



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

THE UNLOVED MEGA-CAPS

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The Unloved Mega-Caps:**Price-Earnings Ratios Make the Case for Overweighting the Very Largest Firms within a U.S. Equity Allocation**

The very largest stocks in the U.S. equity market have been a ponderous, \$6 trillion yoke around the neck of major indices since the market's low point in early 2003. An investor who shorted the mega-cap S&P 100 Index¹ and went long the 400 remaining stocks in the S&P 500 at the beginning of March 2003, devoting equal dollars to both sides of the trade, would have earned a 22% cumulative return on the investment before transaction costs, with very little volatility, compared to a higher but much more volatile return of 61.3% for the S&P 500 as a whole (Table A). In general, large-cap stocks have yet to fully recover their losses from the first years of this decade (the S&P 500 returned -3.5% from the end of 1999 to July 31, 2006), but the market's largest capitalization slice has suffered mightily, with the S&P 100 losing 17.1% of its value over the period. As a result, its weighting in the Dow Jones Wilshire 5000 Index has shrunk to 39% from 47% in 2002 (Table B).

Why have these stocks lost value during a strong economic cycle? The first reason is that investors very sensibly ceased to extrapolate spectacular earnings growth into the distant future (as they had done, for example, in the late 1990s), leading to shrinking price-earnings (P/E) multiples even as the "e" in the ratio rebounded. In fact, the trailing 12-month P/E ratio of the S&P 100 had fallen to 17.28 by the end of July, moderately lower than the 18.85 average P/E over the available history, which extends to 1973 (Table C). Before this summer, the last time we saw P/E values of 17 for the S&P 100 Index was at the end of 1995. However, the normalized real P/E ratio, which divides the price by the average of the past ten years' earnings, and serves as a proxy for sustainable earnings, stood at 22.22 at the end of July, compared to a post-1982 average of 18.5. The divergence in recent years between the normalized P/E (which has been relatively steady) versus the trailing 12-month P/E is due to very strong recent earnings.

U.S. mega-cap equities therefore seem reasonably valued in absolute terms and a bargain relative to the U.S. mid- and small-cap corners of the market (and even compared to most of the large-cap universe) (Tables D and E). However, the valuation picture is not uniform across the sector's entire landscape. For example, in half of the industrial sectors, S&P 100 valuations are higher than those for S&P 500 companies. Thus, S&P 100 utility stocks have a P/E 27% higher than that of S&P 500 utility stocks. Nevertheless, P/E ratios in the mega-cap index are lower for most of the sectors that constitute the largest portions of the indices—technology, health care, and financials, for example (Table F).

In this context, it is perhaps worth noting that the sector make up of the S&P 100 has changed significantly over the past decade, roughly in step with that of the broad market. Financial shares made up

¹ The S&P 100 may not be the purest measure of mega-cap stock, but is a reasonable proxy, for which there is a reasonably long data series. It should be noted, however, that this index is not in fact composed of the 100 largest stocks in the U.S. market. In fact, the 100th largest stock in the United States has a market capitalization greater than \$25 billion, while more than one-third of the stocks in the S&P 100 Index have market capitalizations below that threshold. The S&P 100's constituents are selected to maintain sector balance, and they are, in the words of Standard & Poor's, "generally among the largest and most established companies in the S&P 500," but they are not simply the largest 100 S&P 500 companies.

less than 9% of the index ten years ago, and now account for 21.4% (Table G). Technology shares boasted a 38.6% share of the index in mid-2000, as high valuations and strong earnings boosted the weightings of firms including Microsoft Corp. and Intel Corp. Today, Intel shares trade at just 16 times trailing 12-month earnings (between the valuations of Continental Airlines and Allstate Corp.), and just 13.5% of the S&P 100's capitalization is now in the technology sector.

Slicing up the S&P 500 Index into market capitalization deciles allows us to gauge valuation dynamics in the largest slice of the stock market. The largest decile, which accounts for 48.2% of the S&P 500's market cap, is the cheapest decile by a significant margin, with a capitalization-weighted P/E of 17.8, compared to 19.0 for the next cheapest slice (Table H). Slicing even finer, the largest 25 stocks in the index, which account for 35.4% of the index's market capitalization, have still lower valuations, with a P/E of 15.9. The remaining 448 stocks in the index with positive earnings have a P/E ratio of 23.0.

If mega-cap U.S. stocks already exercise a dominant influence on the broad market, why consider overweighting them further? In addition to compelling relative valuations, these companies display impressive balance sheets. Although debt-to-equity levels across the index have increased fairly steadily over the past 15 years, and total debt has increased by about \$2 trillion since 2000 (Table I), the non-financial firms in the S&P 100 have seen their debt-to-equity ratios fall steadily from 128.1% in 1990 to 82.4% today. In addition to paying down debt, they have also been piling up cash. In 2005, the index's constituents held \$1.9 trillion in cash and cash equivalents—that is nearly 30% of market capitalization under the mattress, compared with 21.7% of the full S&P 500 and 20.2% of the S&P 1500 (Table J).

Cash-rich firms seem to be having difficulty deploying this largesse into internal growth or external acquisitions, and so they are increasingly giving it back to shareholders. Dividends have remained relatively steady, with few chief executive officers committing to major increases, but share buybacks have become larger and more common (even after adjusting for buybacks that are primarily designed to facilitate new grants of stock options and restricted stock to executives). The dividend yield of the S&P 100 is just 2.3%, but the yield together with net stock buybacks has skyrocketed from only 2.1% five years ago to 7.4% today (Table K).

A handful of active managers specialize in very large stocks. Otherwise, long exposure to the S&P 100 and the Russell Top 50™ (another mega-cap metric) can be implemented quite easily using exchange-traded funds or other means.

