The Dow Jones Industrial Average ETF (Symbol: DIA)

FinTrust Brokerage Services

Equity Research

A Benjamin Graham Analysis of the Dow 30

December 17, 2018

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:
Analysis by Allen Gillespie, CFA (864) 288-2849

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

- FinTrust is updating its HOLD rating to a BUY rating for the Dow Jones Industrial Average exchange traded fund (ETF symbol: DIA), as the market is now down for the YTD period and below of the midpoint of our 2019 estimated price range (Walgreens replaced GE in the index since our last report). At the time of our previous report (Oct 2017), we had expected an increase in 2018 earnings due to tax cuts, but stated that "we believe any fiscal tax cuts are now priced into the market." **The market just slightly exceeded our 2018 price target of 26,173 in both January and September of 2018 before experiencing reasonable corrections**.

- **The current analysis suggests levels below 25,376 on the Dow Jones Average would be considered below average, while a level closer to 20,241 would represent low prices, while an index level of 30,511 would be considered rich** in relation to past sales, earnings, book value, dividends and forward analyst estimates. As a result of our updated analysis, we are increasing the low end, the high end, and midpoint of our estimated price range.

- **We are increasing our recommended equities asset allocation** as the data suggest an allocation for defensive investors of 55/45 v. the previous 45/55, as we estimate equities are currently 5% below the midpoint of our valuation range. **Should equities continue to trade lower from here toward the bottom of our estimated price range, we would recommend investors proportionately increase their equity allocations.**

Fintrust Recommendation

Fintrust Rating:	**BUY**
Target Price:	**$305.11**
Current Share Price	**$241.42**
Expected Return	**26.60%**
52 Week Price Range	**$233.2-269.28**

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 57.14% Buy, 28.57% Hold, 14.29%Sell, and 0% Short

Key Figures (Dow 30 @ 12/15/2018)

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	**23.6%**
Earn $	**$1499.20**
Divs $	**$566.63**
Book Value $	**$6433.55**

Valuation (Dow 30 @ 12/15/2018)

P/E (Actual)	**16.08x**
Earns Yield %	**6.22%**
Divs Yield %	**2.35%**
P/B	**3.75x**

Source: Bloomberg and FinTrust est.

Please see pages 8 and 9 of this publication for important certification and disclosure information

