Lessons Learned – Managing Global Equity Risk in Turbulent Times

Adapted from a presentation given by Stephen Mitchell, Senior Vice President & Portfolio Manager – Global Equities in Montreal on September 18, 2018

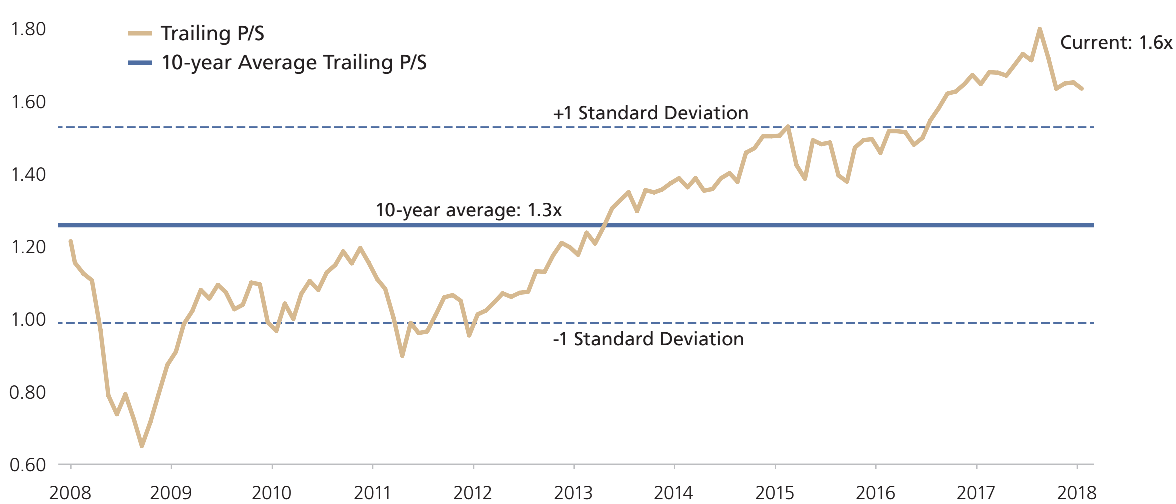
When you are driving on the highway and you see that there is a slowdown in traffic, or a possible stoppage up ahead, what do you do? Do you move into the fast lane and speed up until you are forced to slow down? Or do you move into the right-hand lane, take your foot off the accelerator, or possibly even slow down, allowing yourself the opportunity to take possible off-ramps before you reach the stoppage? We see a lot of risks in the market currently. We don't know when traffic will stop, however, we have moved into the right-hand lane as, at this time, it is the cautious thing to do.

Today's market is expensive – not just because price-to-earnings (P/E) ratios are elevated (we have seen higher levels in the past), but also from a price-to-sales (P/S) basis. P/S is the appropriate way to look at valuation. The only time it was more expensive was in 2000 – and we are not that far off the 2000 levels. Margins are at all-time highs for many companies. The U.S. market is a little more expensive than other global markets. However, on a P/S basis, other developed markets are also at very elevated levels. This situation has resulted from a protracted period of low interest rates.

Although real yields have historically been between 3% and 4%, we have more recently had 0% or negative real yields for a long period of time. When bonds are at these yield levels, the multiples on equities increase. The market poses significant risks currently – either rising interest rates will cause the reverse impact and we will see multiples come down, or, as has been indicated by the flattening of the yield curve, we will go into a period of slower or negative economic activity and earnings will not be as robust in the future as they have been, thereby also affecting valuations.

As a result, we have positioned our portfolios based on our many years of experience investing in global markets and the lessons we have learned through various market cycles.

