Investment Overview

Over the past few years, utility stocks have appeared to be trading more based on interest rate movements and less due to fundamentals. The latest move down in interest rates, as well as indications from the Fed that further cuts could follow, has led to utilities trading near all-time highs. We remain cautious of valuations that are significantly above historical averages. However, we continue to recommend investors hold a portfolio of quality, dividend-paying stocks for the long term and not move in and out of the market based on interest rate predictions.

In this report, we will discuss recent developments in both the utility industry and interest rates and summarize our current view on utility fundamentals, as well as discuss how valuation has changed over the past several years:

- While the inverse relationship between rates and stock prices that has existed historically may not hold perfectly all of the time, we believe it remains intact.
- We believe utility industry fundamentals will remain healthy and supportive of reasonable earnings and dividend growth.
- We continue to recommend that investors remain focused on principles, not predictions, and invest in a diversified portfolio for the long term as opposed to trying to time the market.

We believe it is important to periodically review portfolios to ensure that they remain properly diversified and appropriate for an investor's individual situation. This is especially true now given the changing interest rate environment and its impact on utility stocks.

Why have utility stocks done well over the long term?

Utility investors enjoyed good performance over the past several years as well as consistent dividend growth from many utility companies (see Figure 1 on the next page). We believe a combination of utility-related factors, as well as macroeconomic issues, have created and sustained this positive environment. Within the utility sector, companies increased their emphasis on infrastructure and environmental investments, which has led to improved earnings growth (as utilities are allowed by regulators to earn a specified return on approved investments). This, combined with many utilities’ management teams refocusing on core regulated businesses, has been attractive to investors.
On a separate plane, macroeconomic factors, such as the ongoing historically low interest rate environment, and a corresponding lack of options available to investors to generate current income have helped boost utilities in most years since the financial crisis. Many investors have used utilities and other defensive sectors as substitutes for bonds, as equity dividend yields often exceed bond coupon yields for the same company. This philosophy has worked well in an ascending market for utility stocks, as some investors have undoubtedly been happy and perhaps pleasantly surprised to realize significant capital appreciation in addition to healthy and often rising dividend payments.

Over the past couple of years, utility stocks oscillated primarily due to increases and decreases in interest rates. Utility stocks have seemed to perform well when interest rates fall (or there is an indication that they will not rise further) and fall when rates rise. We have seen several "corrections" in utilities, where the group has dropped 10% to 15%, and these have corresponded with periods when longer-term interest rates were increasing.

Utility company fundamentals remain solid

In our view, utility industry fundamentals remain healthy and supportive of reasonable earnings and dividend growth for the next several years. Regulated utilities hold virtual monopolies in their service territories, and they earn an allowed return on approved investments, of which there are hundreds of billions of dollars’ worth needed in the U.S., according to independent sources. The national average for allowed returns for both electric and gas utilities remains at just under 10%, a level that we believe will enable utility companies to sustain profit growth.

Additionally, many utility companies have realized that infrastructure spending to update, maintain, repair and expand power lines, pipes and power plants is a lower-risk way to grow earnings than diversifying into unregulated businesses. Companies have identified approved projects that they are able to finance and which can potentially lead to higher earnings. We have seen companies focusing on these types of investments and divesting ancillary, unregulated businesses, leading to more stable, reliable earnings. We believe well-managed utilities can increase earnings at 5% to 6% on average for the foreseeable future, with corresponding dividend growth.

Absolute valuation levels significantly higher than historical average

Utility valuations have climbed back to record levels as 10-year Treasury bond rates have fallen back below 2%. On a price-to-earnings basis, remain significantly above their historical average, and have been trading near all-time highs. We have seen utility valuations moving in line with interest rate movements, although there have been exceptions to this. Overall, however, we believe the low-interest-rate environment has been the biggest factor in pushing utilities higher since many investors buy them for their dividend yield.

