Vancity Investment Management

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What counts in the long run, price or value?

Over the past year, there have been plenty of headlines concerning historic highs for stock market indexes. These stories create both elation and anxiety, since investors know expensive markets can come down as quickly as they go up. But what does a market index represent? By providing a snapshot of share price values of the largest companies, the index tells us what investors are feeling about the direction of the overall economy. We say it's a snapshot because individual investors cannot simultaneously capture the current share price of each company, since the price will move based on the actions of each buyer and seller. If there are more buyers the price goes up, more sellers and it falls. At its most basic level, share price is an indicator of what today's buyers and sellers think of how the company will perform under current economic forecasts.

A company's real, or intrinsic, share value is much more than just the market price. It is based on future cash flows plus the value of the company's existing assets, minus liabilities. That real value is where environmental, social and governance (ESG) factors can have the biggest impact.

Managing environmental risks such as hazardous byproducts requires diligence and systematic oversight to protect the financial value of operating assets. Environmental risks can foster opportunities to use preventive measures and diversify towards less damaging products, processes or services. As social preferences and choices evolve, company revenues are impacted and some lines of business may be discontinued and replaced. Good governance by the company's board helps ensure assets are used appropriately to create long-term value, while considering the impact of evolving social and environmental factors, including climate change. How companies present ESG information has become increasingly important for mainstream investors, including mutual funds, pensions and endowments.

Many rating agencies evaluate the quality and depth of information companies provide on their ESG programs, policies and impacts. These ratings can inform investor decision making (e.g., trim, add, buy, sell or hold the company's securities) and influence the performance of a company's stock.

A growing body of evidence suggests ESG factors contribute to long-term company value. A recent academic study[1] reviewed a number of ESG and financial performance measures over a 10-year period for companies listed on the S&P 500 Index, which represents the 500 largest public companies in the U.S. The study examined the use of corporate social responsibility (CSR) goals as a component of executive compensation. The authors found that companies that include ESG metrics in executive compensation goals perform better across a number of measures. Companies incorporating CSR compensation have a longer-term strategic orientation, which is believed to promote enhanced decision making around value-creating project investment. Over the period covered in the study, these companies increased firm value and had better CSR performance, particularly with respect to the environment. In particular, they decreased emissions and increased green innovation for pollution reduction and recycling.

Over the last decade, we have been involved in many initiatives to encourage companies to address ESG risks and report on their ESG risk management strategies and programs. We recently called on Vermilion Energy and ARC Resources to provide better disclosure on water use, treatment and disposal, with a focus on the CDP Water Disclosure initiative. We also joined the Workplace Disclosure Initiative (WDI) launched by ShareAction in the UK, in partnership with the Shareholder Association for Research and Education in Canada.[2] The WDI is encouraging companies to provide investors with more information on the composition, stability, training and engagement of the direct workforce as well as those employed across the supply chain.

Whether it's carbon emissions, water use, supply chain issues, employee engagement or fair compensation, investors are better off when companies provide this information. We believe companies that proactively demonstrate how they manage ESG risks and opportunities are much more likely to earn the confidence and trust of long-term investors.

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.

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[1] Caroline Flammer, Bryan Hong and Dylan Minor, "Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes" (September 10, 2017). Available at SSRN: https://ssrn.com/abstract=2831694. [2]https://shareaction.org/wdi/

Is the equity run losing steam?

Global equities have had a good run, with year-to-date returns exceeding most investors' forecasts. Understandably, there are growing concerns that a bear market may be upon us.

Cutting through market noise and political distractions is one of the biggest challenges to maintaining a long-term investment strategy. We focus on the underlying economic fundamentals to guide our asset allocation strategy. In our assessment, market fundamentals still support the view that equities can counterbalance evolving headwinds and still have room to perform well in 2018.

