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INVESTMENT COUNSEL

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Lessons Revisited – Managing Global Equity Risk in Turbulent Times

In this follow up to our 2018 white paper on the same topic, we revisit the lessons learned from previous market corrections to see whether they are still relevant to today's environment.

Prior to the COVID-19 pandemic, we had been positioning our portfolio in anticipation of a market correction, recognizing the length and breadth of the bull market. However, the unique nature of this health-related recession led to some unanticipated trends that have left many investors wondering "Is this time different?"

For starters, governments and central banks globally were swift to step in last year with unprecedented monetary and fiscal support measures and, as a result, equity markets never came close to the valuation levels we saw in the Global Financial Crisis (2007-2009) even though, by some measures, the economic impact of the pandemic is much greater. However, while today's equity market is expensive, when compared to the bond market, equity valuations look attractive. To illustrate, let's compare the earnings yield for the U.S. equity market to the 10-year Treasury yield in the U.S. bond market. Since 1962[1], any time the S&P 500 earnings yield (now at 2.9%)[2] has been higher than the 10-year U.S. Treasury yield (now at 1.4%)[3], it has usually been a good time to own U.S. equities. No one would claim that the S&P 500 is inexpensive at 34.2 times 2021 earnings, but the equity market valuation looks more attractive when compared to the even more expensive bond market. Low bond yields are driving up equity valuations.

Another unique aspect of the pandemic is that it has created clear winners and losers for business models. If you sell your product digitally, you have been advantaged. If you enable others to sell their products digitally, you have been even more advantaged. If physical presence is a requirement of your sale, you have been in trouble.

To put these observations into perspective, the five largest companies in the MSCI World (and S&P 500) Index – Apple, Microsoft, Amazon, Alphabet (Google's parent) and Facebook – were up by 65% on average in 2020 compared to the overall market return of 14% in U.S. dollars. Index returns were dominated by companies with digitally enabled business models that put them in the winner's column. These five companies had an expected average earnings growth rate of 35% in 2020 and are valued at 39 times price-to-earnings (P/E). By contrast, the overall global stock market is expected to see earnings contract 14% in 2020 and is valued at 26 times P/E. Low bond yields lower the discount rate for stocks, thereby increasing the future value of their earnings even further. Thus, low bond yields are currently supportive of the high valuations for the equities. This phenomenon is even more pronounced for companies with earnings that are growing faster than the overall market.

If bond yields continue to remain low, we question the ability of the largest, most expensive companies to maintain the high growth rates necessary to justify their valuations. If bond yields rise, the discount rate for stocks will also rise, thereby decreasing the future value of their earnings. In this scenario, companies with the highest earnings growth rates would experience a greater decline in earnings than those with more modest but stable earnings growth.

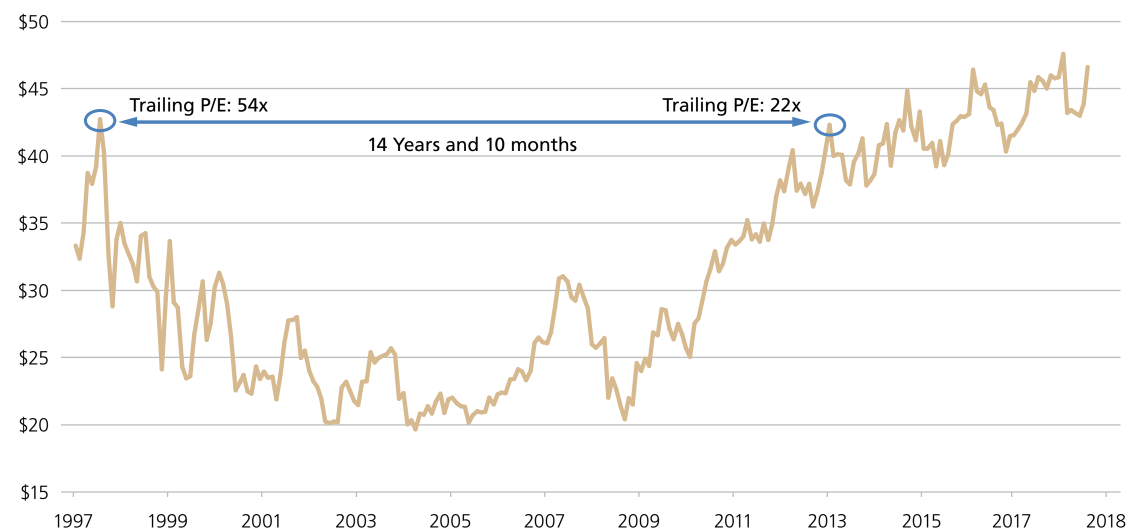
Our portfolios are positioned based on our many years of experience investing in global markets and on the following lessons which we have learned through various market cycles.

