



C A M B R I D G E A S S O C I A T E S L L C

U.S. MARKET COMMENTARY

A CROSS-SECTION OF U.S. EQUITY VALUATIONS

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A Cross-Section of U.S. Equity Valuations

U.S. equity market valuations have improved significantly since the market peak of March 2000, with the price-earnings multiple (P/E) on the Dow Jones Total Market Index of approximately 1,600 stocks decreasing from 29.9 on March 31, 2000, to 16.6 on September 30, 2006.¹ Throughout this period, valuations among U.S. equities have compressed significantly, and not surprisingly, the performance differentials across styles and capitalization sectors have also compressed. For example, between March 31, 2000, and March 31, 2005—the date of our last detailed review of the cross-section of U.S. equity valuations²—small caps outperformed large caps by an annual compound average of 10.9 percentage points, compared to only 2.5 percentage points over the 18 months ended September 2006. Similarly, value outperformed growth by 21.3 percentage points annually in the first five years, compared to 4.6 percentage points over the last 18 months.

The following summarizes our key findings in reviewing a cross-section of market valuations over time since the prior market peak in March 2000. Specifically, we divide the Dow Jones Total Market Index into five groups, sorting companies with positive earnings into quartiles ranked by their P/E ratios and looking at stocks with negative or no earnings to compare the characteristics of the most and least expensive stocks over time.

Valuation Compression Continues

The range of positive P/Es (excluding the highest and lowest 5%) shrunk significantly from a low of 6.8 and a high of 148.2 (or a spread of 141.4) as of March 31, 2000, to a low of 9.2 and a high of 74.9 (or a spread of 65.7) as of March 31, 2005, shrinking slightly further through September 31, 2006, to a low of 7.9 and a high of 67.1 (or a spread of 59.2) (Table A). These statistics somewhat understate the compression of P/Es, as they exclude companies with no or negative earnings, which have declined from 585 in March 2000 to 248 in March 2005 and 200 in September 2006.

Even as the broad market index P/E fell over this period, the median P/E among companies with positive earnings actually increased between 2000 and 2005, while the number of truly cheap stocks (with P/Es below 10) decreased significantly from 267 such stocks to 100. Over the last 18 months, valuations have stabilized, with the median P/E improving modestly, from 20.2 in March 2005 to 19.4 in September 2006, while the number of stocks with P/Es below 10 increased slightly to 121.

¹ We use the Dow Jones Total Market Index, which is similar in composition to the Russell 1000® Index, because it is reconstituted more frequently than the Russell indices and has purer style definitions. See our August 2005 U.S. Market Commentary: *New Equity Indices are Quite Stylish*, for an in-depth comparison of U.S. equity style indices.

² See our April 2005 U.S. Market Commentary: *U.S. Equities are Cheaper, but Fewer Values Remain*.

Small Caps Flip from Relatively Cheap to Expensive

While the ratio of the Russell 2000® Index P/E to the Russell 1000® Index P/E was roughly 2 standard deviations below its post-1978 average of 1.22 in early 2000, indicating that small-cap stocks sold at a significant discount to mid- to large-cap stocks, this ratio was equal to its long-term average by the end of March 2005. By March 2006, the ratio peaked at the other extreme, with small-cap stocks 2 standard deviations more expensive than mid- to large-cap stocks, before quickly falling back to just under 1 standard deviation cheaper following a significant large-cap rally over the six months ending September 30, 2006.

As would be expected, large-cap stocks continue to represent a large, but decreased percentage of the most expensive stocks, falling from 93% of the capitalization of the most expensive quartile of stocks in March 2000 to 75.4% in March 2005 and 62.0% in September 2006 (Table B). Similarly, while the least expensive quartile of stocks was the exclusive domain of small caps in March 2000, 73.3% of the capitalization of these stocks was large cap in March 2005, compared to 81.8% at present.