MSCI World Index: Trailing P/S ratio for the past 10 years

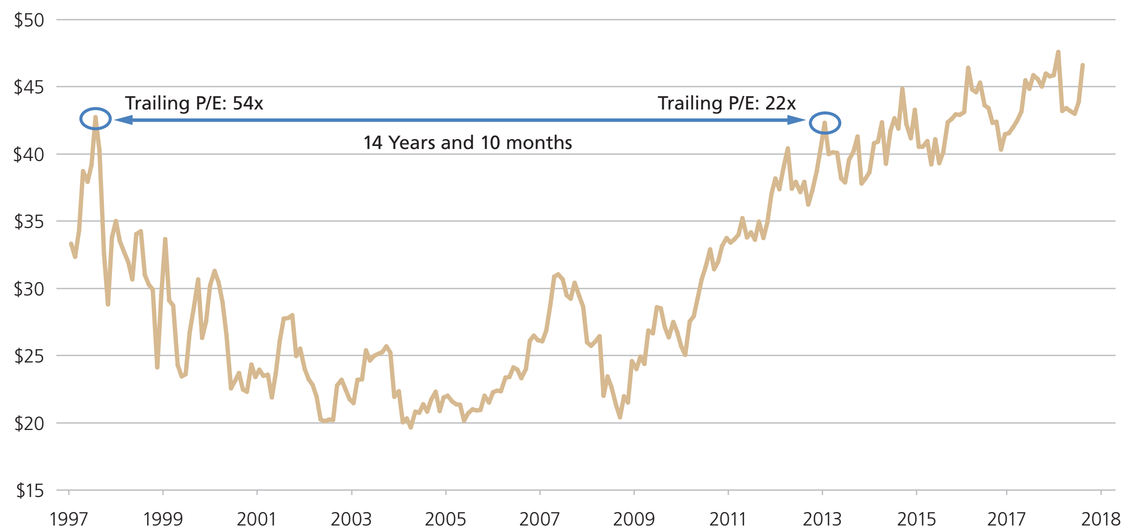


Source: Bloomberg

Lesson #1: You should not overpay for quality

Buying high-quality companies without consideration of valuations will not protect invested capital. For example, if you bought Coca-Cola, a great company, in 1998 when the trailing P/E was 54x, and held it for almost 15 years, you would not have made any money. And this was during a period when other consumer-oriented companies were doing well. In 2000, Microsoft, another great company, had a trailing P/E of 69x and the stock went down 60% in the technology downturn. Microsoft was one of the most dominant companies at the time, and they actually grew earnings over the period. The loss was purely a result of valuation. Currently, Amazon is trading at over 200 times earnings, and we think there is risk of holding Amazon stock as a result.

Coca-Cola Company



Source: S&P Capital IQ

Microsoft Corporation

Source: S&P Capital IQ

Lesson #2: Balance sheets act as a multiplier

If there is a lot of cash on a company's balance sheet, a change in valuation has less of an impact on equity valuation. Conversely, if there is a lot of debt on the balance sheet, then the impact on equity valuations is magnified. We would rather own companies that have no debt, or net cash. Or if they do have debt, then the company must have very resilient earnings streams. In anticipation of a market downturn, we are not invested in highly-leveraged companies.

Enterprise Value	Change in Equity Value for 20% decline in Earnings
50% Cash	-10%
Zero Net Debt	-20%
50% Net Debt	-30%

Lesson #3: The importance of stable earnings growth

Companies with more cyclicality to their earnings streams will bear the full brunt of a significant correction. As you can see in the table below, industrial companies' earnings declined significantly during the last two recessions. Information technology companies' earnings were down 125% from 2000 to 2002 and were slightly positive during the financial crisis. On the other hand, earnings of companies in the consumer staples sector were up significantly during both periods, showing the value of having strong, resilient earnings.

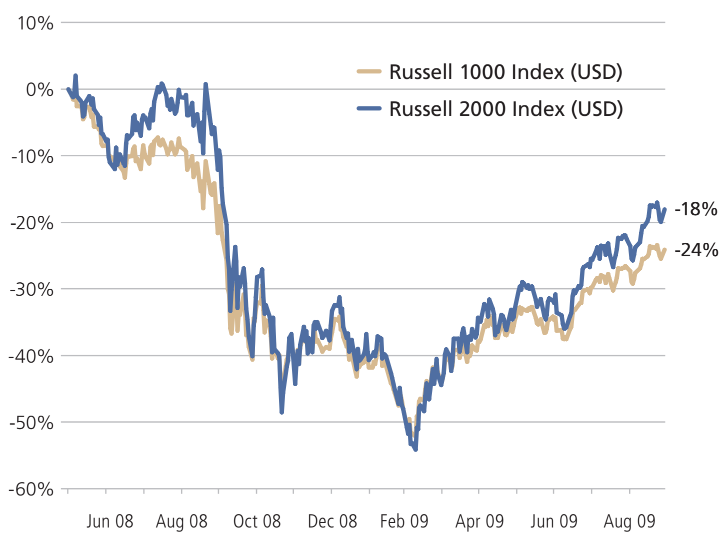
Sector EPS Growth (%)		
	2000 - 2002	2007 - 2009
S&P 500 – Industrials	-15.2%	-33.0%
S&P 500 – Information Technology	-125.2%	+3.8%
S&P 500 – Consumer Staples	+28.7%	+7.9%

Source: S&P Capital IQ

Lesson #4: Performance of large cap companies versus small cap companies at different points in the cycle