[1] Earliest date we have data for both the S&P 500 Index earnings yield and U.S. 10-year treasury yield
[2] As of February 28, 2021
[3] As of February 28, 2021

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. The stock went down 60% in the technology downturn. The company actually grew earnings over the period and the stock price decrease was purely a result of valuation. These were both quality companies, so the question these examples raise is "what is the right price"?

Coca-Cola Company



Source: S&P Capital IQ

Microsoft Corporation

Source: S&P Capital IQ

"Price is what you pay. Value is what you get." ~ Warren Buffet

Generally, most of a company's value comes from its expected future earnings. The average valuation of the overall U.S. equity market (S&P 500 Index) since 1935 is 16.3x P/E[4] based on an expected earnings growth rate of 4 to 5%. For comparative purposes, an earnings growth rate of 10% equates to a valuation of 25x P/E[5] and a 15% earnings growth rate is worth 36x P/E. Some companies have grown at high rates for long periods of time – for example Alphabet and Facebook have grown sales at a compound rate of 20% and 46% respectively over the last 10 years – however this is a rare feat.

Investors who overpay for quality have generally based too much of their assessment of a company's intrinsic value on the strengths of the past versus the challenges to future growth. In the case of Coca-Cola in 1998 and Microsoft in 2000, the valuation multiples of 54x and 69x P/E were not commensurate with the future earnings growth the companies ended up generating, and the price of these companies declined. These are examples of times where investors overpaid for quality. The lesson is that if the growth rate is overly optimistic, paying too high (or too low) a valuation multiple will not protect investor capital.

Lesson #2: Balance sheets act as a multiplier

All else equal, if there is a lot of cash on a company's balance sheet, a change in earnings has less of an impact on enterprise valuation. Conversely, if there is a lot of debt on the balance sheet, then the impact on enterprise valuations is magnified. Having zero debt or net cash also gives a company more flexibility on their balance sheet.

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

In a normal recession, the market tends to favour companies with zero debt or net cash on their balance sheet over those with lots of debt. However, this has not been the case during this health-related recession (at least thus far) due to the swift intervention and unprecedented monetary and fiscal support measures from governments and central banks globally. It is important to remember that market reactions to a recession typically last between 12 and 18 months, so the role of debt is not yet clear. As a result, we continue to favour companies that have no debt, or net cash. If they do have debt, we look for companies with resilient earnings streams.

Lesson #3: The importance of stable earnings growth

Historically, companies with more cyclicality to their earnings streams bore the full brunt of a significant correction. As you can see in the table to the right, industrial companies' earnings declined significantly during the last two recessions as well as the current one. However, the unique, pandemic-induced recession was the only time in history when earnings growth for digitally enabled companies outperformed that of more defensive consumer-facing companies in a downturn. Information technology companies' earnings were down 125% from 2000 to 2002 but were slightly positive during the two most recent crises. While earnings of companies in the consumer staples sector were resilient during all three periods, their growth lagged information technology companies this time around.

Sector EPS Growth (%)			
	2000 - 2002	2007 - 2009	2020
S&P 500 – Industrials	-15.2%	-33.0%	-52.2%
S&P 500 – Information Technology	-125.2%	+3.8%	+7.9%
S&P 500 – Consumer Staples	+28.7%	+7.9%	+3.0%

Source: S&P Capital IQ

In 2020, we believe our portfolio was invested in companies with more resilient earnings performance on average than the overall market: we expect our holdings to have generated average earnings growth of 3% in 2020 while earnings for companies in the MSCI World Index[6] are expected to have contracted by 14%. Yet, despite this better expected earnings performance, our portfolio returns lagged the market in 2020 and this begs the question: Is earnings growth stability still important? We believe the answer is yes, and that this will become more apparent as we progress through and eventually recover from this recession.