Style Valuations Converge, but Pricey Stocks Have Growth Bias

In March 2000, the P/E ratio of the Russell 1000® Growth Index compared to the Russell 1000® Value Index was more than 3 standard deviations above its long-term average of 1.57. This valuation differential has ebbed away during value's prolonged dominance, such that growth stocks have traded at a slight discount to value stocks since late 2004. Given these trends, it is not surprising that growth stocks have decreased as a percentage of market capitalization of the most expensive quartile of stocks. In March 2000, the vast majority of the capitalization of the top quartile of stocks was growth stocks, but by March 2005, the split between growth and value was nearly equal. However, it is somewhat surprising to see that over the last 18 months, even as value stocks have continued their lead over growth stocks, growth stocks' share of the highest P/E quartile of stocks increased considerably, from 39.8% to 65.5% (Table C). As would be expected, value stocks continue to make up the majority of the capitalization of the least expensive quartile of stocks, but contrary to expectations, given the relative outperformance of value stocks, they account for an increased percentage of this quartile relative to 18 months ago: 78.6% of market capitalization, compared to 69.4% in March 2005.

Sector Rotation

As would be expected given the speculative excess in the technology sector, in 2000, 61.7% of the capitalization of the most expensive quartile of stocks was technology issues, compared to only 21.9% in March 2005 and 29.9% in September 2006, although technology maintains the heaviest weighting among economic sectors in the top quartile of stocks (Table D). At the same time, technology's share of the total market also fell from 36.9% in March 2000 to only 15.6% today. As tech stock valuations fell, financials rose, with financials accounting for only 1.7% of the most expensive stocks in March 2000, increasing to 22.2% in March 2005, before moderating somewhat in September 2006 to 16.4%. As would be expected,

financials have continued to dominate the least expensive quartile of stocks and, thanks to healthy earnings growth, have occupied an increasing percentage of the cheapest stocks, rising from 38.3% in March 2000 to 43.2% in March 2005, remaining virtually unchanged at 43.4% today.

Energy shares, which have grown from roughly 4% of the total market's capitalization in March 2000 to roughly 9% at present, have occupied a growing percentage of the lowest P/E quartile, as earnings growth has outpaced capital appreciation in the sector. While energy stocks accounted for only 3.8% of the lowest P/E stocks in March 2000, their weight increased to 19.8% in March 2005 and 25.8% in September 2006.

Quality Matters

The most significant change in valuations over the last 18 months relates to quality. Since the middle of 2004, we have written about our predisposition to hold the most financially sound, high-quality stocks because we value their defensive characteristics and they are relatively inexpensive.³ In March 2000 quality was not an important determinant of valuations, as the distribution of high-quality stocks among the cheapest and most expensive P/E quartiles was roughly in line with its distribution in the total market (Table E). However, over the last six-and-a-half years, and particularly the last 18 months, low-quality stocks, defined as those rated B and lower by Standard & Poor's, have become increasingly expensive, while high-quality stocks, rated B+ and above, have become increasingly cheap. Low-quality stocks accounted for 37.2% of the most expensive quartile of stocks in March 2000, falling slightly to 29.5% in March 2005, and more than doubling since then, reaching 65.1% in September 2006. Among the lowest P/E quartile, high-quality stocks have occupied a steadily increasing percentage of the capitalization, rising from 48.7% in March 2000 to 67.4% in March 2005, and 72.2% in September 2006.