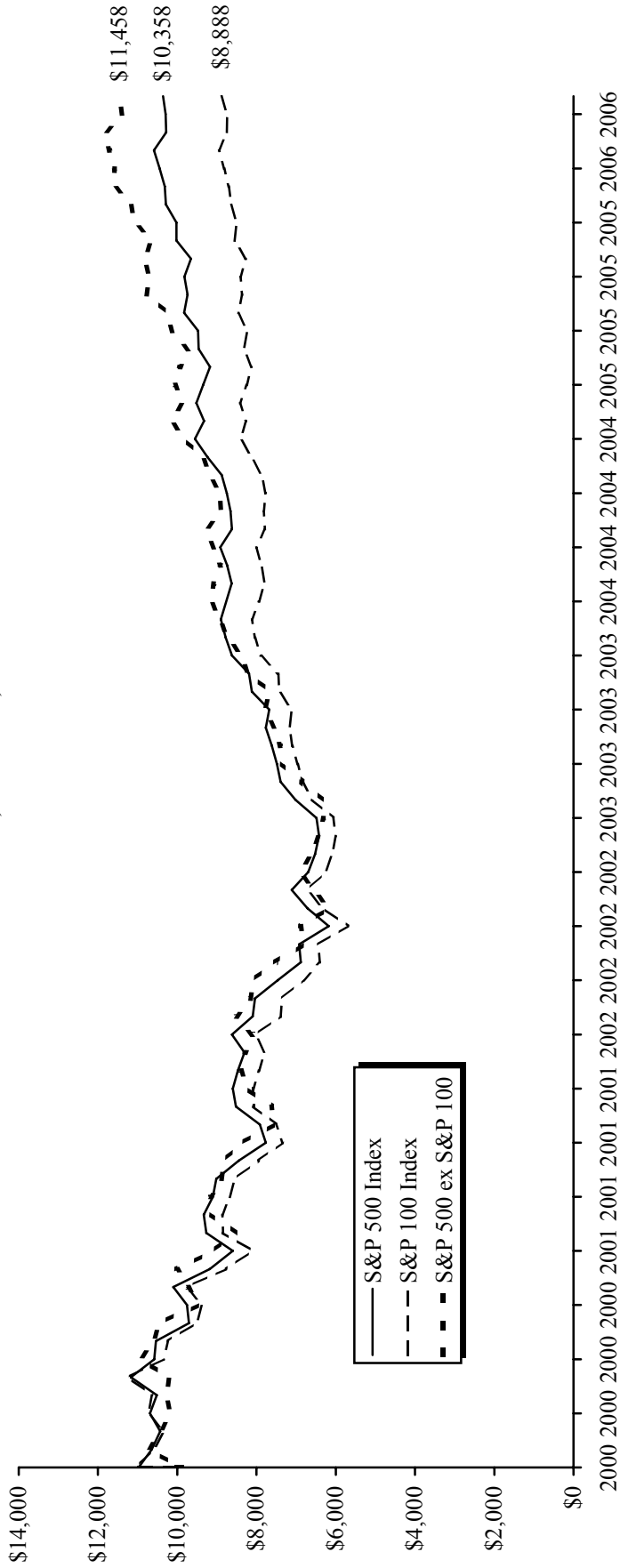
In short, our case for mega-cap U.S. equities is based on three observations: first, valuations are reasonable in absolute terms and compelling in relative terms; second, as a group, these firms' financials are remarkably sound; and finally, our cautious view of U.S. equities in general predisposes us to seek the relative safety of the strongest, fittest, richest companies since these are better equipped to weather stormy weather than are smaller firms with thinner hulls.

Table A

CUMULATIVE WEALTH OF S&P INDICES

March 1, 2000 - July 31, 2006

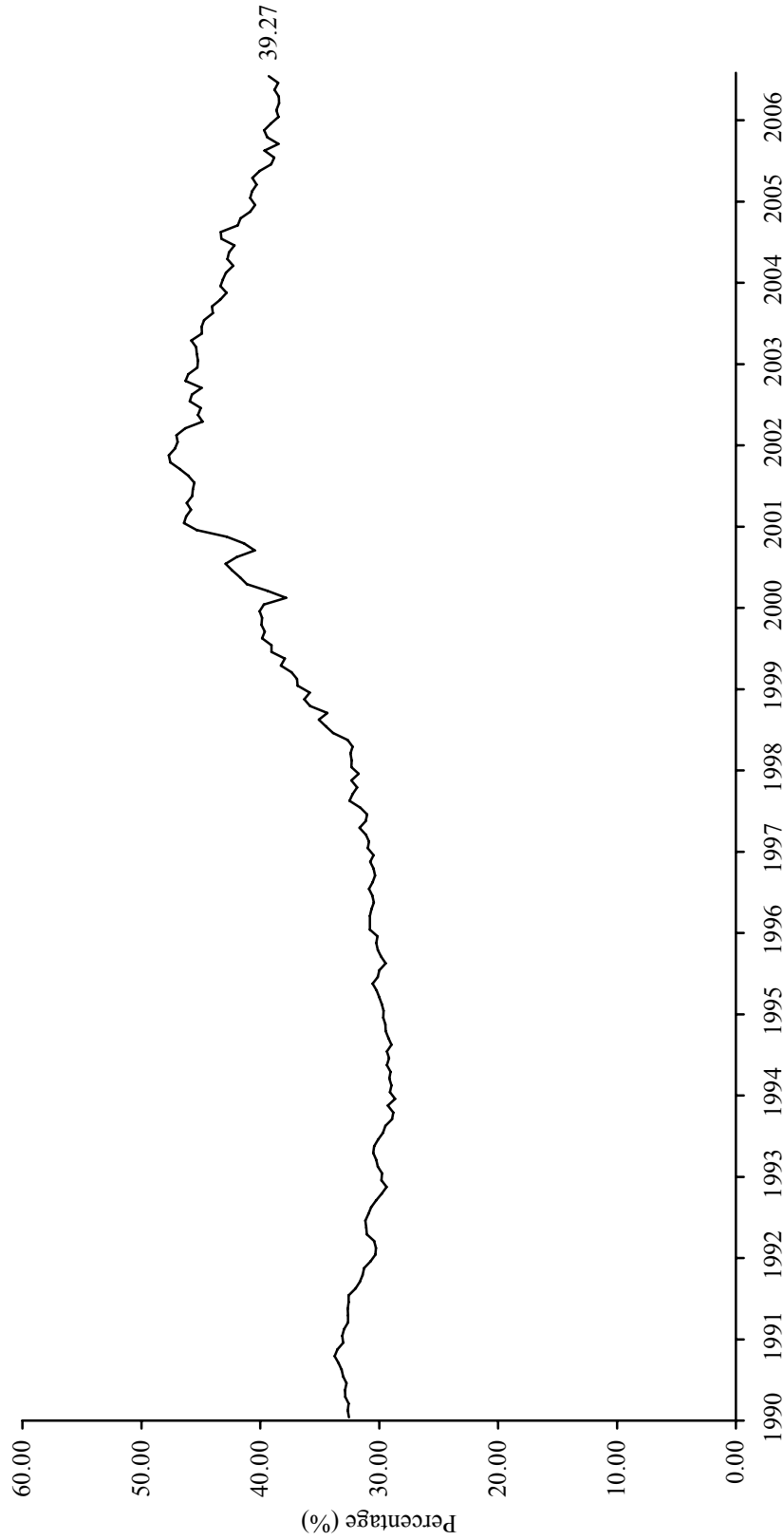
March 1, 2000 = \$10,000



Sources: Factset Research Systems, Standard & Poor's, and Thomson Datastream.