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[4] S&P Dow Jones Indices.

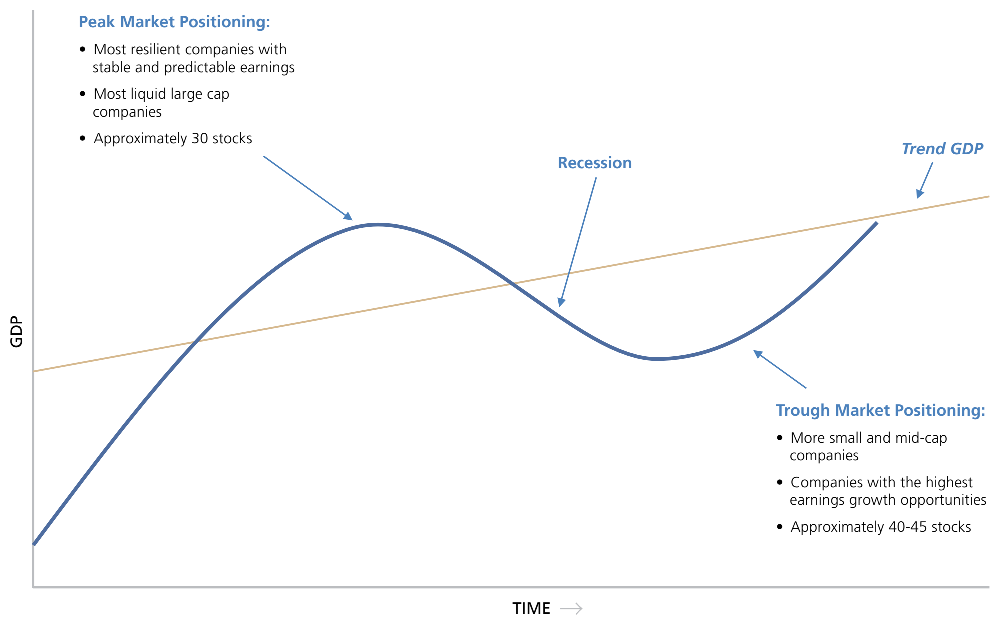
[5] Earnings growth rate over the next 10 years at an 8% discount rate.

[6] Includes only companies with positive earnings.

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. In a downturn, we want to take advantage of market volatility to invest in smaller cap companies that will have faster growing earnings as the economy recovers and that will continue to outperform over the subsequent decade. In an effort to protect client capital during periods of elevated valuations, we opt to own larger companies with slower but more resilient earnings growth than the market while maintaining our lower (better) valuation.

As you can see from the diagram below, investors should expect our strategy to become less concentrated through the recessionary period as we add smaller cap stocks that are selling at a greater discount to their intrinsic value. In 2018, when we wrote the original version of this white paper, valuations were at "peak market" levels and our portfolio was consequently invested in a highly concentrated collection of 30 companies. The events of 2020 allowed us to take advantage of market weakness to initiate positions in companies on our "dream team" list whose share prices fell to levels at which we are comfortable owning them. The number of holdings in our portfolio has increased to 46, which is consistent with what our investors would expect of our positioning in a "trough market." The positions we added should ensure our portfolio is well positioned to deliver strong earnings growth over the next number of years, at valuations that are more attractive (less expensive) than the market.



We are always open to learning new lessons. There is still some time to go before we recover from this recession and only then will we know whether this time was actually different. In the meantime, our strategy aims to invest in a collection of companies with resilient earnings that are growing faster than the market, that have zero-to-low debt or net cash on the balance sheet and valuations that are on average less expensive than the market. We believe these qualities will better protect capital and that capital protection remains the best means to deliver long-term outperformance for our clients.

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