Conclusion

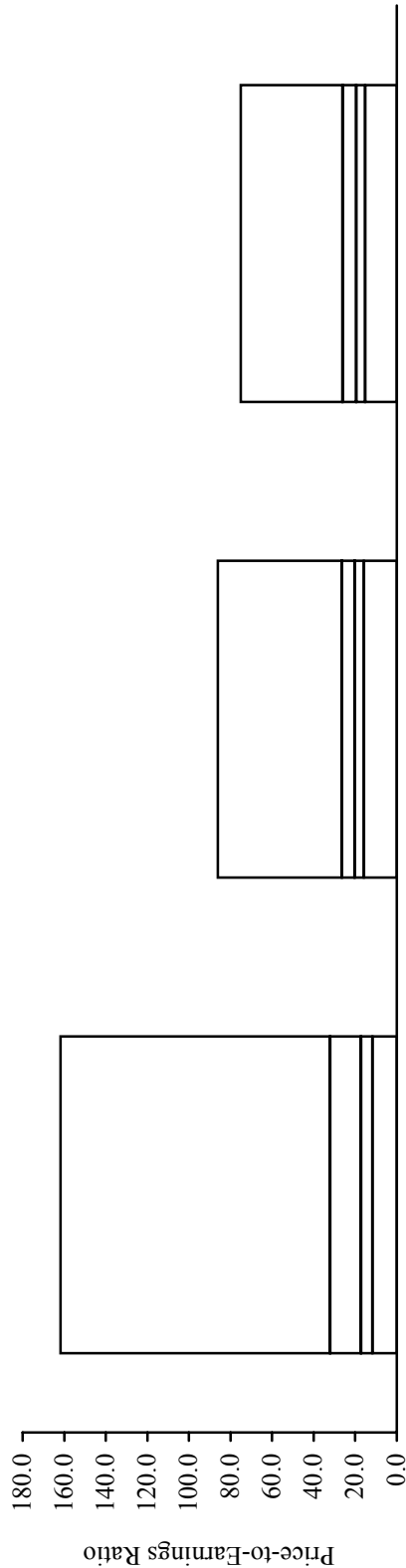
In sum, over the last 18 months, valuations have continued to compress, making identification of relatively attractive opportunities difficult. As we have noted many times in the last couple of years, high-quality stocks continue to stand out as one of the best relative opportunities.

³ See the following U.S. Market Commentaries: *The Unloved Mega-Caps* (August 2006), *Still Pounding the Table on Quality* (June 2006), *The Appeal of Quality* (October 2005), and *Underweight Small Caps?* (June 2004).

