Investing in Equities in Today's Growth Environment

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The high valuation of equity markets in recent years—especially U.S. equities—has been a constant point of vigilance for us, not because we have a distinct edge at the macro level, but because equity market exposure usually represents the most significant component of portfolio risk. Our major concern is with the potential for non-rational behavior to create excesses which may have systemic portfolio consequences.

In short, while equity market levels represent no bargain relative to history, given growth expectations and low interest rates we do not view them as extreme. The premium being paid for future growth does, however, create heightened vulnerability to earnings disappointments. This vulnerability is a source of opportunity as well as risk, making it a particularly important time to invest based on bottom-up fundamentals.

That we are in a period of strong anticipated earnings growth is evident from the data in **Exhibit 1**. Over the 24-month period comprising this year and next (2017 and 2018), analysts are estimating earnings per share to increase by 32% for U.S. equities, 37% for non-U.S. developed equities, and 37% for emerging equities. About a quarter of this projected growth has already been realized in the first half of 2017, and it obviously will be a very positive outcome if the fully anticipated EPS are realized.

Exhibit 1: Earnings Growth, Forward P/E Ratios, and Forward Earnings Yields[1]

		U.S. Equities	Non-U.S. Developed Equities	Emerging Market Equities
(1)	**24 month estimated EPS growth (FY 2018 versus FY 2016)**	32%	37%	37%
(2)	**Estimated 2018 EPS vs pre-financial crisis peak EPS**	50%	-20%	11%
(3)	**P/E on estimated 2018 earnings**	19.3 x	14.8 x	11.7 x
(4)	**Earnings yield (based on estimated 2018 EPS)**	5.2%	6.7%	8.6%

[1] Source: HighVista Analysis.

For context, an increase of U.S. EPS by 32% would rank in the top 25% of two-year earnings gains since 1900 (inflation adjusted). Moreover, U.S. EPS in 2018 are forecast to be 50% above their pre-financial crisis peak EPS levels (**Exhibit 1, line 3**). By contrast, for non-U.S. developed equities, forecast EPS for 2018 will be well below their pre-crisis peak levels; for emerging equities, they will be only 11% above their pre-crisis peak levels. The U.S. vs non-U.S. disparity is explained partly by the strength of the U.S. dollar since 2008.

While corporate earnings appear to be very robust, real bond yields continue to remain historically low. Long-dated (30 year) U.S. inflation protected bonds are yielding only 0.92% p.a. today, some 2.5% p.a. below the historical average real return on bonds. Discount rates for equity earnings therefore should be lower—and P/E ratios higher—than their historical average levels. Today's forward-looking P/E ratios (**line 3**) are not extreme when viewed in this context. Said another way, if the earnings estimates are realistic, equities continue to offer earnings yields (**line 4**) significantly greater bond yields.

With so much riding on future growth, we like that our portfolio is globally diversified, with a strong reliance on bottom-up security selection achieved primarily through external manager investments. At a high level, our external managers are business analysts who fundamentally research and evaluate companies and industries, aiming to own those that offer the best long-term risk-reward trade-off. Some of their positions are, in fact, higher multiple equities, but whose valuations they consider reasonable for market leaders with outsized and sustained future growth rates of earnings. Some of our managers also have significant short positions in stocks they consider to be overvalued and with dim business prospects, including "growth" stocks they deem to be anything but. Our managers' ability to underwrite their positions and the confidence they have to be invested in them for the long term is particularly reassuring for us in this market environment.

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