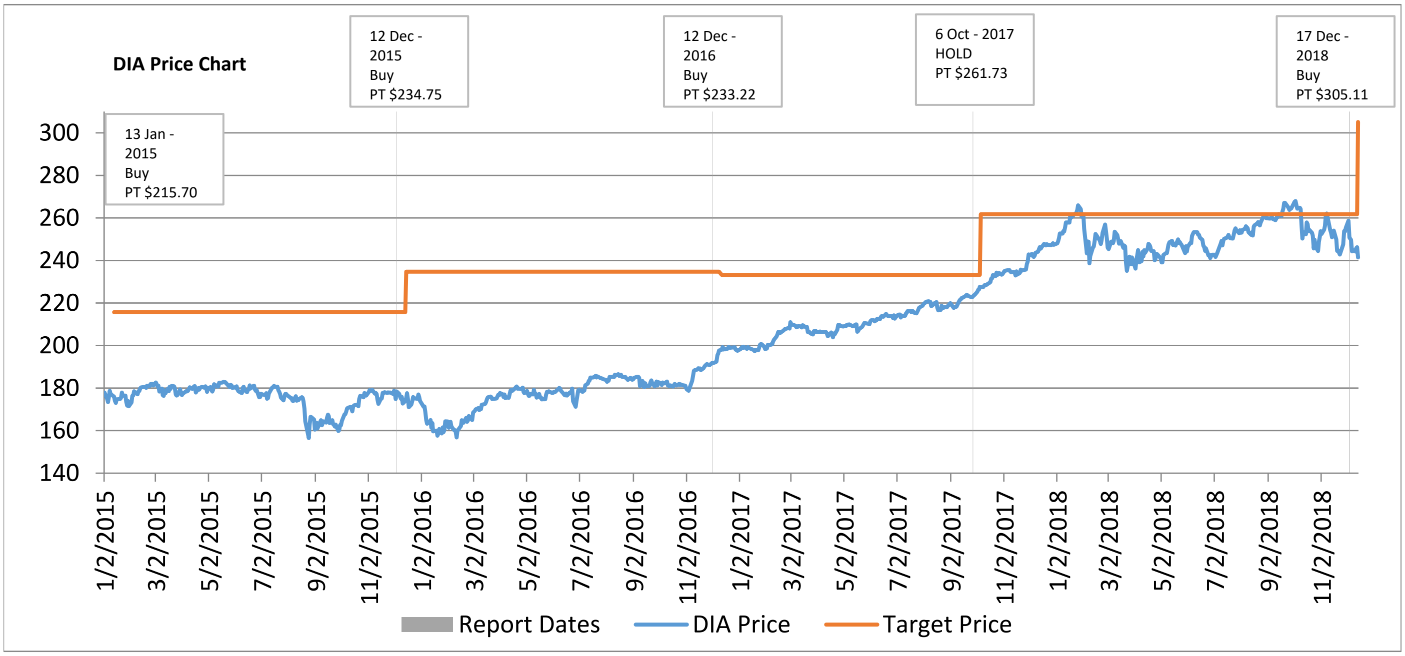
Analyst's Notes.... Continued

- As in our previous reports, the data suggests that for the "defensive investor" reasonable allocations, toward the common stocks of the Dow Jones Industrial Average levels appear appropriate and reasonable. For fixed income investors, we continue to recommend inflation protected, tax-free, floating rate and high-quality bonds, while for aggressive investors we recommend gold equities, gold, and cryptocurrency in place of short-term fixed income and money market holdings.

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) political risks (7) and all other risks normally associated with investments in common equities.

Price Chart



Analyst's Notes.... Continued

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 conservative 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, Market Smith, Bloomberg, and Barron's*.

What We Said in October 2017

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

"We believe that the market is attempting to shift from an interest rate driven market to an earnings driven market. We remain skeptical that this can be accomplished without volatility."

"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 may represent near peak conditions.**

Analyst's Notes.... Continued

What Has Happened Since October 2017?

In January 2018, the Dow Jones Industrial Index slightly exceeded our 2018 target price by reaching a high price of 26,616 before equity markets experienced their **highest volatility event since the 2008 financial crisis.** The Dow Jones Industrial Index then recovered to a September 2018 peak of 26,951 before experiencing its first correction in a number of years.

The volatility has largely been attributed to concerns that the Federal Reserve's interest rate increases are likely to kill off the recovering economy.

Since last year, earnings have advanced nicely, as we expected, due to both tax rate reductions and improved corporate performance. This improvement, however, has been slightly offset by higher interest rates, as the yield on the DJ Equal Weight US Corp Bond Index climbed from 2.97% last October to 4.41% now, while the yield on high quality tax-free bonds as measured by the Bond Buyer 20 Bond Index has risen to 4.18% from 3.64% at the time of our last report.

What Policy Now? – A Top Down Look

As of the week ending December 14, 2018, according to *Standard and Poor's*, an investor can obtain a 4.41% yield from the DJ (Dow Jones) Equal Weight US Corp Bond Index. The Bond Buyer 20 Bond Index (index of yields on 20 general obligation municipal bonds) yields 4.18%. Meanwhile, the dividend yield on the leading Dow Stocks is 2.35%.

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 December 14, 2018, the 12-month trailing earnings for the Dow 30 components stood at $1499.20 v. $1235.96 for the prior year and paid dividends totaled $566.36 while equity book value rose to $6433.55 from $6258.03. Based on an earnings retention rate of 62.2% and a return on average equity of 23.6%, the implied expected book value growth would be a solid 14.7%, which when added to the initial 2.35% dividend yield would lead to an expected 17.05% total return under average conditions. **While impressive and consistent with historical ranges, I continue to point out that this 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 to $146.44 from $123.04, which is less than one would have predicted based on the tax law changes. Like the Dow stocks, the S&P 500 companies experienced an earnings increase year over year, and dividends increased to $53.82 v. the prior year's $50.53. Average equity for the S&P 500 was $828.85 this past year, which when combined with the 63.25% earnings retention rate yields an expectation for book value growth of 11.17%. This 11.17% growth when added to the initial 2.07% yield leads to a total return expectation of 13.25%.

Given that our interest is in determining portfolio policy for the defensive investor, we have previously suggested a few modifications to Mr. Graham's methods. First, we have suggested deflating current profits by 1/3 for a normalization of interest rates in order to stress test the analysis. Secondly, we also suggested adjusting the return expectations by the one-year probability of a down year in stocks (35.65% for the 115 years since 1901).