Table A

U.S. EQUITY PRICE-TO-EARNINGS RATIO QUANTILES

Distribution of P/E Ratios, 5th - 95th Percentile



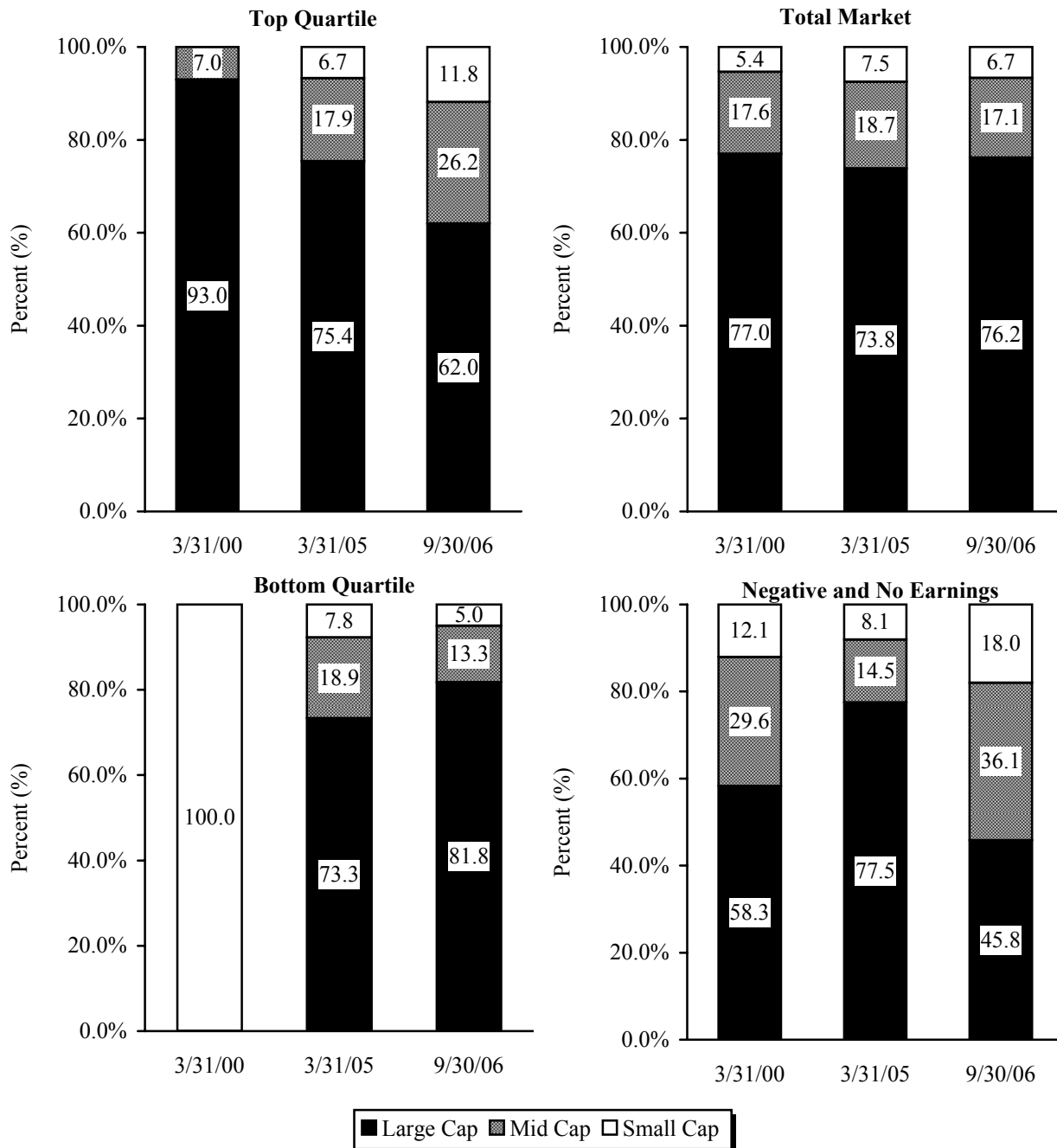
	March 31, 2000				March 31, 2005				September 30, 2006			
	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	First Quartile	Second Quartile	Third Quartile	Fourth Quartile
Mean	159.4	23.9	13.8	8.4	74.2	23.3	17.9	11.6	75.0	22.7	17.1	10.8
Median	67.5	22.8	13.8	8.8	39.8	22.9	17.9	12.1	38.1	22.3	17.2	11.8
High	Dow Jones U.S. Total Market Index 3,981.3				Dow Jones U.S. Total Market Index 1,114.7				Dow Jones U.S. Total Market Index 2,778.0			
95th Percentile	148.2				74.9				67.1			
75th Percentile	34.7				27.7				27.1			
Median	17.2				20.2				19.4			
25th Percentile	11.3				15.3				14.7			
5th Percentile	6.8				9.2				7.9			
Low	0.3				3.6				0.7			
Index P/E	29.9				17.5				16.6			

Sources: Dow Jones & Company, Inc., FactSet Research Systems, and Standard & Poor's Compustat.

Notes: Graph data represent price-to-earnings (P/E) ratios within the 5th and 95th percentile, while data in the exhibit represent all positive P/E ratios in the index. Quartiles are arranged from highest to lowest P/E ratios. Therefore, the top quartile includes those stocks with the highest P/E ratios as of the specified date.

