INSTITUTIONAL IMPERATIVE

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Don't chase utility yield.
There are better alternatives.

Recent market volatility combined with seemingly high correlations (all securities moving in the same direction simultaneously) has prompted a search for stable assets. Recently, Jason Zweig encouraged his readers at *the Wall Street Journal* to examine utilities for their steady income, lack of exposure to foreign markets and currencies, and ability to keep up with inflation.

Zweig is a fine student of Benjamin Graham, having ably edited the last edition of Graham's investment classic, *The Intelligent Investor*. With this in mind, we decided to take a look at Graham's recommendation of utilities in that edition for their decent returns and their stable business models, and compare them their descendants today. While it seems somewhat random to make a single 40-year historical comparison of a sector, we think a study beginning with this comparison can stimulate some fruitful thought about current valuations.

Exhibit 1
Graham's 1971 Utility List

Company	P/E	P/B	Dividend Yield	EPS 10-yr growth	Earnings/Dividends
Am. Elec. Pwr	11	1.38	6.5%	87%	1.41
Cleveland El.	11	1.5	6.4%		1.38
Columbia Gas	11	1.29	5.3%	85%	1.68
Commonwealth Ed.	12	1.3	6.2%	56%	1.39
Consolidated Ed.	10	0.8	7.4%	19%	1.33
Consd. Nat. Gas	9	0.86	6.8%	53%	1.6
Detroit Ed.	11	0.84	7.3%	40%	1.29
Houston Ltg. & Pwr	15	2.22	3.1%	135%	2.18
Niagara-Mohawk Pwr	11	0.93	7.2%	32%	1.32
Pacific Gas & Elec.	11	1.14	5.6%	79%	1.62
Panhandle E. Pipe	11	1.66	5.5%	79%	1.61
Peoples Gas Co.	8	1.04	6.6%	23%	1.3
Philadelphia El.	10	1.03	8%	29%	1.22
Public Svc. El. & Gas	9	1.16	6.4%	80%	1.71
Southern Cal. Ed.	10	1.07	5.1%	85%	1.87
Average	**10.67x**	**1.21x**	**6.23%**	**63%**	**1.53**

Graham presented a resume of "the 15 issues in the Dow Jones public utility average" that met reasonable criteria for performance and price. Exhibit 1 shows Graham's list with some key valuation and performance metrics. No company has a P/E ratio of more than 15 and the average is less than 11.

No company is trading at more than 2.22x book value, and the average is only 1.2x book value. No company has a lower dividend yield than 3.1% and the average is a robust 6.23%. Unsurprisingly for slow growth, regulated companies, all but one is paying more than half its earnings out as dividends. Finally, Graham notes that he has required an adequate proportion of stock capital to debt without specifying his criterion, and includes an earnings-per-share growth metric.

We infer that an earnings-per-share growth metric is important because, as Graham remarks, utilities regularly issue both bonds and equity to finance their operations. Therefore, mere earnings growth won't account for the dilutive effects of share issuance. The average EPS growth for the 15 companies is 63%, while only one has achieved more than 100% growth in EPS. Three companies failed to achieve 30% EPS growth for the decade.

