing theme in the US market. On the one hand, a significant premium remains attached to companies with healthy growth prospects. On the other, good quality companies with more challenged near term growth are not inexpensive either.

Source: Capital IQ

Nonetheless, pockets of value persist. In Orlando, we had the opportunity to receive an operational update from Aflac's management team. Aflac is the largest provider of supplemental health insurance in Japan and the US. It is also the largest holding in our global strategy. The company has raised its dividend for 34 consecutive years, its return on equity is consistently above 15% and it currently trades at a P/E of 10.4x. While management expects earnings to only grow between 4-7% in 2016, the company's progress in its large US business group as well as the ongoing sales channel build out in 24,700 Japan Post outlets provide interesting long term growth potential. In the meantime, the business' strong capital levels and consistent profitability allow it to return over $2 billion in capital to owners in both 2016 and 2017, which equates to a 8.3% annual shareholder yield. Although our time in Orlando didn't yield any immediate new ideas this year, it certainly reaffirmed why we continue to own businesses like Aflac.