Analyst's Notes.... Continued

<u>What portfolio policy then for the "defensive" investor?</u>

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 are more confident now in the analysis given that interest rates have in fact risen, the index membership has changed and because the tax cuts have help to alleviate much of the overvaluation in equities**. Despite the improved picture, the case for equities at today's prices is still not so compelling when compared to high quality bonds, given that earnings may be at a peak, as to lead a defensive investor to completely abandon balanced asset allocations in the search of a little more growth and income.

<u>Portfolio Policy – A Bottom's Up Look</u>

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 *<u>The Intelligent Investor</u>*, 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 (2008-2018), if available, 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 various trailing time periods. 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.

<u>What portfolio policy then for the "defensive" investor?</u>

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 25,375 on the Dow Jones Industrial Average would appear reasonable, while prices above 30,511 would appear to be too high for the defensive investor. **We would note these estimates are materially higher than our prior estimates, but are largely a reflection of the effects of the tax law changes and the change in the composition of the index itself, as Walgreens Boots Alliance replaced General Electric since our last report.**

Analyst's Notes.... Continued

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 ten 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 $6433 and our low-price estimate rest at $20,241 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 25,376 on the Dow Jones Industrial Average would be below the 10-year average, and levels closer to 20,241 would represent low prices relative to the average results, while an index level of 30,511 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. **Given the components of the Dow 30 collectively appear to trade at slightly below average levels (24,100 v. 25,376 or 94.97% of average), portfolio policy for the "defensive investor" should lean toward above average equity allocations (so if one normally splits funds in a 50/50 ratio, the analysis suggests a 55/45 ratio)**.

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 still 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. **We believe, however, that the next large inflation could be digital in nature as the millennial generation is more likely to be attracted to digital and mobile assets verse fixed assets**. In addition to unanticipated inflation, other risks to the recommendation include, but are not limit to, regulatory, governmental, and tax law changes, political risks, 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 range estimates for the individual securities in the Dow Jones Industrial Index.

Stock	Symbol	AveLowEst	AveHighEst	Last_Price 12/14/2018
Apple	AAPL	147.46	217.57	165.48
American Express Company	AXP	85.02	153.44	105.7
The Boeing Company	BA	236.33	387.83	318.75
Caterpillar Inc.	CAT	110.78	180.93	126.77
Cisco Systems, Inc.	CSCO	30.94	43.00	45.82
Chevron Corporation	CVX	98.85	139.91	113.83
DowDuPont	DWDP	74.00	110.70	52.78
The Walt Disney Company	DIS	96.53	143.71	112.2
Walgreens Boots Alliance Inc.	WBA	74.64	112.34	78.74
The Goldman Sachs Group, Inc.	GS	189.89	350.91	172.77
The Home Depot, Inc.	HD	161.45	228.73	119.90
International Business Machines	IBM	164.32	233.27	146.72
Intel Corporation	INTC	43.54	72.24	47.86
Johnson & Johnson	JNJ	113.91	147.13	133
JPMorgan Chase & Co.	JPM	83.49	125.12	100.29
The Coca-Cola Company	KO	37.88	49.58	49.34
McDonald's Corp.	MCD	116.99	167.03	183.29
3M Company	MMM	166.5	231.65	196.10
Merck & Co. Inc.	MRK	47.43	71.66	76.48
Microsoft Corporation	MSFT	73.46	103.08	106.03
Nike, Inc.	NKE	49.84	72.04	72.53
Pfizer Inc.	PFE	32.73	45.61	43.80
The Proctor & Gamble Company	PG	80.47	101.65	96.64
The Travelers Companies, Inc.	TRV	107.02	155.75	120.55
UnitedHealth Group Incorporated	UNH	189.96	293.66	265.02
United Technologies Corporation	UTX	109.28	155.44	118.80
Visa Inc.	V	87.57	163.23	135.09
Verizon Communications Inc.	VZ	41.66	57.60	57.08
Wal-Mart Stores Inc.	WMT	75.05	97.96	91.85
Exxon Mobil Corporation	XOM	82.69	111.26	75.58
	Total	2985.29	4499.85	3554.36
	DowDivisor	0.14748072	0.1748072	0.14748072
	Index Est.	20241.90	30511.45	24100.51

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