Fidelity Manager's Formula For Mega-Cap Winners

Mega cap stocks have clearly been also-rans in this bull market. The iShares S&P 100 ETF (OEF) is a distant third to the SPDR S&P 500 ETF (SPY) and the small cap SPDR S&P 600 ETF (SLY).

OEF Total Return Price data by YCharts

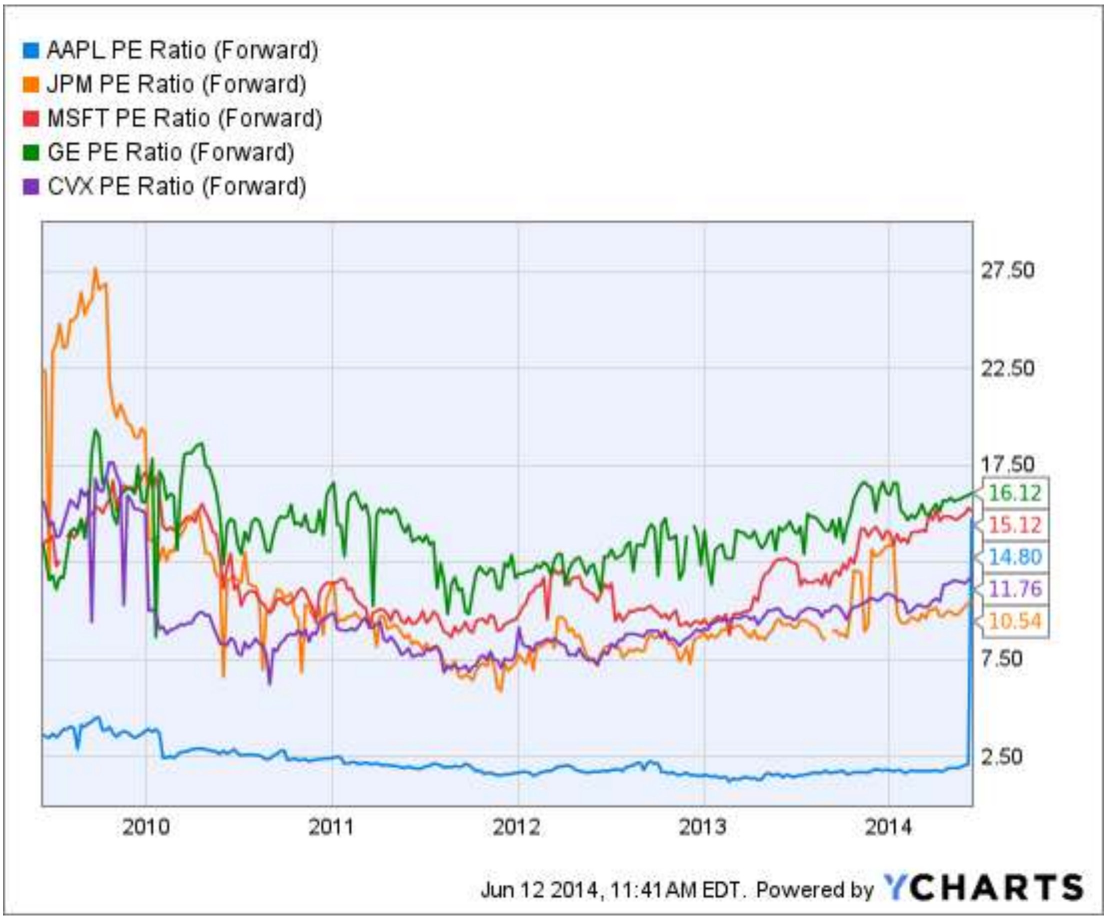
And that's just a microcosm of a lag that has been in place since the 2000 sell off. At this late stage in the bull market, cheap-ish mega caps present an interesting opportunity, given the resilience of the big names when markets do correct. Fidelity mega-cap fund manager Matt Fruhan recently noted that the 15 forward PE ratio for the biggest stocks is nearly half of the level in the go-go late 1990s.

"The further down in market cap you go, the more expensive prices are, despite what I would argue are worse balance sheets and lower profit margins," Fruhan noted in a recent Fidelity presentation.

Since taking over Fidelity Advisor Mega Cap fund five years ago, Fruhan's 18.9% annualized gain is four percentage points ahead of the S&P 100 and nearly a point better than the S&P 500. He oversees $13 billion in large and mega cap portfolios.

Fruhan is especially keen these days on the slower growth mega caps that pair a 2%-3% dividend yield with stable high-single-digit earnings growth selling between 13x and 16x forward earnings. "Five years into a bull market, I think a combination of earnings growth plus yield of at least 10%, at reasonable valuations, is an attractive area to invest."

In the most recent quarterly filing Fruhan added to all five of his largest holdings: Apple (APPL), JPMorgan Chase (JPM), Microsoft (MSFT), General Electric (GE) and Chevron (CVX). On forward PE ratio, that's indeed a pretty inexpensive crowd:



AAPL PE Ratio (Forward) data by YCharts

In addition to JPMorgan Chase, the fund also added to its Bank of America (BAC) in the last quarter, but was trimming its Wells Fargo (WFC) position. Wells fargo more than doubled over the past five years, about five times the gain for Bank of America.