Utilities recently hit new all-time highs, and are still trading significantly above their average price-to-earnings ratio over the past decade. The premium valuation continues to reflect not only the low interest rate environment, but also the stable and predominantly regulated earnings growth we foresee. (see Figure 2)
Utilities trading at a premium to market valuations

Having addressed absolute valuation, we believe it is also important to examine relative valuation. In other words, it is necessary to evaluate how utilities have performed relative to other investments and how expensive they are relative to alternatives. Clearly, with the overall market (as measured by the S&P 500) having recently set new records, other sectors have appreciated as well. So, how have utilities fared compared with the market?

What about interest rates?

Let us turn our attention to the relationship between utility stocks and interest rates (the 10-year Treasury yield). We believe that investors should be aware that, historically, utility stock prices and the 10-year Treasury yield have tended to have an inverse relationship. This means that when interest rates rise, utility stock prices tend to move down, and vice versa. We saw a weakening of this relationship post-2002 (see Figure 4), but we believe this was largely due to unusual circumstances. We do believe that this relationship generally still holds, and we have seen evidence of this over the past few years.

Since the market lows in 2009, utility valuations have fluctuated from a roughly a 20% discount to approximately a 20% premium versus the overall market (see Figure 3). Recently, utilities traded at a premium to the market, as investors have continued to purchase them for the stability and current income they offer. Utilities’ perceived safe and steadily growing dividends continue to make utility stocks an attractive source of current income for investors. Additionally, the marked decline in interest rates has led to the group achieving all-time high levels.

After an environment in which higher-growth stocks outperformed and utilities lagged, given their relative inability to accelerate earnings growth compared with high growth companies, investors have apparently now turned more positive on less risky stocks. We believe this sentiment is at least partially driven by macroeconomic and trade war concerns. We think quality utilities are positioned to continue to provide competitive total returns. But we also believe utility relative returns are narrowed by utilities’ limited growth potential versus faster-growing sectors.

Should I adjust my portfolio as interest rates move?

We think it is appropriate to periodically review portfolios and rebalance sector weightings. Certain life events or macroeconomic changes can demand timely examination of portfolios. We are aware that many investors have a weighting in excess of 4% in utilities, and we understand that there may be individual reasons why this is appropriate.
Importantly, we recommend investing based on principles and not trying to move in and out of stocks based on predictions, whether for the economy, the stock market as a whole, or interest rates in particular. We preach diversification and quality and advocate owning a portfolio of dividend-paying stocks for the long run, through the ups and downs of the interest-rate cycle.

Coming out of the recession, most people thought interest rates had nowhere to go but up, but they have yet to move significantly higher, relative to historical levels. The main point to remember is that even professionals find it very difficult to predict the direction and magnitude of interest rate changes, so we would not recommend making major changes to portfolios based on predictions. We continue to believe utility stocks have some attractive characteristics, and we believe they should always be part of a diversified portfolio, regardless of short-term movements in interest rates.

While utilities offer a number of positives for investors, we note the risk of having too heavy a weighting in any one sector. For those investors whose utility holdings are significantly higher than our 4% recommendation, we suggest looking to the Edward Jones Equity Income Buy List for ideas in other sectors. The Equity Income Buy List consists of a mix of 20-25 dividend-paying stocks from different sectors recommended by the Edward Jones Securities Research Department. The list is designed to provide an above-average dividend yield and the potential for rising income.

We note that approximately half of the stocks on the Equity Income Buy List have increased their dividends every year for 15 years or more and most of the stocks on the list have paid a dividend for 50 years or more. The average yield of the stocks on the Equity Income Buy List exceeds 3%, with an average expected annual dividend growth rate of approximately 7%.

**Risks besides valuation**

Despite their regulated nature, utility stocks carry various risks that investors should consider. Risks to the relative performance of utility stocks would include better-than-expected or faster overall economic growth, evolving or new legislation concerning environmental guidelines and/or renewable power sources, and rising long-term interest rates. Utility-specific risks would include the potential for declining allowed returns, rate-case fatigue as companies repeatedly seek reimbursement of capital spending, fluctuations in commodity prices, and managing regulatory relationships.

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