Table B
CAPITALIZATION SECTORS OF THE MOST EXPENSIVE AND LEAST EXPENSIVE U.S. EQUITIES

Percentage Distribution of Market Capitalization



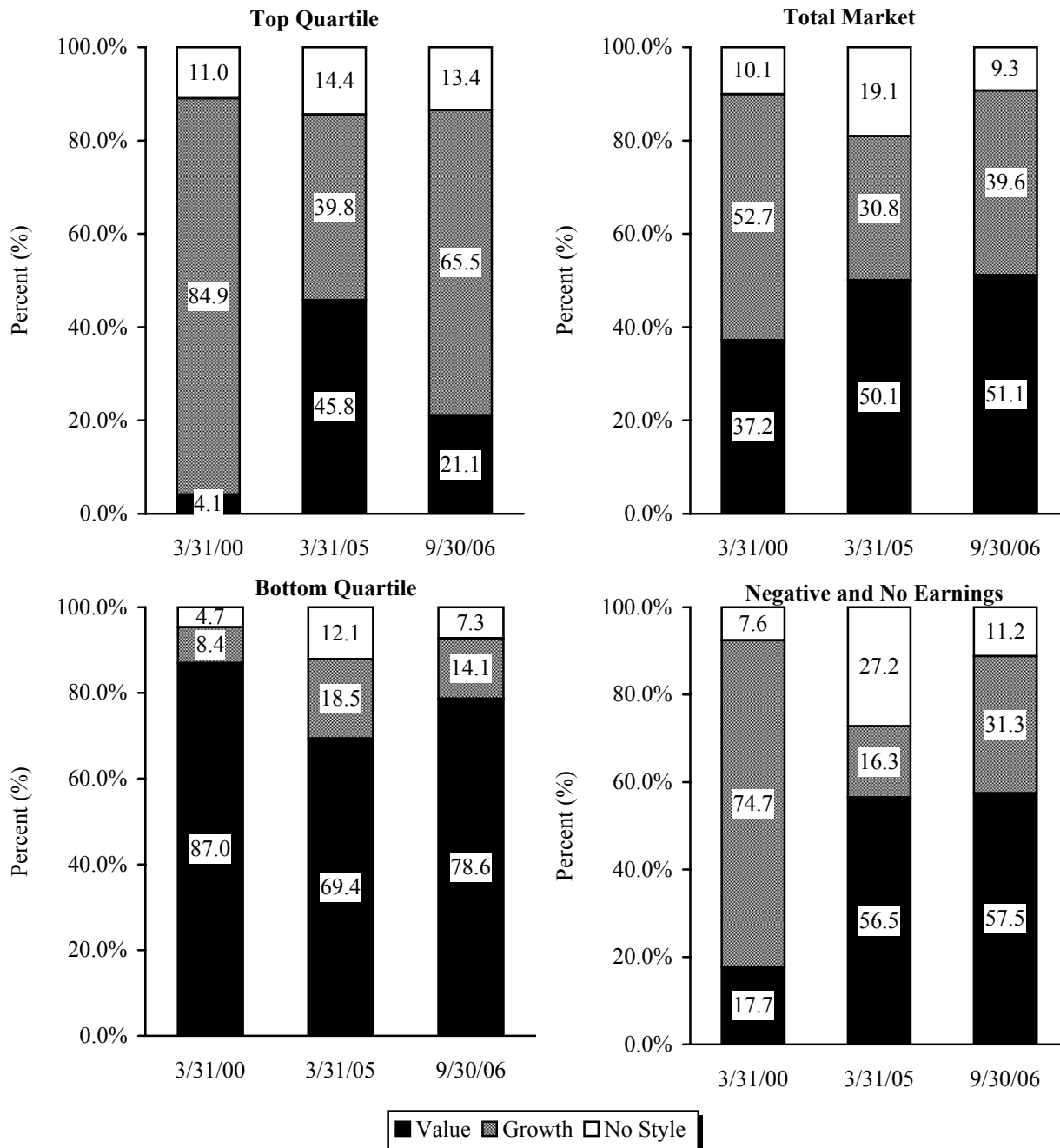
Sources: Dow Jones & Company, Inc., FactSet Research Systems, and Standard & Poor's Compustat.

Notes: The negative and no earnings category includes companies with negative and no reported earnings. Quartiles are arranged from highest to lowest price-to-earnings (P/E) ratios. Therefore, the top quartile includes those stocks with the highest P/E ratios as of the specified date. Figures may not total due to rounding.

Table C

STYLE CHARACTERISTICS OF THE MOST EXPENSIVE AND LEAST EXPENSIVE U.S. EQUITIES

Percentage Distribution of Market Capitalization



Sources: Dow Jones & Company, Inc., FactSet Research Systems, and Standard & Poor's Compustat.

