The Dow Jones Industrial Average

A Benjamin Graham Analysis of the Dow 30

Industry: Diversified
Tracking ETF: SPDR Dow Jones Industrial ETF (DIA)

Index Overview: Two-thirds of the DJIA's 30 component companies are manufacturers of industrial and consumer goods while the others represent diverse industries. When Charles H. Dow first unveiled his industrial stock average on May 26, 1896, the stock market was not highly regarded. Prudent investors bought bonds, which paid predictable amounts of interest and were backed by real machinery, factory buildings and other hard assets. Today, stocks are widely accepted as investment vehicles, even by conservative investors. The 30 stocks now in the Dow Jones Industrial Average are all major factors in their industries, and their stocks are widely held by individuals and institutional investors. Besides longevity, two other factors play a role in its widespread popularity: It is understandable to most people, and it reliably indicates the market's basic trend. **Source:DJAverages.com**

Analyst Notes:
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Are Stocks Too High To Buy?
A Benjamin Graham Analysis of the Dow Jones Industrial Average

- FinTrust is updating its coverage of the Dow Jones Industrial Average exchange traded fund (ETF symbol: DIA) and downgrading our rating to HOLD, as the market is now within 2% of our high-end price target for 2017. As we stated last year, "Earnings should increase on corporate tax cuts. At current valuations of 20.2x, a 22% tax rate would target 23,101 on the Dow close to our highest estimated target price." Given current pricing, we believe any fiscal tax cuts are now priced into the market.

- We believe the risk reward ratio has now skewed to the downside, despite the fact we are raising the high end of our price target for 2018. The current analysis suggests levels below 21,726 on the Dow Jones Average would be considered below average, while a level closer to 17,279 would represent low prices, while an index level of 26,173 would be considered rich in relation to past sales, earnings, book value, dividends and forward analyst estimates.

- As in our previous reports, the data suggest that for the "defensive investor" reasonable allocations, toward common stocks at today's Dow Jones Industrial Average levels appear appropriate and reasonable, but mainly because of the low level of today's interest rates. For fixed income investors, we continue to recommend inflation protected, tax-free, and floating rate bonds, while for aggressive investors we recommend gold equities, gold, and cryptocurrency.

- We are lowering our overweight equities asset allocation recommendation as the data suggest an allocation for defensive investors of 45/55 v. the previous 50/50.

Fintrust Recommendation

Fintrust Rating:	**HOLD**
Target Price:	**$261.73**
Current Share Price	**$227.64**
Expected Return	**18.1 %**
52 Week Price Range	**$178.64-227.66**

Fintrust Brokerage Services, LLC rates companies a BUY, HOLD, SELL, or SHORT.

- A BUY rating is given when the security is expected to outperform the broad equity market as measured by the S&P 500 on a risk adjusted basis over the next year.
- A HOLD rating is given when the security is expected to perform in line with the broad equity market as measured by the S&P 500 on a risk adjusted basis over the next year.
- A SELL rating is given when the security is expected to perform below the broad equity market as measured by the S&P 500 on a risk adjusted basis over the next year.
- A SELL SHORT is given when the security is expected to decline in value over the next year.

The distribution of ratings across Fintrust's entire company universe is 62.5% Buy, 25% Hold, 12.5%Sell, and 0% Short

Key Figures (Dow 30 @ 10/5/2017)

Key figures pricing data reflects previous trading day's closing price. Other applicable data are trailing 12-months unless otherwise specified.

R.O.A.E	**19.1%**
Earn $	**$1111.79**
Divs $	**$510.11**
Book Value $	**$5818.74**

Valuation (Dow 30 @ 10/5/2017)

P/E (Actual)	**20.48x**
Earns Yield %	**4.96%**
Divs Yield %	**2.28%**
P/B	**3.91x**

Source: Barron's

Please see pages 7 and 8 of this publication for important certification and disclosure information

Analyst's Notes.... Continued

Risks to the Recommendation:

- Risks include, but are not limited to (1) Unanticipated changes in inflation, interest rates and industrial production (2) credit risk (3) regulatory, governmental, and tax law changes (4) product and business risks (5) the mere fact the future is uncertain (6) and all other risks normally associated with investments in common equities.

A Benjamin Graham Analysis of the Dow Jones Industrial Average

In his investment classic*, The Intelligent Investor*, the father of security analysis Benjamin Graham endeavored to answer the following question:

"Is the stock market too high for conservation purchase?"