Note: Data for the S&P 500 ex S&P 100 represents performance of the S&P 500 Index excluding companies listed in the S&P 100 Index.

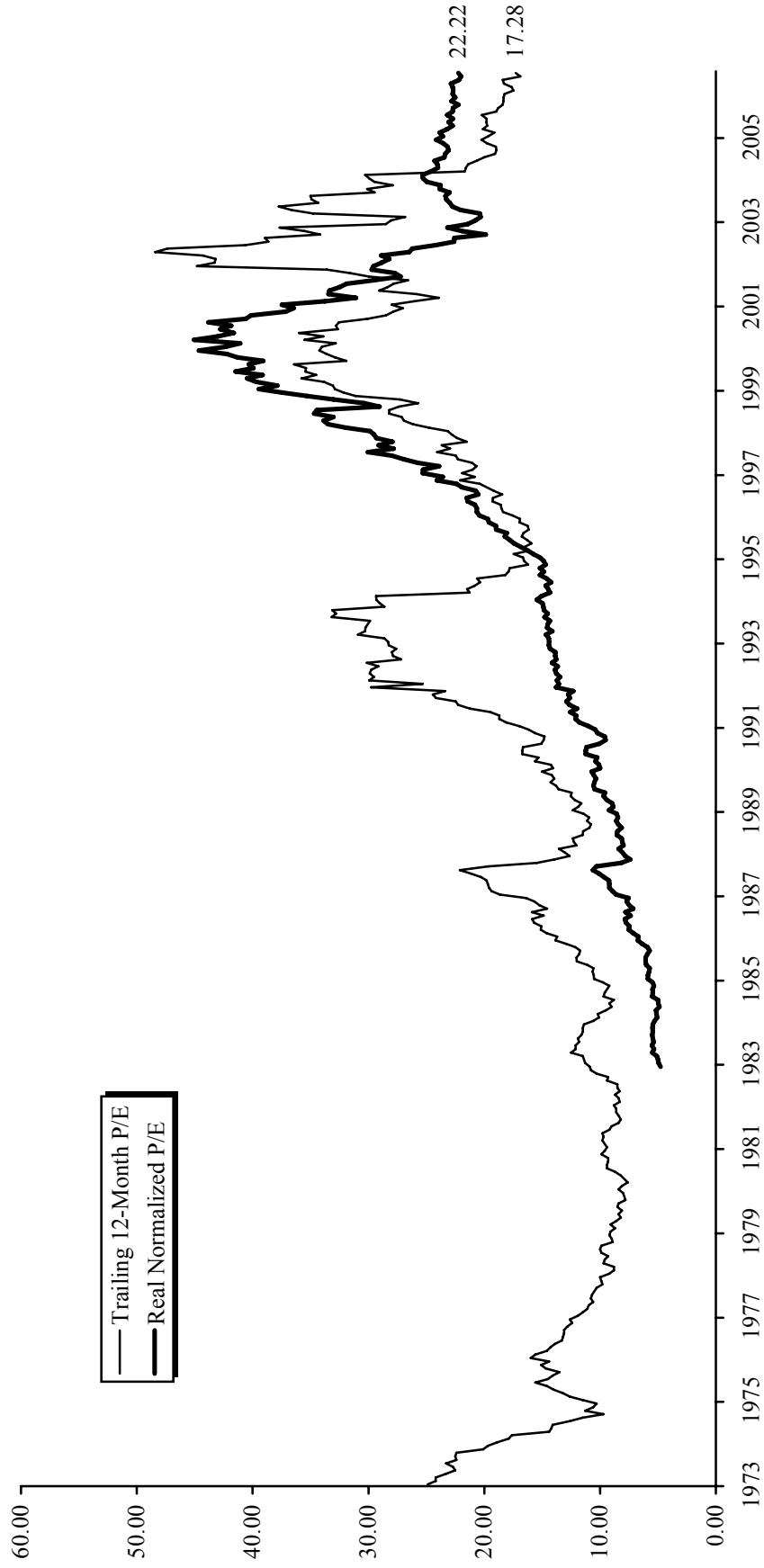
Table B
MARKET CAPITALIZATION OF S&P 100 AS A PERCENTAGE OF DOW JONES WILSHIRE 5000
January 31, 1990 - July 31, 2006



Sources: Dow Jones & Company, Inc., Factset Research Systems, Standard & Poor's, and Wilshire Associates.

Note: Market capitalization for the Wilshire 5000 Index represent the full capitalization-weighted index.

Table C
PRICE-EARNINGS RATIOS
S&P 100
January 1, 1992 - July 31, 2006



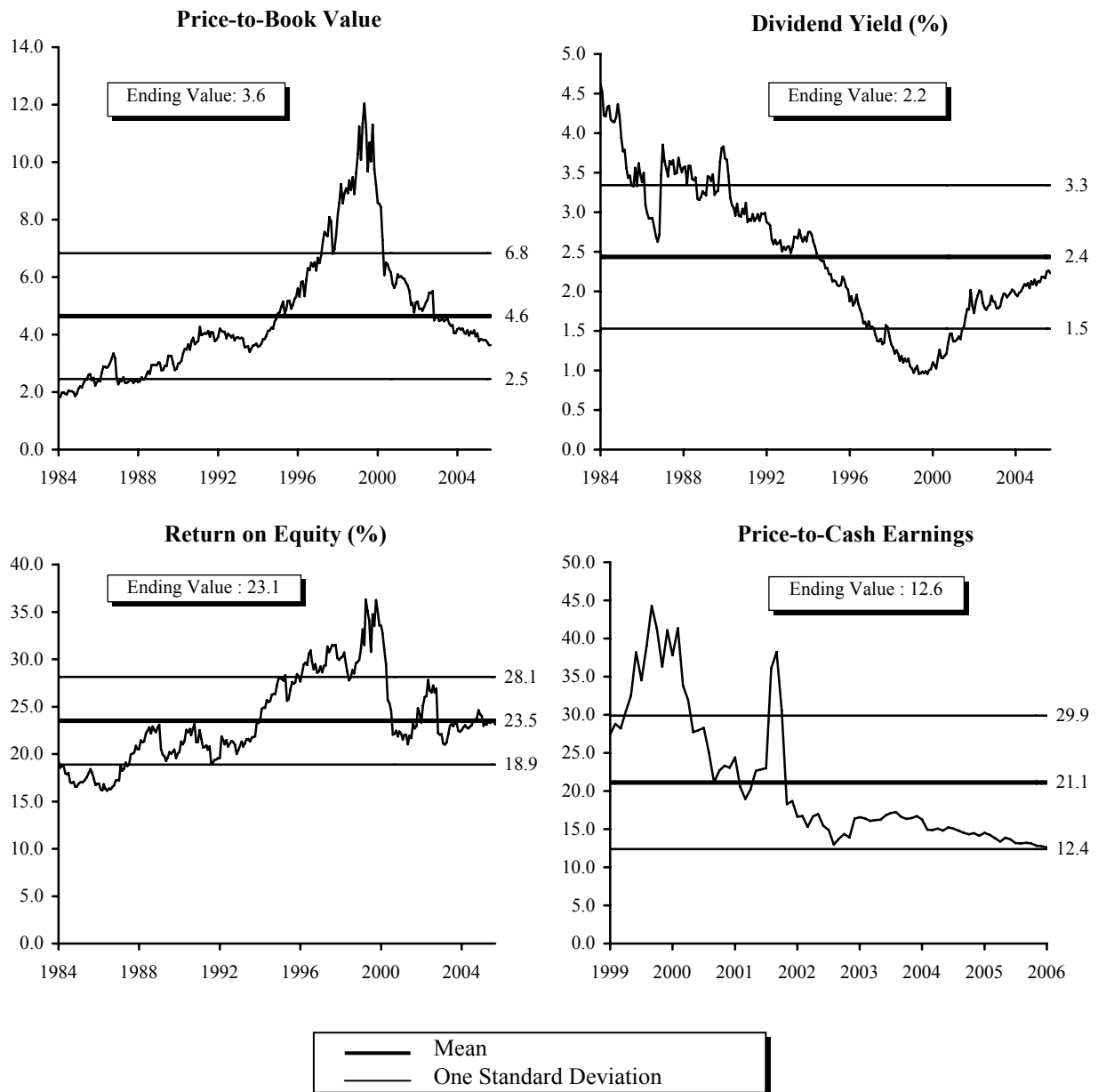
Sources: Bureau of Labor Statistics, Standard & Poor's, and Thomson Datastream.