Notes: The negative and no earnings category includes companies with negative and no reported earnings. Quartiles are arranged from highest to lowest price-to-earnings (P/E) ratios. Therefore, the top quartile includes those stocks with the highest P/E ratios as of the specified date. Figures may not total due to rounding.

Table D**ECONOMIC SECTORS OF THE MOST EXPENSIVE AND LEAST EXPENSIVE
U.S. EQUITIES****Percentage Distribution of Market Capitalization****March 31, 2000**

<u>Economic Sector</u>	<u>Top Quartile</u>	<u>Bottom Quartile</u>	<u>Negative and No Earnings</u>	<u>Total Market</u>
Consumer Discretionary	10.67	24.97	11.60	11.11
Consumer Staples	6.42	6.51	0.68	7.03
Energy	2.25	3.79	2.03	4.37
Financials	1.70	38.34	2.01	12.90
Health Care	6.92	0.99	15.86	9.67
Industrials	8.35	9.53	2.64	8.15
Information Technology	61.70	1.56	46.81	36.86
Materials	1.41	3.28	1.06	2.08
Telecommunication Services	0.20	0.00	17.01	5.93
Utilities	0.38	11.04	0.30	1.89

Percentage Distribution of Market Capitalization**March 31, 2005**

<u>Economic Sector</u>	<u>Top Quartile</u>	<u>Bottom Quartile</u>	<u>Negative and No Earnings</u>	<u>Total Market</u>
Consumer Discretionary	17.56	12.58	13.20	16.62
Consumer Staples	3.44	1.73	0.11	5.39
Energy	4.85	19.83	0.88	6.45
Financials	22.22	43.15	4.67	20.81
Health Care	11.16	5.84	9.78	8.61
Industrials	6.70	2.48	6.76	11.29
Information Technology	21.90	2.61	37.87	16.97
Materials	7.34	7.87	15.04	7.68
Telecommunication Services	0.87	0.33	10.10	1.76
Utilities	3.96	3.58	1.59	4.42

Table D (continued)**ECONOMIC SECTORS OF THE MOST EXPENSIVE AND LEAST EXPENSIVE
U.S. EQUITIES****Percentage Distribution of Market Capitalization****September 30, 2006**

<u>Economic Sector</u>	<u>Top Quartile</u>	<u>Bottom Quartile</u>	<u>Negative and No Earnings</u>	<u>Total Market</u>
Consumer Discretionary	10.89	7.36	21.95	10.82
Consumer Staples	2.59	4.22	0.83	8.56
Energy	2.20	25.78	2.83	9.12
Financials	16.43	43.41	19.58	22.14
Health Care	21.44	1.13	16.15	12.69
Industrials	6.82	5.58	3.49	10.94
Information Technology	29.92	3.43	11.30	15.63
Materials	2.89	4.38	10.12	3.13
Telecommunication Services	2.87	0.29	9.24	3.26
Utilities	3.95	4.42	4.50	3.72