Exhibit 2

Current Statistics, Top-15 Components of DJ U.S. Utilities Index

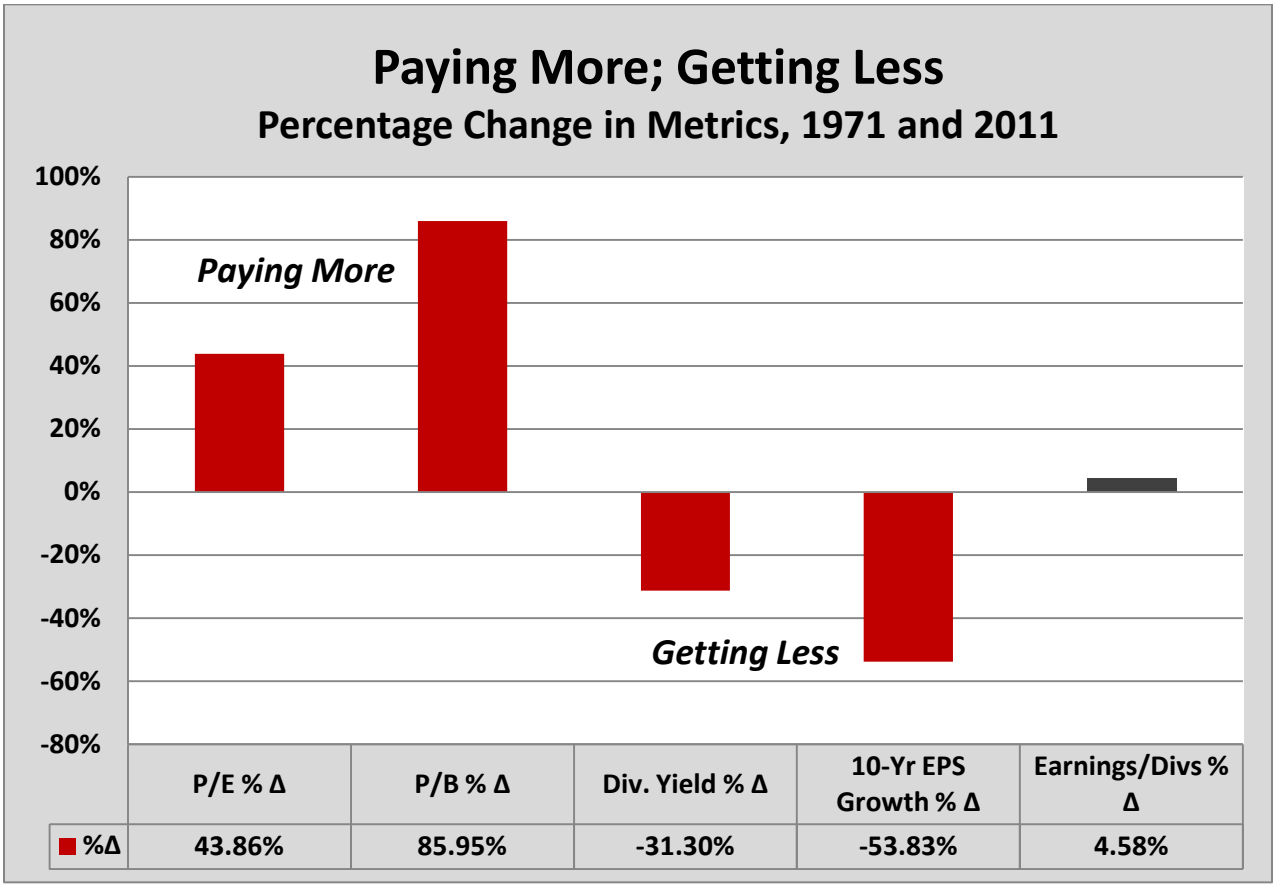
Company	P/E	P/Net Tangible Assets	Dividend Yield	EPS 10-yr growth	Earnings/Dividends
Southern Co.	17.9	2.1	4.3%	30%	1.29
Dominion Res.	19.9	3.4	3.8%	42%	1.32
Excelon Corp.	12.4	2.6	4.7%	64%	1.73
Duke Energy	15.2	1.5	4.9%	-37%	1.38
NextEra Energy	15.3	1.6	4%	90%	1.65
American Electric Power	10.5	1.3	4.9%	25%	2
FirstEnergy Corp.	18.2	3.4	4.9%	-11%	1.13
Spectra Energy Corp.	15.7	4.8	3.8%	-20%	1.67
Public Service Enterprise	12.1	1.7	4%	52%	2.04
PPL Corp.	11.5	3.2	4.6%	234%	1.89
Consolidated Ed.	16.1	1.6	4.1%	16%	1.55
PG&E Corp.	15.9	1.4	4.5%	-16%	1.39
Progress Energy	20.5	2.5	4.6%	-0.7%	1.06
XCEL Energy	15.3	1.5	3.9%	-25%	1.65
Edison Intl.	13.8	1.2	3.2%	-7%	2.3
Average	**15.35x**	**2.25x**	**4.28%**	**29.09%**	**1.60**

Exhibit 2 shows the same statistics for the top-10 components of the Dow Jones U.S. Utilties Index as of November 12, 2011. We used net tangible assets instead of stated book value, eliminating the effects of goodwill, and trailing twelve-month earnings numbers; it's not clear to us if Graham included or excluded goodwill.