Notes: Price-earnings ratios based on trailing 12-month earnings were constructed using Datastream calculated figures from January 1973 to November 1984, Compustat data from December 1984 to December 1991, and actual Standard and Poor's index data from January 1992 to present. Real normalized price-earnings ratio uses data calculated by Datastream and is represented in June 30, 2006 dollars.

Table D

EQUITY VALUATIONS OF THE S&P 100 INDEX

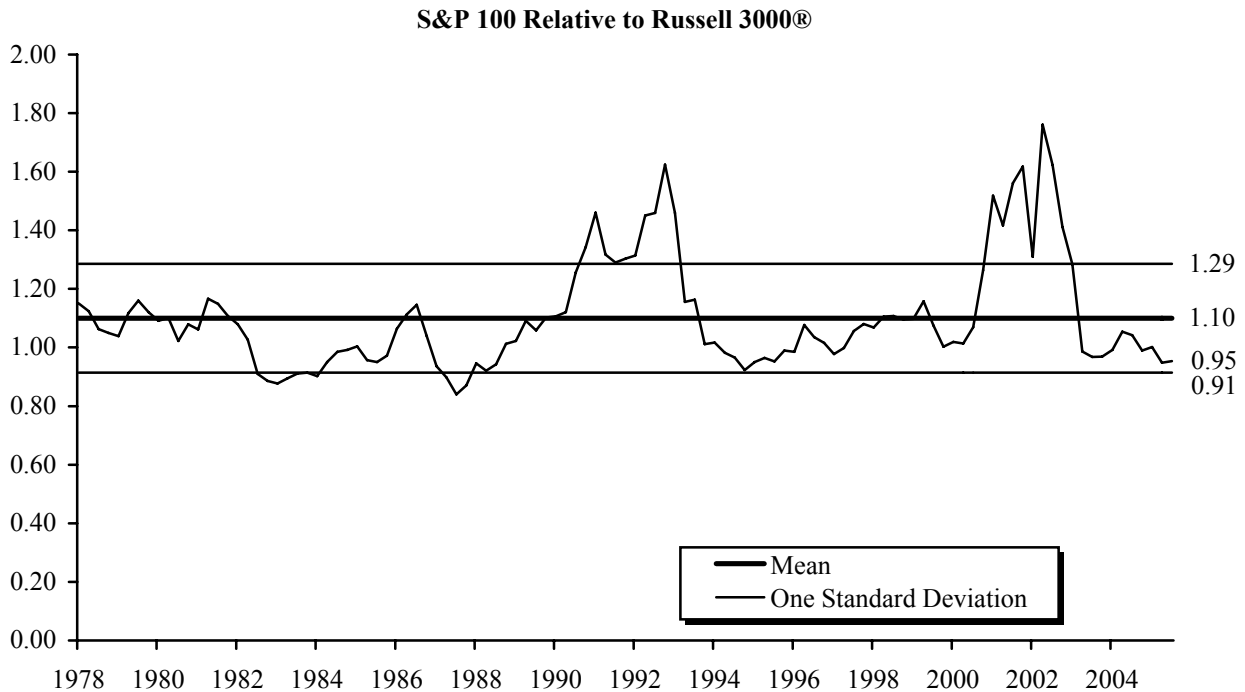
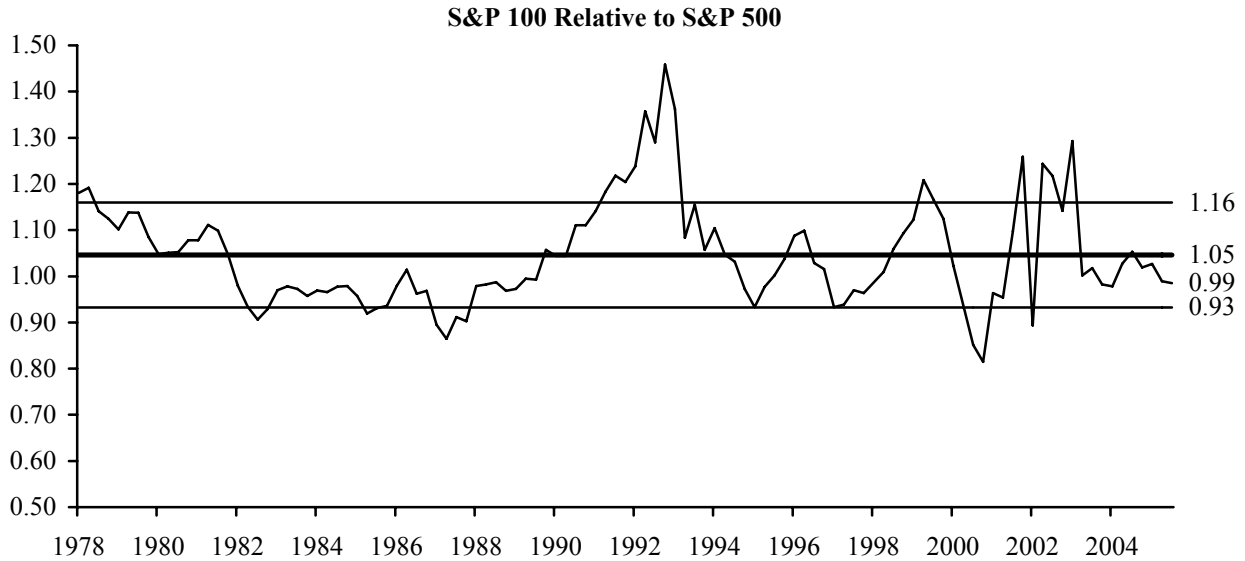
November 30, 1984 - July 31, 2006



Sources: Factset Research Systems and Standard & Poor's.