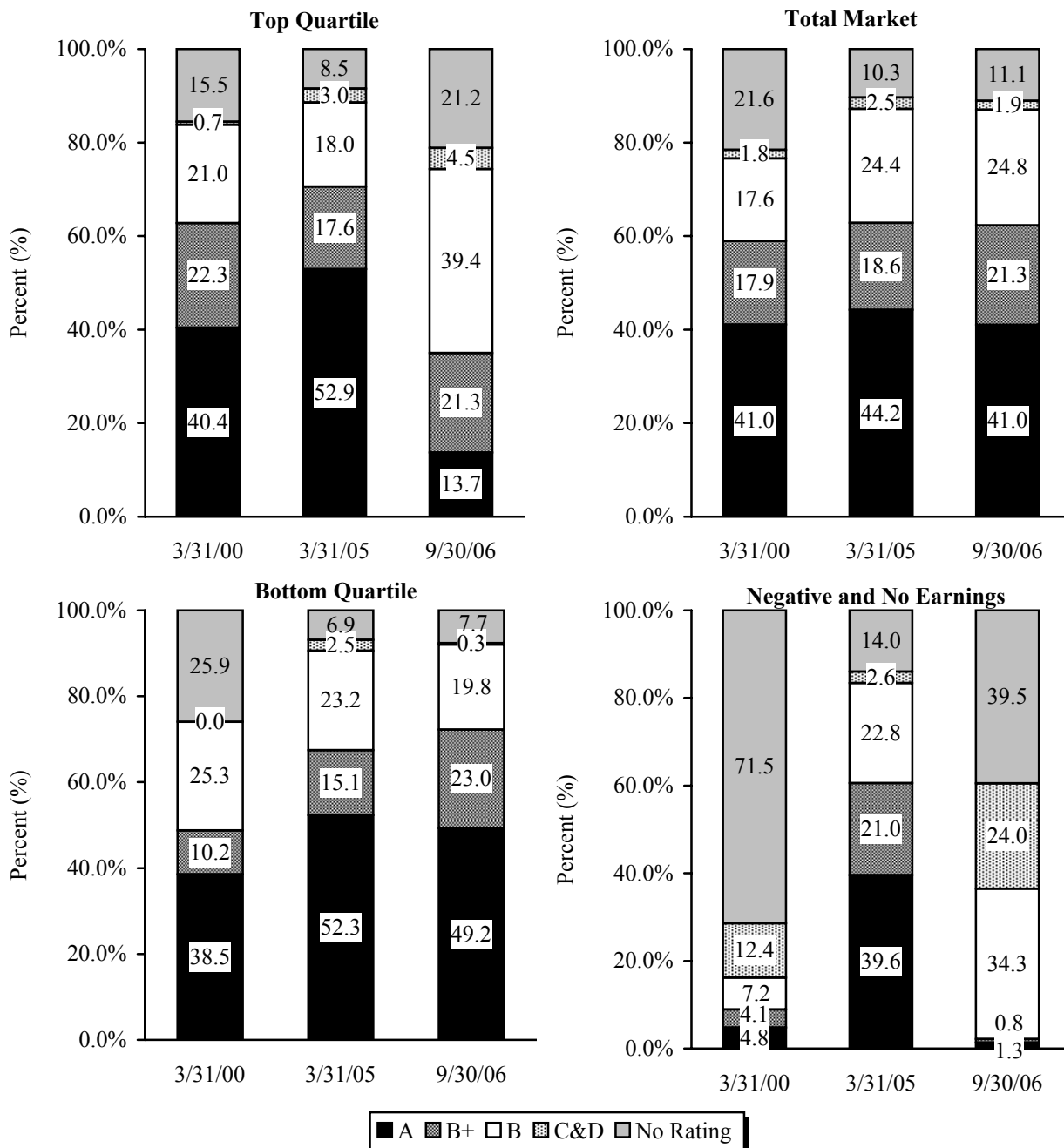
Sources: Dow Jones & Company, Inc., FactSet Research Systems, and Standard & Poor's Compustat.

Notes: The negative and no earnings category includes companies with negative and no reported earnings. Quartiles are arranged from highest to lowest price-to-earnings (P/E) ratios. Therefore, the top quartile includes those stocks with the highest P/E ratios as of the specified date. Economic sectors are based on the new S&P Global Industry Classification Standard. Figures may not total due to rounding.

Table E

QUALITY CHARACTERISTICS OF THE MOST EXPENSIVE AND LEAST EXPENSIVE U.S. EQUITIES

Percentage Distribution of Market Capitalization



Sources: Dow Jones & Company, Inc., FactSet Research Systems, and Standard & Poor's Compustat.

Notes: The negative and no earnings category includes companies with negative and no reported earnings. Quartiles are arranged from highest to lowest price-to-earnings (P/E) ratios. Therefore, the top quartile includes those stocks with the highest P/E ratios as of the specified date. "S&P Common Stock Rankings" are determined by appraising the past performance of a stock's earnings and dividends, as well as its relative standing at the time of the company's current fiscal year-end. Growth and stability of earnings and dividends are key elements in establishing S&P's earnings and dividends rankings. Figures may not total due to rounding.