Paying More; Getting Less

Exhibit 3 compares the 1971 and 2011 lists, showing the change in key valuation and growth metrics from Graham's 1971 list to November 12, 2011. Utilities are significantly more expensive today than they were in 1971 on a P/E and P/B basis, while they are also paying a lower dividend yield. It also shows that 10-yr EPS growth has been slower over the past decade than it was through the 1960s, and that the Earnings/Dividends ratio for utilities has remained constant. Investors today, compared to their counterparts in 1971, are paying roughly 50% more on a P/E basis and nearly 100% more on a P/B basis for roughly 30% lower dividend yields and roughly 50% of the EPS growth.

Exhibit 3



Comparison to 10-Year U.S. Treasury Note

Although utilities appear more expensive now than in Graham's day, comparing them to the 10-Yr Treasury produces a different impression. In the early 1970s the 10-Year note never yielded less than 6%, as Exhibt 4 shows That's considerably more than the 2% yield it's offering investors now.

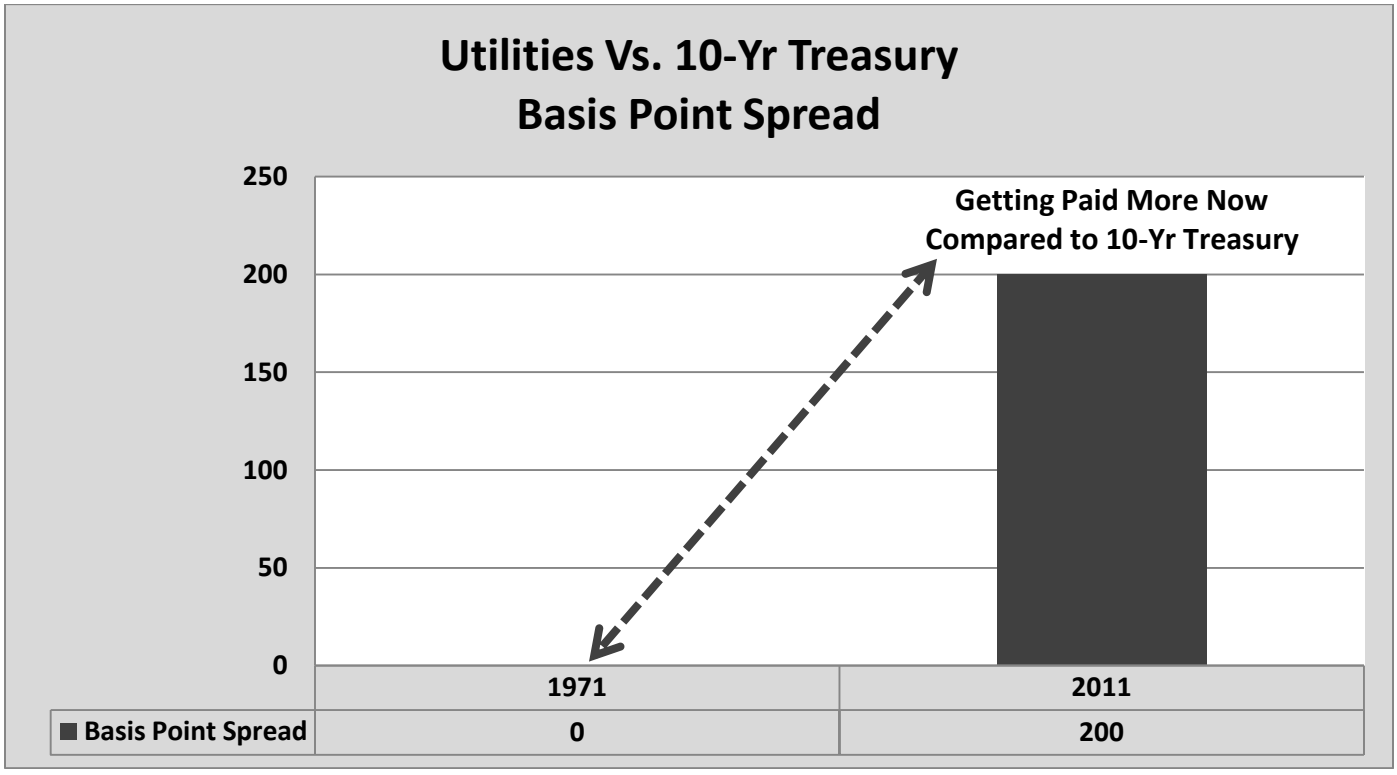
The 6% yield of utilities in 1971 was about equal to or less than that of the note, while today the 4% yield of utilities is around double or 200 basis points more than the 2% yield of the note. Exhibit 5 shows the difference or "spread" in yields for utilities and Treasuries in 1971 and 2011. This comparison makes utilities seem considerably cheaper today than they were in 1971.

