Vancity Investment Management Insight

RESPONSIBLE INVESTING NEWSLETTER – MARCH 2017

Vancity Investment Management

iA Clarington™ Investments
be invested

Wheels in motion

Big changes are happening in the transportation industry as a result of car sharing, ridesharing and the development of self-driving vehicles. Over the next few years, we expect society's fundamental relationship with the car to undergo a profound realignment. These changes are likely to have a positive impact on urban design, the global environment and the economy. From the environmental perspective: it is none too soon.

Transportation and transportation fuels are very significant sources of greenhouse gases, accounting for 36% of Canada's emissions. In 2014, road transportation resulted in 140 mega-tonnes (MT) of direct emissions, while the production and processing of petroleum products for domestic use and export resulted in a further 125 MT. The U.S. Energy Administration estimates that 25% of the world's energy is used to transport people and goods. So it's no surprise that more than 65% of the world's oil production is used as fuel for transportation. Addressing climate change means reducing our demand for energy, and changing the way we use automobiles for personal transportation is key to reducing that demand.

Until recently, automobile ownership in North America has been seen as a measure of individual success, much like owning a single-family detached home. Significant advertising dollars are dedicated to increasing our desire for new vehicles. In the U.S. alone, GM spent $3.5 billion on advertising in 2015 to sell 3.6 million cars – roughly $1000 for each car sold. And for many, particularly those who live in suburban communities, car ownership is essentially a necessity. Whether it's out of need or desire, today there are approximately 250 million cars and trucks on the road in the U.S. and 33 million in Canada.

However, we believe the entire transportation sector is entering a period of transition due to technological change, new business models and changing behaviours.

Car sharing companies such as MODO car co-op, Car2Go (owned by Daimler Chrysler) and ReachNow (owned by BMW), along with other pay-as-you go car rental companies, are making the idea of not owning a car a realistic possibility for more people, at least in major urban areas. Ridesharing software, which helps match drivers and passengers through phone Apps, GPS systems and networks, is also making car ownership optional. While Uber is the most high-profile ride-matching company, there are dozens of other ventures underway. In 2016, Apple invested $1 billion in the world's largest ride-matching company, Didi Chuxing, which provides these services in China. The company claims that in one year its ride matching services resulted in one million fewer road trips per day, saved 500 million litres of gas and avoided 12.3 million tonnes of greenhouse gases.

Car companies recognize the potential disruption to their industry and several have developed partnerships or directly invested in these ride-matching companies. GM invested in Lyft and purchased the assets and intellectual property of SideCar. Volkswagen invested in Gett Taxi, Toyota made a direct investment in Uber and BMW invested in Scoop, a ride-matching company operating in San Francisco. Ford Smart Mobility acquired Chariot, a ridesharing shuttle service, and Honda invested in Grab, a ridesharing service in Southeast Asia. These companies clearly see the need to adapt to the broad pattern of change that is well underway.

We are also witnessing the development of self-driving vehicles for personal transportation and freight delivery. The artificial intelligence underlying these developments has the potential to completely alter the pattern of fuel consumption, reduce emissions and decrease personal injuries and fatalities.

Since 2015, California has issued permits to 11 companies for road testing autonomous vehicles. Waymo, owned by Alphabet Inc., uses lasers and sensors to allow its artificial intelligence system to guide self-driving vehicles on city streets. Waymo vehicles have logged 635,000 miles on state roads, far more than any competitor. While these vehicles may not be on the road in the next six months, over the next couple of years they are quite likely to be found on city streets and highways.

Toyota, the world's leader in production of hybrid gasoline-electric vehicles, recently allocated $1 billion towards a research institute dedicated to autonomous vehicles and robotics. Toyota has already produced over 10 million hybrids and estimates that these vehicles have reduced gasoline consumption by 25 billion litres and avoided 54.5 mega-tonnes of greenhouse gases. While the hybrid is a dramatic improvement over the conventional automobile engine, coming generations of vehicles will likely see further improvements through the use of artificial intelligence features for defensive driving and fuel optimization.

There are also significant changes in how vehicles are powered. In 2015, there were 1.3 million electric vehicles on the road – double the number from 2014. But make no mistake: these are not emission-free cars, as emissions are associated with all aspects of manufacturing the vehicle and electricity generation. But electric vehicles represent significant gains in the efficiency of power consumption when compared to internal combustion engines. Electric vehicles also eliminate the need for motor oil. Consumer electronics giant Panasonic is responsible for 40% of the battery market for electric vehicles and is in partnership with Tesla to develop advanced power storage systems.