Notes: Return on equity is calculated by dividing the index's price-book ratio by its price-earnings ratio. Price-to-cash earnings data begin in July 31, 1999. Campbell Soup Company was excluded from price-to-book and return on equity graphs in the fourth quarter of 2002 due to negative book values.

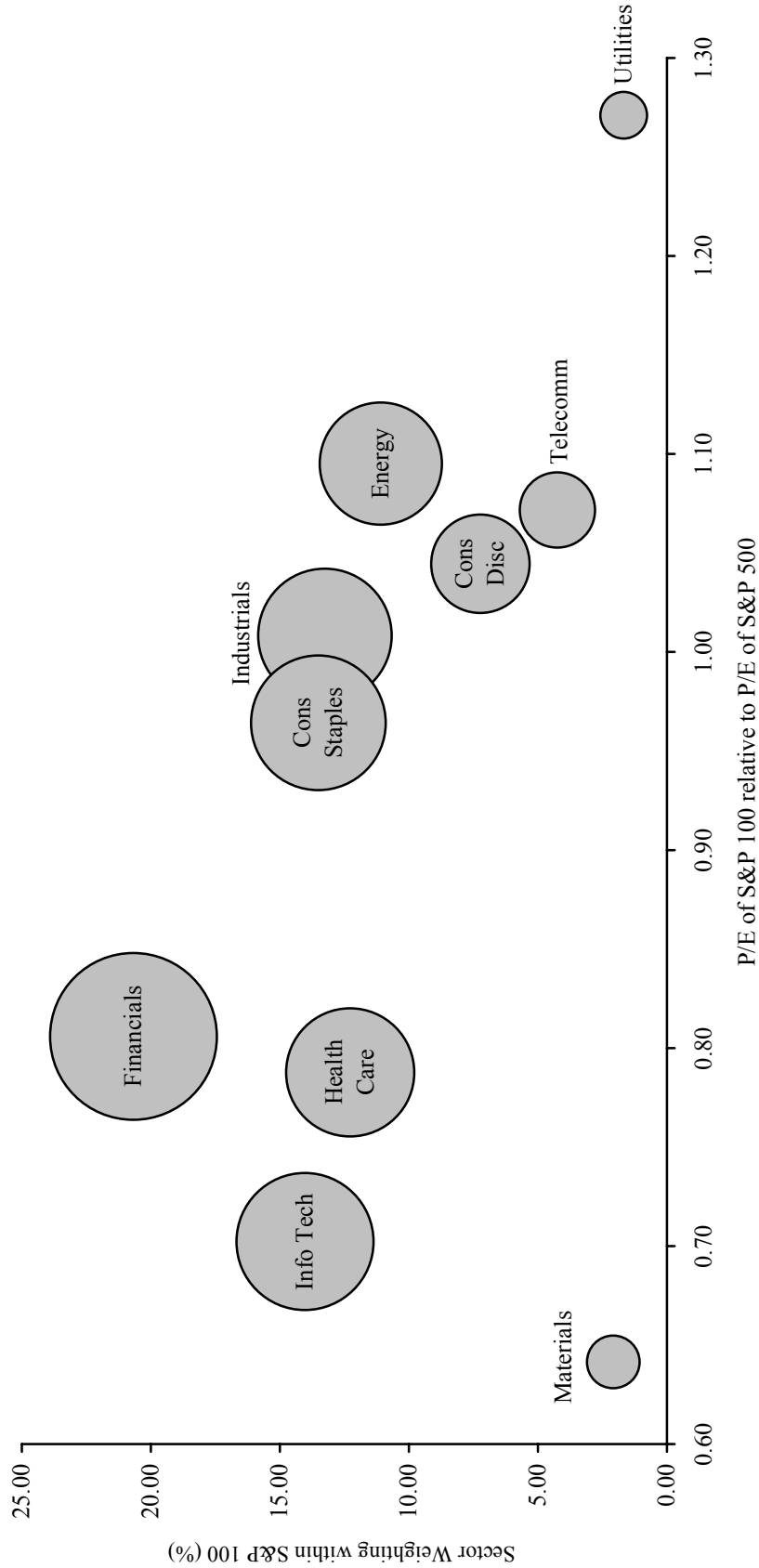
Table E
RELATIVE PRICE-EARNINGS MULTIPLES
January 1, 1992 - July 31, 2006



Sources: Frank Russell Company, Standard & Poor's, and Thomson Datastream.

Note: S&P 100 Price-earnings ratios were constructed using Datastream calculated figures from December 1978 to November 1984, Compustat data from December 1984 to December 1991, and actual Standard and Poor's index data from January 1992 to present.