Treasuries are often considered the "risk-free" rate of return, so today's utility investors are arguably getting paid more than the risk-free rate, whereas they didn't get paid more than the risk-free rate in 1971.

Exhibit 4

Yield of 10-Year U.S. Treasury Note

Exhibit 5



Another Comparison

Another useful comparison is the one between the yield of utilities and that of the S&P 500 Index. As of October 31, 2011, the index was yielding around 2.2%, which is a bit more than the Treasury and nearly 200 bps less than utilities. So again utilities are paying more in current yield than the broader stock market, or at least the largest companies in the market.

However, we screened on Morningstar.com for stocks that had market capitalizations larger than $15 billion (for stability), had achieved a 6% or better return on assets (ROA) in each of the past five years, and are paying a dividend of 2.5% or more. We came up with 28 names shown in Exhibit 6. Even excluding foreign stocks for fear of bad data, we have 10 domestic candidates, including 3M, Chevron, Coca Cola, and Intel, that have more consistent returns on assets than the utilities and, are trading at equivalent P/E multiples.

Exhibit 6

Name	Yield
3M Co	2.7%
AstraZeneca PLC ADR	3.7%
BHP Billiton PLC ADR	2.8%
Chevron Corp	3%
China Mobile Ltd. ADR	3.7%
CNOOC, Ltd. ADR	2.9%
General Dynamics	2.9%
Illinois Tool Works Inc	3.1%
Intel Corp	3.4%
Kumba Iron Ore Limited	9.3%
Lockheed Martin Corporation	5.2%
Lukoil Company ADR	3%
Medtronic, Inc.	2.8%
Novartis AG ADR	3.6%
NTT DoCoMo, Inc. ADR	2.7%
P.T. Telekomunikasi Indonesia Tbk. ADR	6.6%
Philip Morris International, Inc.	4.3%
Reckitt Benckiser Group PLC ADR	3.1%
Roche Holding AG ADR	2.9%
Sasol, Ltd. ADR	5.2%
Singapore Telecommunications Limited ADR	6%
Southern Copper Corporation	8.9%
Sysco Corporation	3.8%
Taiwan Semiconductor Manufacturing ADR	3.2%
Takeda Pharmaceutical Co., Ltd. ADR	4.3%
The Coca-Cola Co	2.8%
Total SA ADR	2.7%
Williams Partners LP	5.2%
Average	**4.1%**

Conclusion

Utilities Vs. Treasuries
Clearly utilities are yielding considerably more than Treasuries. Indeed a recent study by Morningstar shows that the yield spread of utilities over Treasuries is nearly as much as it's been over the past two decades. However, utilities have also traded at significantly cheaper multiples in the past.

While deflation could mean lack of growth for utilities, it will also likely mean depressed Treasury yields, which in turn would continue to make utilities a decent, though perhaps not a great deal, with a significant margin of safety.

Inflation, on the other hand, means that utilities may enjoy some growth, but it will also likely mean an increase in Treasury yields, making utilities less attractive on a relative basis. Even if investors think deflation or stagnation is more likely than inflation, it's questionable whether utilities are currently offering investors a margin of safety. The Morningstar study estimated that the sector was overvalued a year ago, when yield spreads were 250 basis points rather than 200 basis points.

Utilities Vs. Blue Chips
Although Coca Cola, Intel, Chevron, and the other stocks that met our large-cap screen are not yielding 4% each, they seem like a better place for capital than utilities given their consistently high returns on capital, 2.5%+ yields, and equivalent price multiples compared to utilities.

It makes sense that this situation should exist because the early 1970s were the age of the "Nifty Fifty," when large-cap, prominent, so-called "one-decision" stocks reached stratospheric levels. Boring utilities got comparatively less attention then, and this is reflected in Graham's table of utilities. Today, something like the opposite is the case. Investors have been chasing yield in bonds, REITs, and utilities, and have left large-caps behind, relatively speaking.

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