The strategies and investments being deployed by industry leaders are a good indicator that a dramatic shift is occurring. We believe the cumulative impact of these changes will reduce the consumption of fossil fuels and help create a lower carbon economy – a necessary step in the fight against human-induced climate change.

Alphabet Inc., Apple Inc., BMW, Panasonic Corp. and Toyota Motor Corp. are held in the IA Clarington Inhance Global SRI Class (as of February 28, 2017).

Dermot Foley, CFA, is Portfolio Manager – ESG Analysis at Vancity Investment Management Ltd. He takes a lead role in analyzing the environment, social and governance (ESG) risk of companies for the IA Clarington Inhance SRI Funds.

Economic and market commentary

The bull market for stocks recently celebrated its eighth birthday from the lows of March 2009. It's the third-longest expansion and the twenty-third bull market for the S&P 500 Index since 1928.

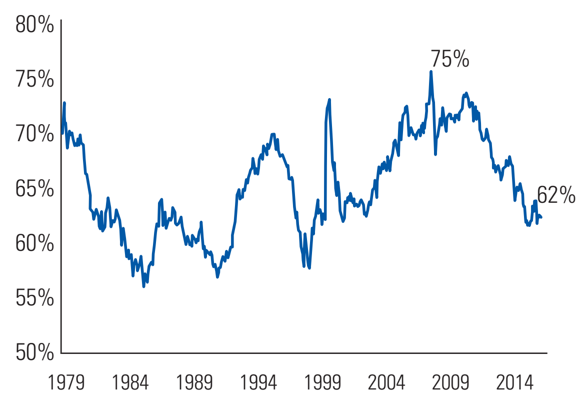
Despite all the economic and political noise, global growth, continues to strengthen in 2017. Optimism in the U.S. is driven by expectations that the Trump administration will deliver on tax cuts, deregulation and infrastructure spending. Although we may be in the latter phases of this economic cycle, implementation of some or all of these initiatives should have a positive impact for U.S. and international stocks, including Canadian equities.

Following five years of underperformance relative to other developed markets, Canada bounced back strongly in 2016. One of the drivers of this strength was a recovery for commodities that followed a period of significant underperformance (in some cases reaching decade lows). Let's not forget that 2016 also brought us Brexit, the U.K.'s surprise vote to exit the European Union. The decision initially caused a negative shock across global markets, but the decline was short-lived, as most markets regained their momentum fairly quickly. Brexit proved to be a wake-up call for politicians on the growing populist movement in Europe. Governments also realized they could no longer rely on monetary policy alone, and as a result we started to see announcements of fiscal stimulus plans to support growth. Canada's infrastructure announcements last year led that charge.

The U.S. had been a laggard on the fiscal front. Trump's election promises of tax cuts for both corporations and individuals, deregulation and infrastructure projects heightened expectations for equity markets. We are waiting for signs that these promises, which the market has largely priced in, will translate into policy decisions.

We believe Canada remains well positioned for continued growth, regardless of the magnitude of announcements in the U.S. Performance for the S&P/TSX Composite Index relative to the S&P 500 Index has been positive when key macro indicators have been strong. These indicators include solid commodity prices, rising inflation expectations and positive global growth (particularly for the U.S. and China). Global PMIs (purchasing manager indices) have been pointing toward improving manufacturing activity for some time now, supporting the view that global growth has been improving. This a positive for Canada as the S&P/TSX Composite Index generates roughly 62% of its revenues from outside Canada.

Estimated percentage of S&P/TSX Composite Index revenue and earnings that comes from outside Canada



Source: RBC CM Canadian Equity Strategy; RBC CM Quantitative Research, as of December 31, 2016.

Note: Calculation is based on current revenue percentages that come from outside Canada for all sectors except for Energy and Materials held constant for entirety of period above and weighted according to changes in weights for each sector in the index. Energy and materials are assumed to be 100% outside Canada, as commodity prices are globally driven and are not subject to domestic forces.