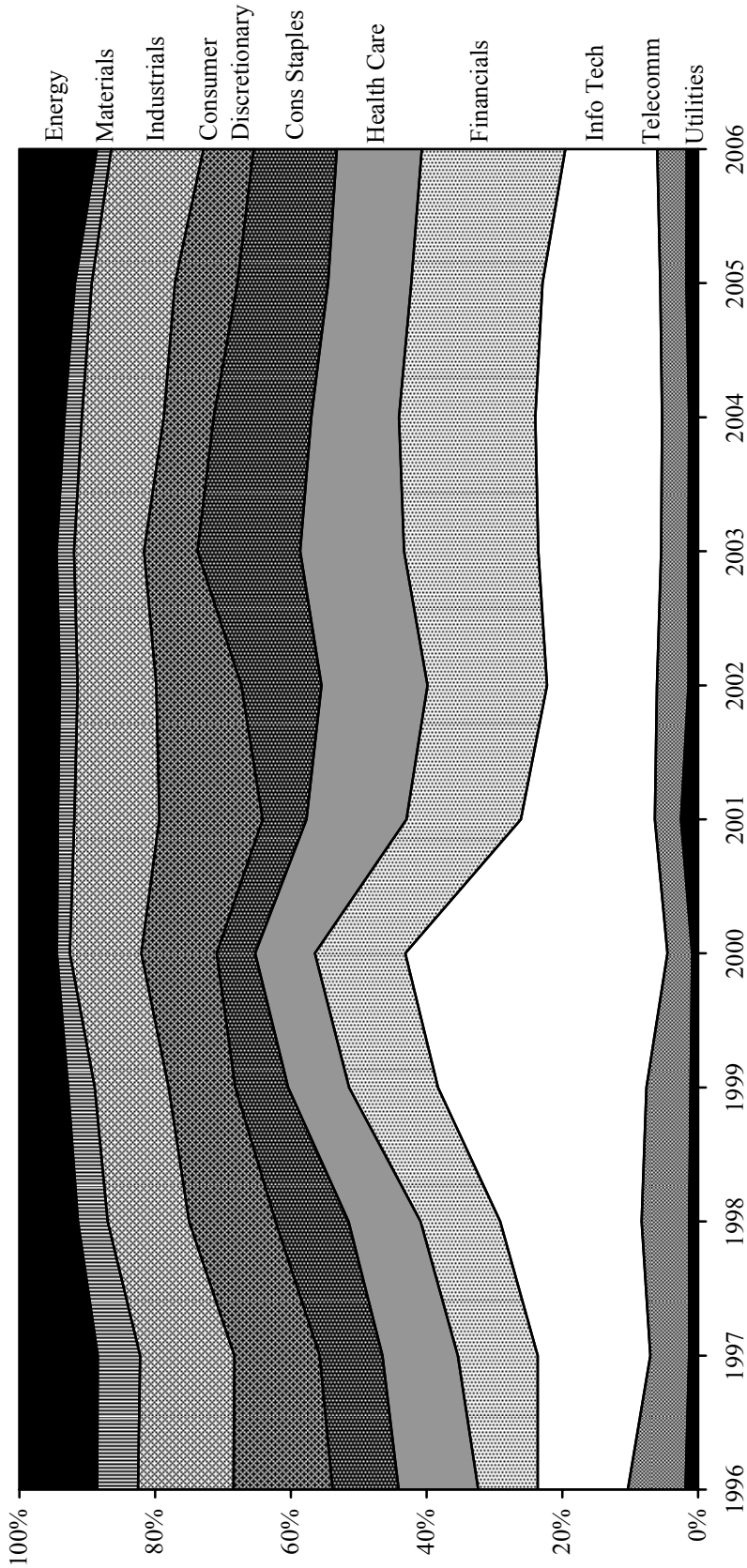
Table F
SECTOR WEIGHTS AND RELATIVE VALUATIONS OF THE S&P 100 INDEX
As of July 31, 2006



Sources: Factset Research Systems and Standard and Poor's.

Note: S&P 100 sector weights exclude companies with negative price-earnings ratio.

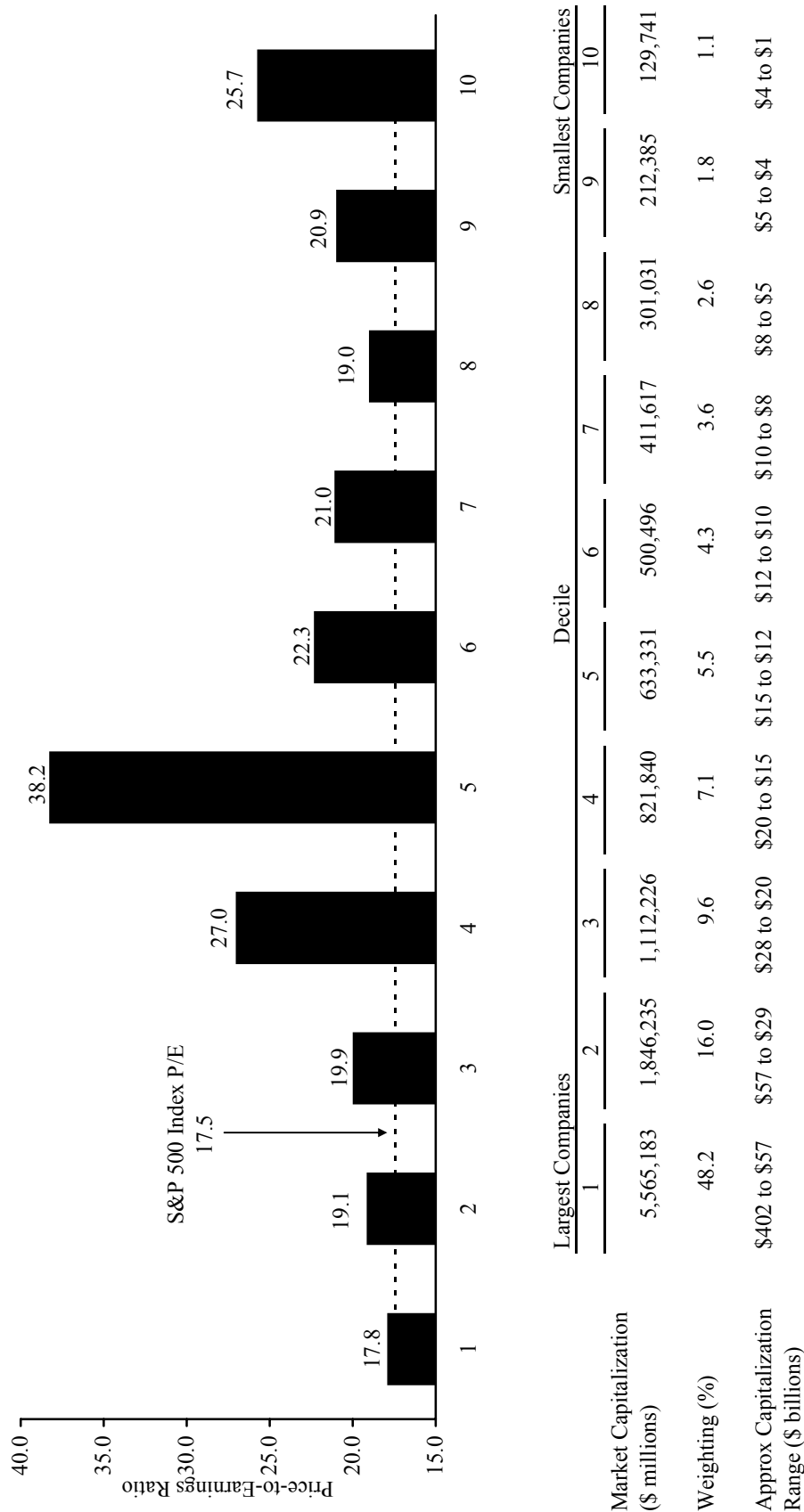
Table G
SECTOR ALLOCATIONS OF THE S&P 100 INDEX
July 31, 1996 - July 31, 2006



Sources: Factset Research Systems and Standard and Poor's.