While Bank of America has not been allowed to increase its dividend payout since the financial crisis and recently had to resubmit its capital plan after catching a major bookkeeping error, the bank is nearing the stretch run of write offs for bad mortgages. And while Bank of America is in the late stages of negotiating a mega $12 billion+ deal to settle civil charges with the Justice Department, that deal has long been anticipated by investors and would be more relief than bad news.

If you're on board that Bank of America's headaches are getting smaller and smaller in the rear view mirror, its valuation suggests the market has yet to catch on.

BAC Price to Book Value data by YCharts

One cautionary note on mega caps recently came from the Leuthold Group. The research and money management firm noted that while mega caps look like a decent value, that's deceptive once you back out the fact that the appeal is relative to a pricier broad market and the fact that record profit margins among the mega caps can't be counted on as sustainable. Leuthold notes that the S&P 100's recent price to sales ratio of 2.19x is higher than its 2000 level.

By that measure, among the Fidelity fund's largest holdings, Chevron is holding tight to its long-term low price-to-sales ratio:

AAPL PS Ratio (TTM) data by YCharts

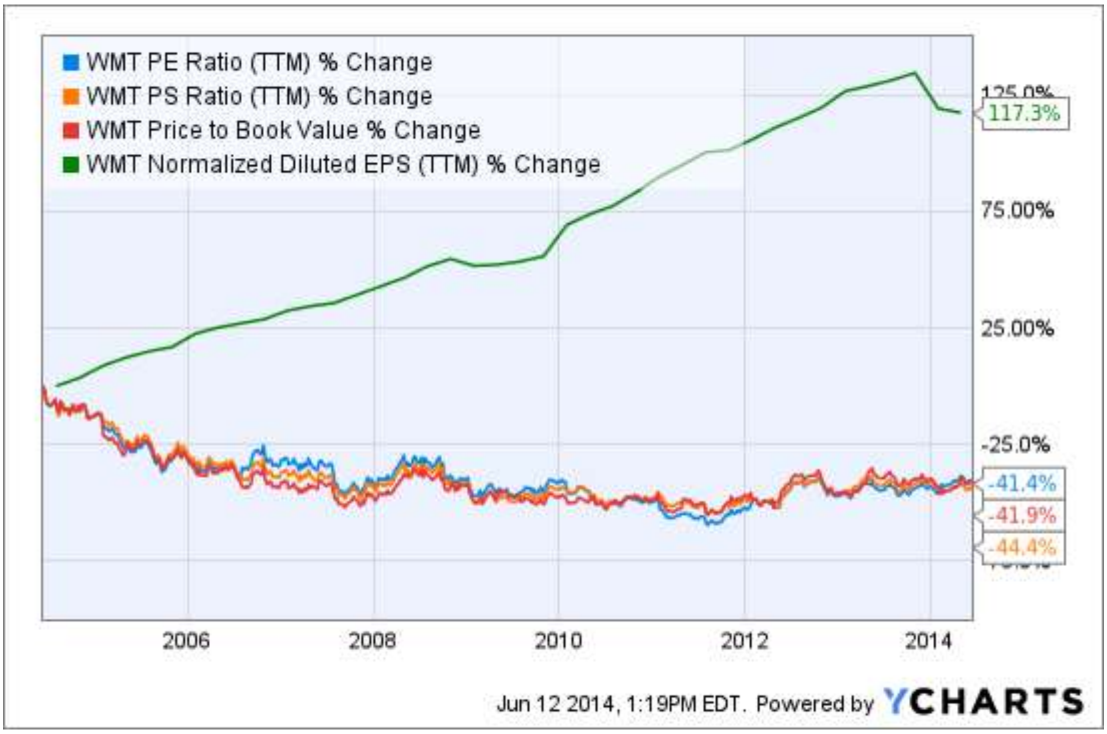
And we won't belabor (again) what a compelling value and dividend story Chevron is at this juncture.

Truth is, there's a whole lot of mega cap value to be had in energy. Exxon Mobil (XOM) Phillips 66 (PSX) and ConocoPhillips (COP) all have sub 14 forward PE ratios and reasonable price-to-sales readings.

Using YCharts Stock Screener, a quick sort of the 100 largest companies in the S&P 500 based on price-to-sales turns up plenty of other names worthy of further financial research.

For example, Walmart (WMT) has been a bull market wallflower. While Walmart is not going to be mistaken for a growth story, there is a persistent uptrend in EPS growth over the long term that befits a "stable" story.

And its current valuation seems to discount plenty of the near term headwinds:



WMT PE Ratio (TTM) data by YCharts

Shareholders have pocketed an 80% dividend growth over the past five years, yet the payout ratio remains at a healthy 40%. The current yield of 2.5% is about a half a percentage point ahead of the S&P 500.