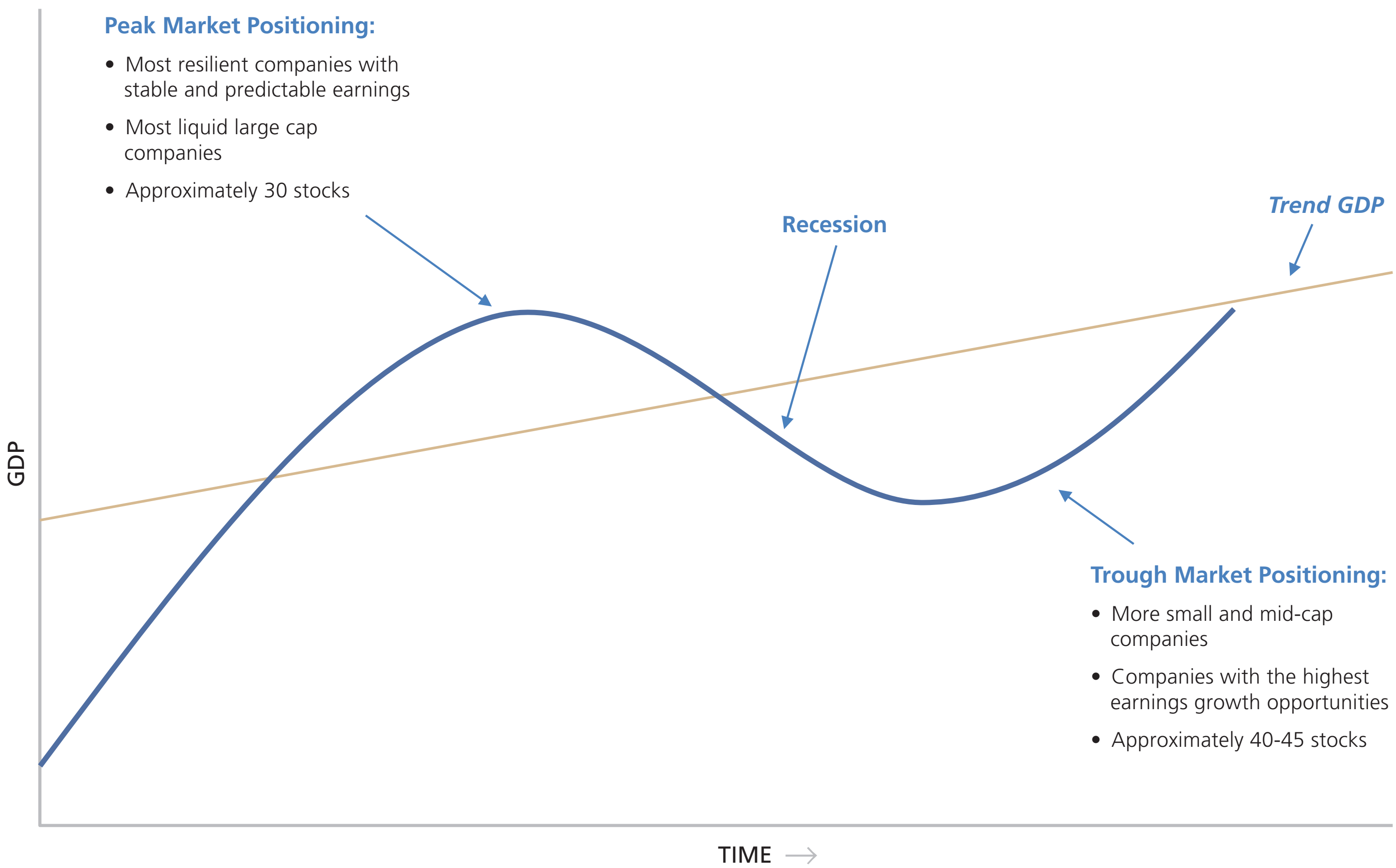
Large-cap and small-cap companies perform differently at various points in the market cycle. Since we can't time the market, and we don't know when valuations will come down, we are fully invested in large-cap, highly-liquid companies that can be sold quickly, giving us a chance to take the off-ramp. We want to invest in smaller cap companies because they will be the faster growing businesses. However, you can't build or dispose of a small-cap position quickly. Although we know that owning large-cap companies will cause greater underperformance in the initial stages of a downturn, we are being patient and waiting for the right time to buy smaller businesses.

U.S. Large Cap vs. U.S. Small Cap



Source: S&P Capital IQ

Given these four lessons, we have invested our portfolios to protect our clients' capital and to be ready to take advantage of opportunities when the market changes. We know we are at the tail end of a bull market – we don't know when it will end, but we know it will end. As a result, we are invested in a concentrated portfolio of large-cap, liquid, highly-resilient businesses with strong balance sheets. We know that we are giving up growth in this environment since growth is very expensive – we want to buy growth when it is free. As we go through the recession, we will look for opportunities to invest in smaller businesses that will grow faster and outperform over the next 10+ years. As you can see from the schematic below, the portfolio will become less concentrated through the recessionary period as we add smaller cap stocks that are selling at a greater discount to their intrinsic value.



Our experience tells us that it is time to move out of the fast lane and prepare for the slowdown ahead.

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