Note: Chart represents annual data ending on July 31.

Table H
CAPITALIZATION-WEIGHTED PRICE-TO-EARNINGS RATIOS
S&P 500 MARKET CAPITALIZATION DECILES

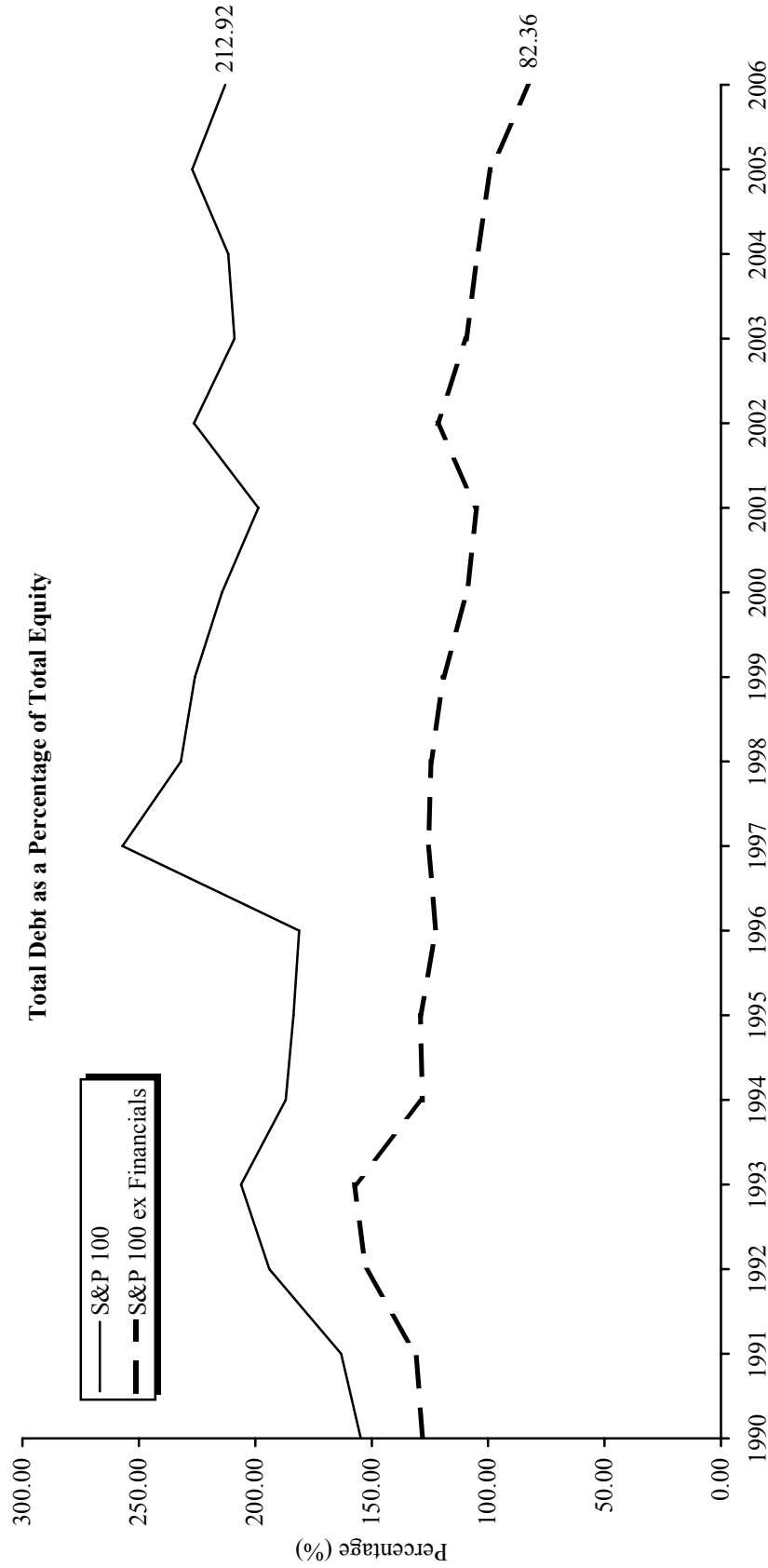


	Largest Companies					Smallest Companies				
	1	2	3	4	5	6	7	8	9	10
Market Capitalization (\$ millions)	5,565,183	1,846,235	1,112,226	821,840	633,331	500,496	411,617	301,031	212,385	129,741
Weighting (%)	48.2	16.0	9.6	7.1	5.5	4.3	3.6	2.6	1.8	1.1
Approx Capitalization Range (\$ billions)	\$402 to \$57	\$57 to \$29	\$28 to \$20	\$20 to \$15	\$15 to \$12	\$12 to \$10	\$10 to \$8	\$8 to \$5	\$5 to \$4	\$4 to \$1

Sources: Standard and Poor's and Thomson Datastream.

Notes: Data are as of July 31, 2006. Calculations excluded approximately 27 companies for which P/E data were unavailable. Percentages may not total due to rounding.

Table I
DEBT TO EQUITY OF THE S&P 100 INDEX
1990-2006



Sources: Factset Research Systems, Standard & Poor's, and Standard & Poor's Compustat.