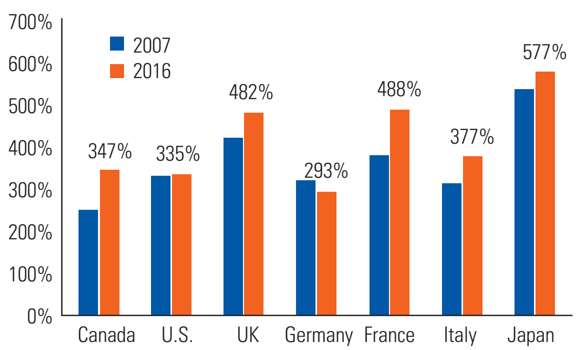
Positive macro factors have supported earnings growth and analyst estimates have generally been on the rise. This brings us to valuations, where Canada can sometimes experience distortions as a result of the composition of its market. The long-term average price-to-earnings (P/E) multiple for the S&P/TSX Composite Index is roughly 17.9x, while currently we sit somewhere around 22.6x 2016 earnings. This appears high, but since one-third of the index is in resources, which have suffered depressed earnings, we are inclined to consider an adjustment that excludes that part of the market. Factoring the adjustment, the P/E multiple on last year's earnings drops to 16.7x, which is much closer to the long-term ex-resources average of 15.3x. In sum, we remain comfortable with valuations, especially in a context of persisting tailwinds.

But risks remain. The two that Canadian strategists talk about most are trade risk and domestic risk. Trade risk refers to the potential negative impact of protectionism and a border-adjusted tax. Risk stemming from protectionism would take the form of potential trade disputes between the U.S. and China, which could have a negative impact on commodity prices and investor sentiment.

Domestic risk in Canada relates to high consumer debt levels, house prices and the competitiveness of Canada in the global marketplace. While domestic debt-to-GDP ranks in the mid-range of G7 markets at 347% – in line with the U.S. and below Japan's 577% – concerns remain regarding Canadians' personal leverage. Of G7 countries, Canada now has the highest household debt-to-disposable income (the U.S. is at 102%, while Canada has reached 165%). Housing is a major factor here. For example, home prices in Vancouver are still up double digits year-over-year, though they have declined roughly 6% since August 2016.

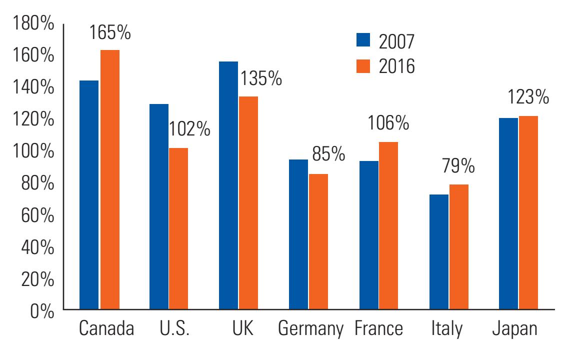
We believe the balance of risk versus return at this point in the economic cycle still favours maintaining your target equity allocation as part of a diversified long-term investment portfolio.

Total domestic debt to GDP



Source: Haver Analytics; RBC CM Canadian Equity Strategy, as of December 31, 2016.

Household debt-to-disposable income – 2007 vs. 2016



Source: Haver Analytics; RBC CM Canadian Equity Strategy, as of December 31, 2016.

Andrew Simpson, CFA, is the Portfolio Manager at Vancity Investment Management Ltd. He takes a lead role in the portfolio management of the IA Clarington Inhance SRI Funds.

We are iA Clarington.
And we will be invested in you.

As one of Canada's leading investment management companies, iA Clarington brings clarity, integrity and commitment to a complicated global investment landscape. We believe passionately in the value of active management, the investment products we deliver, and the importance of maintaining unwavering attention to both the big picture and the smallest details. Home to a number of highly respected portfolio management teams, together, we earn the trust of advisors and investors by bringing diverse investment views forward through our broad selection of offerings.

As a wholly owned subsidiary of Industrial Alliance Insurance and Financial Services Inc. – Canada's fourth-largest life and health insurance company – iA Clarington offers a wide range of investment products, including actively managed mutual funds, managed portfolio solutions, socially responsible investments and target date funds.

Vancity Investment Management

iA Clarington™ Investments
be invested

522 University Avenue, Suite 700, Toronto, ON M5G 1Y7 | 888.860.9888 | funds@iaclarington.com | www.iaclarington.com

(17-0300) 03/28/17