He recommends methods by which a defensive investor might determine the appropriate portfolio level asset allocation and simple methods by which to value securities in order to develop long term return expectations. He defined a defensive investor as one that is "interested chiefly in safety plus freedom from bother."

He also defined an "investor" and a "speculator" with his famous statement that "an investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." He argued for a 50/50 split of funds between stocks and bonds for defensive investors, unless the weight of the evidence suggested a tilt toward a 75/25 or 25/75 mix.

In this analysis, I seek to logically implement his recommendations by analyzing the Dow 30 by using data from *Value Line* and *Barron's*.

What We Said in December 2016

Last December, in conducting this analysis, I wrote the following:

"It must be evident to the reader that we continue to find the stocks of the Dow Jones Industrial Average at today's prices look better on average than taxable bonds. We, however, continue to find large uncertainties in the calculations due to the low level of interest rates, though perversely, we are encouraged in the strength of the calculations now that earnings are on the decline. **We would also point out that earnings will increase on a decrease in the tax rate**. Despite our higher confidence in the analysis, the case for equities is still not so compelling when compared to high quality municipal bonds as to lead a defensive investor to abandon balanced asset allocations in the search of a little more growth and income.

Our analysis suggests levels below 19,296 on the Dow Jones Industrial Average would be below the 10 year average, and levels closer to 15,314 would represent low prices relative to the average results, while an index level of 23,277 would be considered rich in relation to past sales, earnings, book value, dividends and forward analyst estimates. The data suggest that for the "defensive investor" reasonable allocations toward common stocks at today's levels appear appropriate and reasonable, but in part, because of the low level of today's interest rates and the expectation of tax cuts. Given that the data and history would argue for a fair degree of caution toward bond portfolios, and **given the components of the Dow 30**

Analyst's Notes.... Continued

collectively appear to trade at slightly above average levels (19,754 v. 19,296 or 102.37% of average), portfolio policy for the "defensive investor" should lean toward average equity allocations (so if one normally splits funds in a 50/50 ratio, the analysis suggest maintaining the 50/50 ratio) with an eye toward inflation protected, tax-free, and floating rate bonds on the fixed income side."

What Has Happened Since December 2016?

Prices have changed, and we believe that the market is attempting to shift from an interest rate driven to an earnings driven market. We remain skeptical that this can be accomplished without volatility. Earnings have recovered slightly over the prior nine months, but interest rates have fallen slightly, as the yield on the DJ Equal Weight US Corp Bond Index climbed fell from 3.16% last December to 2.97% now, while the yield on high quality tax-free bonds as measured by the Bond Buyer 20 Bond Index fell from 3.78% to 3.64%. As a result of the forgoing, the Dow Jones Industrial Average is currently trading at its high for the year on October 5, 2017 22,775.39 and its low for the year way made on January 19, 2017 at 19732.40.

What Policy Now? – A Top Down Look

As of the week ending September 29, 2017, according to *Barron's*, an investor can obtain a 2.97% yield from the DJ (Dow Jones) Equal Weight US Corp Bond Index. Barron's also reports that the Bond Buyer 20 Bond Index (index of yields on 20 general obligation municipal bonds) yields 3.64%. Meanwhile, the dividend yield on the leading Dow Stocks is 2.25%.

Much like last year's analysis, the current low levels of dividend yields and interest rate yields suggest a fair degree of caution. For the 52 weeks ending September 29, 2017 Barron's reports the 12-month trailing earnings for the Dow 30 components at $1111.79 v. $921.51 for the prior year and paid dividends of $510.11 while equity book value rose slightly from $5799.91 to $5818.74. Based on an earnings retention rate of 54.12% and a return on average equity of 19.14%, assuming no further asset dispositions or asset write-downs, the implied expected book value growth would be a solid 10.36%, which when added to the initial 2.25% dividend yield would lead to an expected 12.63% total return under average conditions. While impressive and consistent with historical ranges, I should point out that this is increase may represent near peak conditions

In expanding this analysis to the broader S&P 500 index, using data for book value, return on equity, dividends and earnings returns, one finds that earnings power is clearly mean reverting back toward historical averages as earnings rose from $86.43 to $110.29 for the index. Like the Dow stocks, the S&P 500 companies experienced an earnings increase year over year, and increased dividends to $49.88 v. the prior year's $46.18. Average equity for the S&P 500 was $754.64 this past year, which when combined with the 50.26% earnings retention rate yields an expectation for book value growth of 6.68%. This 6.68% growth when added to the initial 1.98% yield leads to a total return expectation of 8.66% v. last year's 7.56% total return expectation.