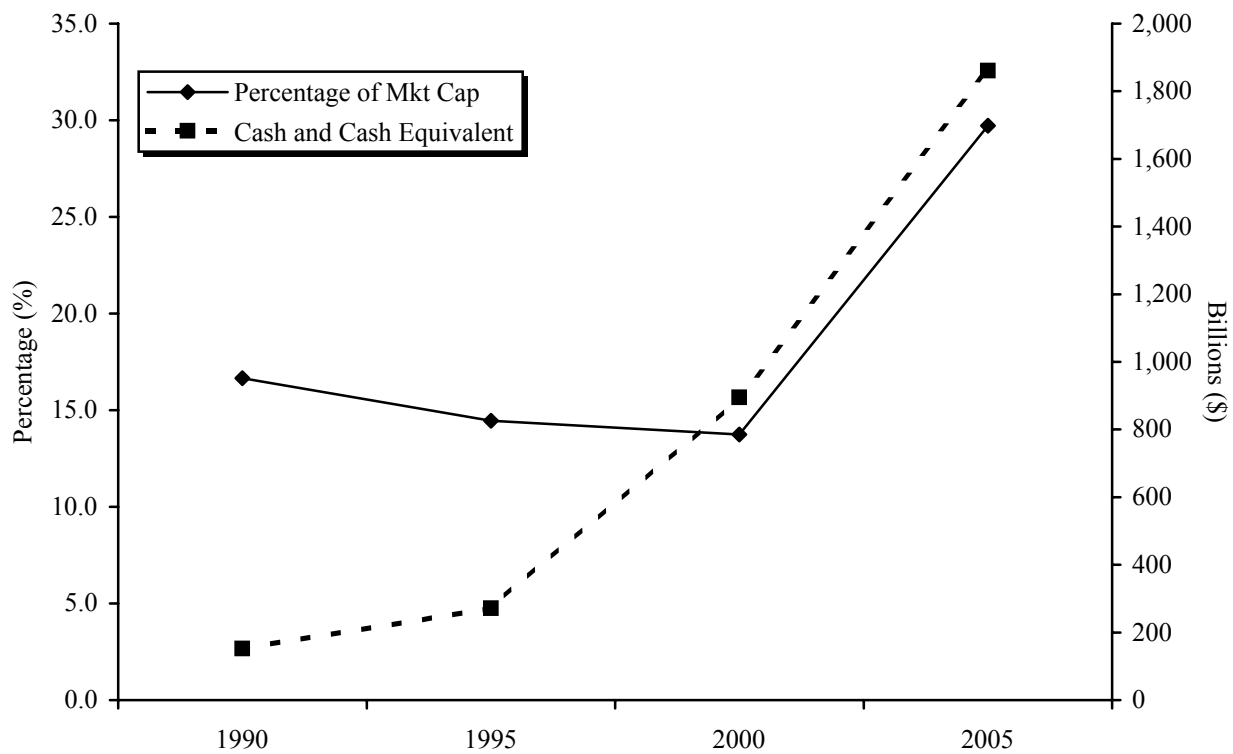
Notes: Figures are based on actual calendar year data. Data for 2006 are quarterly reported data as of June.

Table J

**CASH AND CASH EQUIVALENT AS A PERCENTAGE OF MARKET CAPITALIZATION OF
THE S&P 100 INDEX**

1990-2005

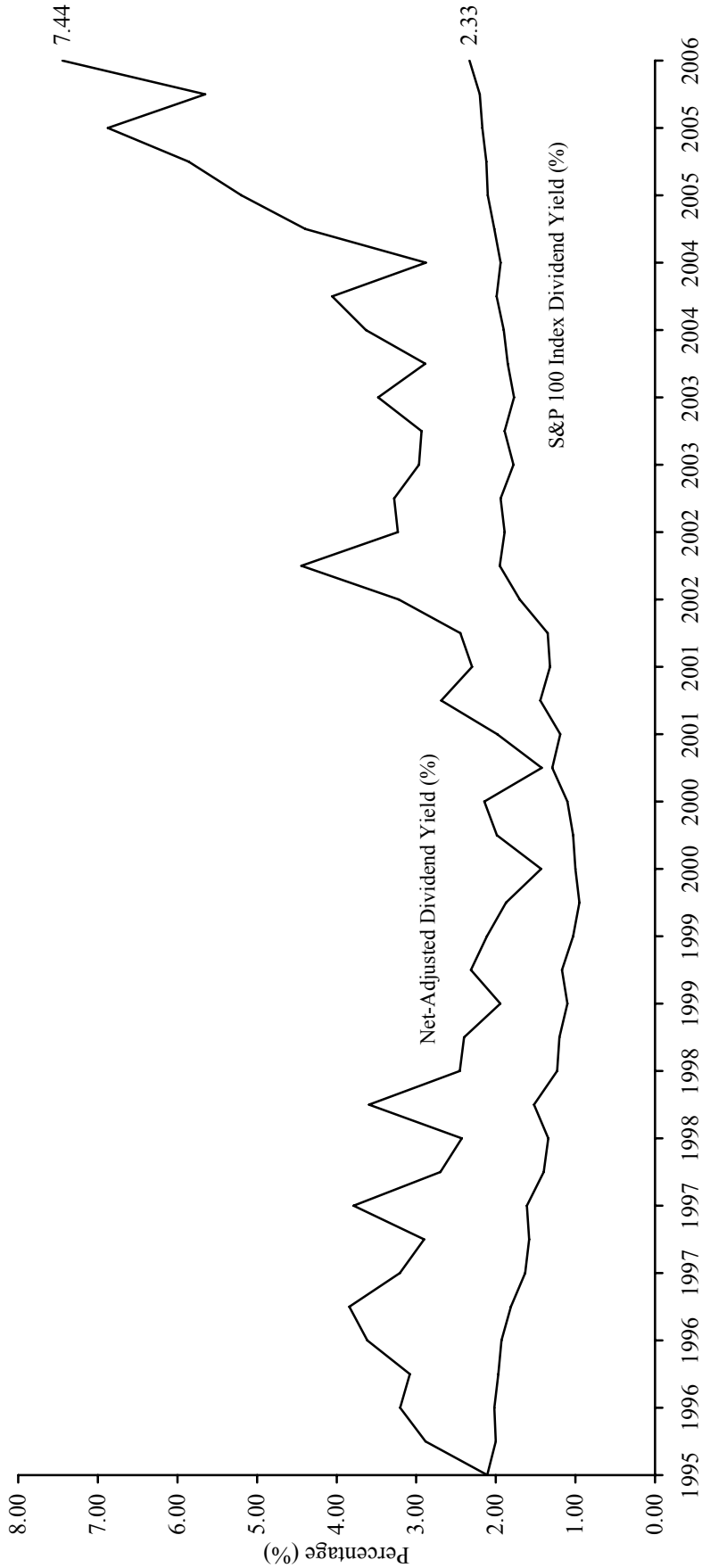
	1990	1995	2000	2005
Cash and Equivalent	151,944	271,270	895,373	1,860,618
Market Capitalization	912,336	1,876,984	6,518,492	6,261,908
% of Mkt Cap	16.65	14.45	13.74	29.71
# of Cos Analyzed	89	92	97	100



Sources: Factset Research Systems, Standard & Poor's, and Standard & Poor's Compustat.

Note: Figures are based on actual calendar year data.

Table K
DIVIDEND YIELD OF THE S&P 100 INDEX
December 31, 1995 - June 30, 2006



Sources: Factset Research Systems, Standard & Poor's, Standard and Poor's Compustat, and Thomson Datastream.

Note: Net-adjusted dividend yield represents aggregate dividend yield of the S&P 100 Index adjusted for share repurchases and new issuance.