We highlight five supporting points:

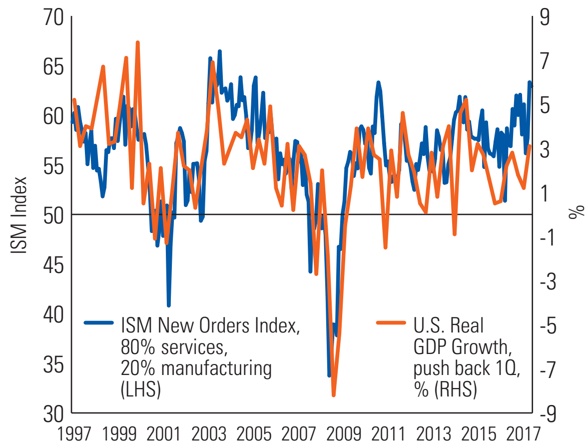
1. Macro backdrop remains positive
2. Strong earnings outlook for 2018
3. Equities still appear attractive relative to bonds
4. Ample room for inflows into equities
5. Absence of tell-tale signs of recession

1. Macro backdrop remains positive

The largely synchronized economic recovery since the financial crisis is reflected in strong GDP growth across all regions. The percentage of countries reporting a purchasing managers' index (PMI) above 52 (a PMI above 50 indicates economic expansion) is now the highest since the financial crisis and consistent with healthy global GDP growth of 3.5%. We continue to be encouraged by these figures because the global economy has had to navigate a number of headwinds to GDP growth since the financial crisis, including: restrictive fiscal policies; emerging market slowdowns (China, India) and recession (Brazil, Russia); numerous European crisis points (PIIGS, bank deleveraging); a significant downturn in commodities; financial sector stress testing and regulation that revised leveraged business models and capped credit supply.

The ISM New Orders Index shows that capital expenditures have been rising. This increased level of business investment continues to support GDP growth. Unemployment has fallen and capacity utilization has risen above long-term averages.

ISM New Orders Index vs. U.S. Real GDP Growth



Source: Bloomberg as at October 31, 2017.

2. Strong earnings outlook for 2018

We believe the majority of equity gains have been driven by earnings and not multiple expansion. If the earnings component of a company's price-to-earnings ratio rises, the share price will have to rise to keep the valuation multiple constant. With multiple expansion, investors are willing to pay more for an expected future earnings stream.

The earnings outlook for 2018 continues to be favourable. We expect earnings-per-share growth in the high single digits, which is still ahead of any wage growth pressures. The recent corporate earnings season appears to support this projection, with 71% of companies in the U.S. beating expectations.

3. Equities still appear attractive relative to bonds

The equity risk premium – the excess return that investing in the stock market provides over a risk-free investment, such as government treasury bonds – is still quite attractive. However, we believe this premium will narrow over time as both bond yields and equity prices rise.

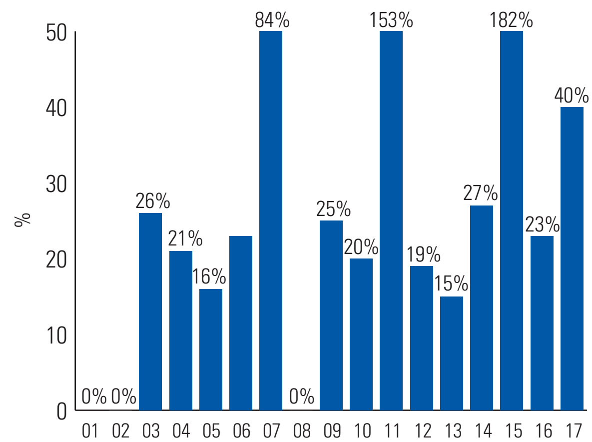
4. Ample room for inflows into equities

We think money on the sidelines will flow mainly into equities. One Credit Suisse strategist calculated that since 2009's market lows, there has been US$600 billion of inflows into global equity funds and US$1.8 trillion into global bond funds. As pension funds review their asset allocations, the lower volatility of stock market returns may lead them to increase their equity weightings. Current pension fund equity allocations are estimated to be well shy of prior peaks and only approaching long-term averages.

5. Absence of tell-tale signs of recession

The New York Federal Reserve Bank's recession probability model is at 8%. Historically, when the recession probability rises above 20%, equities begin to show some stress. Market peaks are often associated with narrow leadership or declining market breadth. In other words, performance is being driven by a small number of stocks. Today, despite the performance of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google), market leadership in 2017 has not been an outlier. The chart below shows the contributions of the top 10 stocks to the S&P 500 Index in positive return years.

Share of gains accounted for by top 10 stocks (in SPX up years)



Source: Bloomberg as at October 31, 2017.

No one can pinpoint a market peak in advance, but the fundamentals appear to indicate a continued economic expansion driven largely by corporations delivering decent earnings growth.

Investors will continue to benefit from sticking to their long-term investment strategy and prudently rebalancing to their target asset mix.

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.

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