An Update on the IA Clarington Global Equity Fund

Mathew Hermary
Portfolio Manager
QV Investors Inc.

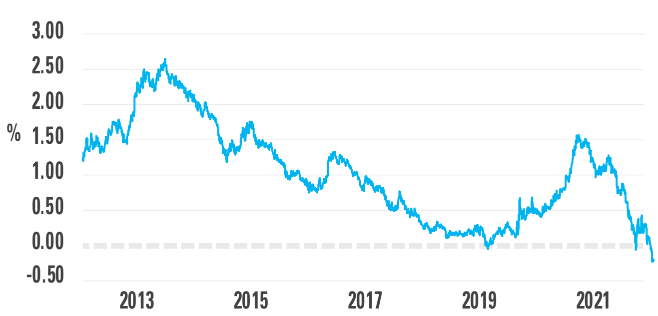
Funds managed:
IA Clarington Global Equity Fund
IA Clarington Global Equity GIF
IA Clarington U.S. Equity Currency Neutral Fund
IA Clarington U.S. Equity Class

Has recent market volatility changed your near-term outlook?

- We spend the majority of our time focusing on the mid- to long-term (3–5 years). We think about how our holdings are going to evolve and what their earning power is going to be over that timeframe.
- But we have been circumspect on the outlook for the economy for some time now. Persistently high inflation and very aggressive central bank rate hikes have rarely resulted in good outcomes for the economy.
- The yield curve is currently inverted, and historically this has been a strong indicator of future recessionary risks. Since the beginning of the post-World War II era, an inverted yield curve has been followed by a recession (after about 24 months) in around 90% of cases. On that basis alone, investors need to be careful about paying too much attention to current earnings without thinking about some of the risks in the broader economy.

U.S. Yield Curve

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



Source: Federal Reserve Bank of St. Louis, as at July 25, 2022. Data is daily and non-seasonally adjusted.

How does this impact growth versus value?

- Value is still trading very cheaply relative to growth on an historical basis. So, we certainly think that we are still in the earlier innings of a rotation.
- There are two important factors at play today that were not in place in the prior decade: higher interest rates and higher inflation. We think both will help drive down excessive values in the growth space and fuel mean reversions in the top lines of many value-oriented businesses.

Value vs. Growth Relative Valuations

Relative forward P/E ratio of value vs. growth, 1997 to present

Source: JP Morgan Guide to the Markets, as at June 30, 2022. Growth is represented by the Russell 1000 Growth Index; value represented by the Russell 1000 Value Index. *Long-term averages are calculated monthly since December 1997.

How are you positioned within consumer discretionary?

- If you look at the sector more broadly, it is typically hit hard during periods of market decline or economic weakness. Over the last four recessions, the sector has fallen by around 40% on average.
- The fund currently has a significant weighting to consumer discretionary, but about 85% of it is in businesses that have very staple-like products. Because they are selling everyday products that people need throughout an economic cycle, these companies have very persistent cash flows. This translates into lower volatility over time.

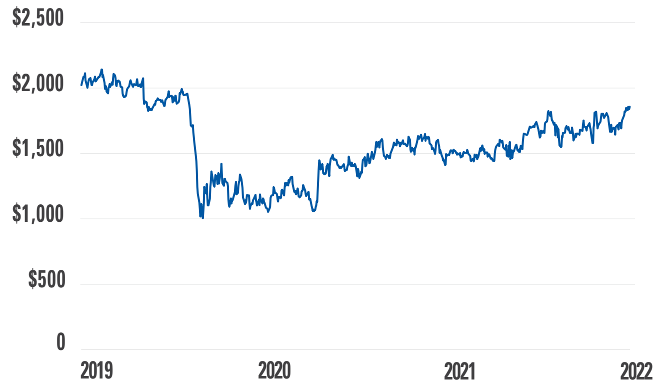
IA Clarington Global Equity Fund

Sector	Weight
Consumer discretionary	17.9%
Health care	17.1%
Financials	14.0%
Consumer staples	12.5%
Energy	8.3%
Communication services	8.2%
Information technology	7.1%
Industrials	5.4%
Materials	1.6%
Cash and other net assets	7.0%
Treasury bills	1.0%

Source: iA Clarington, as at June 30, 2022.

- A good example is U.K.-based Compass Group PLC, the largest caterer in the world and our largest holding within consumer discretionary. When there is weakness in the economy, the company will experience a deceleration in growth, but its top and bottom lines remain very resilient. For instance, during the financial crisis of 2008, growth slowed to 0% for a year before returning to high-single-digit rates. This exemplifies the resilience that is characteristic of our consumer discretionary holdings.

Compass Group PLC



Source: Bloomberg, as at July 25, 2022.

Is the recent correction in equities justified?

- We think the selling was justified where market prices were being underwritten by long-dated growth expectations alongside historically low discount rates. This was concentrated within the technology sector, but there were many businesses in other areas – industrials, consumer discretionary and even financials – where over the last year prices and valuations have come down 30–40% or more from recent highs. Even after that decline, many of these businesses are currently trading at their long-term average price-to-earnings (P/E) ratios. So, valuations are by no means at depressed or distressed levels.
- We are starting to see opportunities and have been deploying capital as prices have fallen. A recent addition to the fund is Germany-based SAP SE, the largest enterprise resource planning software provider in the world. The company is currently turning its existing offering into a cloud-based offering, which we think is going to help drive double-digit earnings over the long term. We bought SAP at around 16–16.5× earnings, which we think is attractive for a business with such persistent growth over time.

SAP SE

Source: Bloomberg, as at July 25, 2022.

In your view, are equity markets cheap from a global perspective?

- After the decline we saw in the first half of the year, P/E ratios for the global market and within the U.S. are back to long-run averages. So, they are neither high nor low.
- But you have to look deeper than the headline P/E to get a better understanding of valuations. You also have to focus on earnings. Currently, earnings expectations are at all-time highs and are expected to continue higher. Corporate profit margins also remain near all-time highs. If we go back to around 1970 and look at the long-term upward trend in U.S. earnings, what we find is that the current level of earnings is almost as far from trend as it has ever been. So, even though the P/E for the market may look reasonable, we think there is some risk – especially given the issues we see in the macro environment – that earnings may not be as supportive as we would have hoped.
- The fund has one of the largest valuation advantages relative to the index in its history. Also, the earnings generated by the companies we hold are more sustainable; specifically, they are less cyclically extended than what we see in the broader market.
- So, we think we have downside support both from the valuations we are paying and from the underlying earnings potential of our businesses. In our view, this translates into potential for differentiated performance as well as enhanced risk mitigation going forward.

What is QV's edge relative to peers?

- We think it comes down to our philosophy and our discipline in sticking to it. We aim to own quality businesses and focus on reducing the risk of loss through balance sheet strength, long-term compounding characteristics and valuations that provide a margin of safety.
- We consistently adhere to our investment process regardless of what the market may be doing. This is a lot easier said than done, especially when the market is favouring a different approach. It requires that we stay patient and maintain a long-term focus.

Visit iaclarington.com to learn more about Mathew Hermary and the IA Clarington Global Equity Fund.

(22-1553) 08/22