Last year, we suggested given that our interest is in determining portfolio policy for the defensive investor, we suggested three two modifications to Mr. Graham's methods. First, we suggested deflating today's profits by 1/3 for a normalization of interest rates in order to stress test the analysis. Secondly, we also suggested adjusting the return expectation by the one year probabilities of a down year in stocks (35.65% for the 115 years since 1901). **Third, we highlighted that President Elect Trump and House Speaker Ryan, campaigned for a lowering of the corporate tax rate from 34% to 15% and from**

Analyst's Notes.... Continued

34% to 20% respectively. We also pointed out that the average global corporate tax rate is 22% and provided the following table:

	Est. Earnings	Tax Cut Effect Total Return Expectation	Earnings Normalized	Probability Adjusted
Est. Pre-Tax Earnings @ 34%	1410.33			
Trailing Twelve Month Earnings @ 34%	930.82	10.47%	7.01%	4.51%
Earnings @ 25%	1057.75	11.90%	7.97%	5.13%
Earnings @ 22%	**1100.06**	**12.37%**	**8.29%**	**5.33%**
Earnings @ 20%	1128.27	12.69%	8.50%	5.47%
Earnings @ 17.5%	1163.53	13.09%	8.77%	5.64%
Earnings @ 15%	1198.78	13.48%	9.03%	5.81%

What portfolio policy then for the "defensive" investor?

It must be evident to the reader that we continue to find the stocks of the Dow Jones Industrial Average at today's prices look better on average than taxable bonds. Despite the improved earnings picture and the potential for corporate tax cuts, the case for equities at today's prices is still not so compelling when compared to high quality municipal bonds as to lead a defensive investor to abandon balanced asset allocations in the search of a little more growth and income.

Portfolio Policy – A Bottom's Up Look

In discussing common stock selection for the defensive investor, Graham suggests the following:

1. Adequate though not excessive diversification, meaning a minimum of ten to a maximum of about 30 stocks.
2. Limit selections to large prominent and conservatively financed corporations.
3. Each company should have a long record of continuous dividends.
4. An investor should place a limit on the price he will pay in relation to average earnings over say the past 7 years.

Later, in *The Intelligent Investor*, Graham figures that estimates for a group of equities are likely to be a good deal more dependable than those for individual companies and he uses data from *Value Line* to illustrate his point. The outcome of this effort, in 1965, found that while earnings estimates proved to be high, and many wrong, the use of low multipliers on earnings led reasonable results for a portfolio of equities over the following five years.

In an effort to produce an analysis similar to Prof. Graham, I once again took the Dow 30 Components, a diverse set of 30 prominent and conservatively financed corporations, and calculated the average ratios of price to sales, price to earnings, dividend yields, and price to book value for at least the previous 10 years if available (2007-2017), in order to capture the period both before and after the great recession and possibly the prior recession as well. Then using both the annual high and annual low for the stock price, I calculated the corresponding price to sales, price to book, price to earnings and dividend yields and averaged these for each security across the trailing decade. I further applied these average ratios to the forward estimates for each respective variable from *Value Line* and *MarketSmith* and FinTrust estimates to develop price range estimates for each of Dow Components.

Analyst's Notes.... Continued

What portfolio policy then for the "defensive" investor?

As Mr. Graham cautions, the valuations reached by the method above are unlikely to prove sufficiently dependable, particularly on an individual company level, so an investor must endeavor to pay a low-prices in relation to average earnings. This suggests prices below 21,736 on the Dow Jones Industrial Average would appear reasonable, while prices above 26,174 would appear to be too high for the defensive investor.

Nominal v. Real Prices

One of the difficulties for the modern analyst is the degree of monetary deformation wrought by modern central banks and central planners over the last eight years. We are forced to analyze assets based upon nominal price fixing arrangements across a large number of assets, including stocks and bonds. Fortunately, the universe has now provided the modern analyst additional tools for measuring real prices, a roll historically reserved for the reserve asset of gold. We believe any real price estimates should be converted into gold for tangible assets and bitcoin for goodwill and intangible assets associated with technology and service businesses. Thus, we would add this final comment to our analysis. If the tangible book value of the Dow sits at $5818 and our low-price estimate rest at 17,279 then the bitcoin value would be the delta, as we think one gold coin plus one bitcoin will approximate the value of one Dow share over time.

Recommendation:

Our analysis suggests levels below 21,726 on the Dow Jones Industrial Average would be below the 10 year average, and levels closer to 17,279 would represent low prices relative to the average results, while an index level of 26,173 would be considered rich in relation to past sales, earnings, book value, dividends and forward analyst estimates. The data suggest that for the "defensive investor" reasonable allocations toward common stocks at today's levels appear appropriate and reasonable, but in part, because of the low level of today's interest rates and the expectations of tax cuts. Given that the data and history would argue for a fair degree of caution toward bond portfolios, and **given the components of the Dow 30 collectively appear to trade at slightly above average levels (22,775 v. 21,725 or 104.8% of average), portfolio policy for the "defensive investor" should lean toward below average equity allocations (so if one normally splits funds in a 50/50 ratio, the analysis suggest maintaining the 45/55 ratio) with an eye toward inflation protected, tax-free, and floating rate bonds on the fixed income side**.

Risks to the Recommendation:

With the benefit of hindsight, Mr. Graham recognized in later editions that he underestimated the risks associated with bonds in 1965, as future inflation proved quite devastating to bond portfolios in the 1970s. Interestingly, today's data points certainly look similar to those of Mr. Graham's 1965 edition. No one, in 1965, anticipated the high inflation rate of the 1970s and the impact it was to have on both the earnings power of corporations and bond portfolios. In addition to unanticipated inflation, other risks to the recommendation include, but are not limit to, regulatory, governmental, and tax law changes, the mere fact the future is uncertain, and all other risks normally associated with investments in common equities.

Analyst's Notes.... Continued

Source: *Value Line, MarketSmith,* and FinTrust estimates

The table below contains the summary results of the calculations:

Stock	Symbol	AveLowEst	AveHighEst	Last_Price 10/5/2017
Apple	AAPL	117.79	173.57	155.39
American Express Company	AXP	72.5	132.63	91.16
The Boeing Company	BA	166.35	255.51	258.89
Caterpillar Inc.	CAT	76.27	133.54	126.4
Cisco Systems, Inc.	CSCO	27.43	38.44	33.59
Chevron Corporation	CVX	84.24	121.56	118.58
E.I. du Pont de Nemours and Company	DD	86.3	132.38	100.11
The Walt Disney Company	DIS	50.03	75.68	70.97
General Electric Company	GE	23.28	35.82	24.54
The Goldman Sachs Group, Inc.	GS	188.19	363.22	246.06
The Home Depot, Inc.	HD	116.95	184.56	166.12
International Business Machines	IBM	164.32	233.27	146.72
Intel Corporation	INTC	34.52	59.97	39.53
Johnson & Johnson	JNJ	107.18	138.45	133.19
JPMorgan Chase & Co.	JPM	67.46	106.44	97.09
The Coca-Cola Company	KO	34.81	46.07	45.52
McDonald's Corp.	MCD	101.7	141.9	158.8
3M Company	MMM	140.05	197.2	216.37
Merck & Co. Inc.	MRK	45.31	71	64.6
Microsoft Corporation	MSFT	57.14	82.09	75.97
Nike, Inc.	NKE	44.58	66.22	52.18
Pfizer Inc.	PFE	26.78	37.7	36
The Proctor & Gamble Company	PG	78.36	101.35	92.03
The Travelers Companies, Inc.	TRV	95.13	143.47	124.44
UnitedHealth Group Incorporated	UNH	150.83	233.14	197.9
United Technologies Corporation	UTX	96.46	140.11	118.17
Visa Inc.	V	76.71	116	106.24
Verizon Communications Inc.	VZ	34.56	47.84	49.77
Wal-Mart Stores Inc.	WMT	67.24	87.08	79.41
Exxon Mobil Corporation	XOM	77.14	105.05	82.02
	Total	2509.61	3801.26	3307.76
	DowDivisor	0.14523397	0.14523397	0.14523397
	Index Est.	17279.77277	26173.35325	22775.38788

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