

Market Perspective

2021: The Case for Conviction

For 40 years, CBIS has navigated the intersection of faith and finance for the benefit of our Catholic investors. During that long tenure, we have never experienced a year like 2020.

If there is one lesson we should take from the past 12 months it is this: Throughout the hardship, disruptions and volatility, investors who maintained conviction in their long-term investment strategies were rewarded. We all experienced the strong temptation to abandon equity markets at the inception of the global pandemic last spring. In the subsequent months, we witnessed the power of a disciplined investment process. Investors who abided by their investment policy statements, retained faith in their investment approaches, and avoided the pitfalls and temptation of tactical market timing, emerged from the crisis intact.

At the start of 2021, many of us are experiencing a similar temptation to veer from our long-term strategies. Major global stock indices, particularly in the U.S., have reached or approached all-time record levels. This performance has many investors

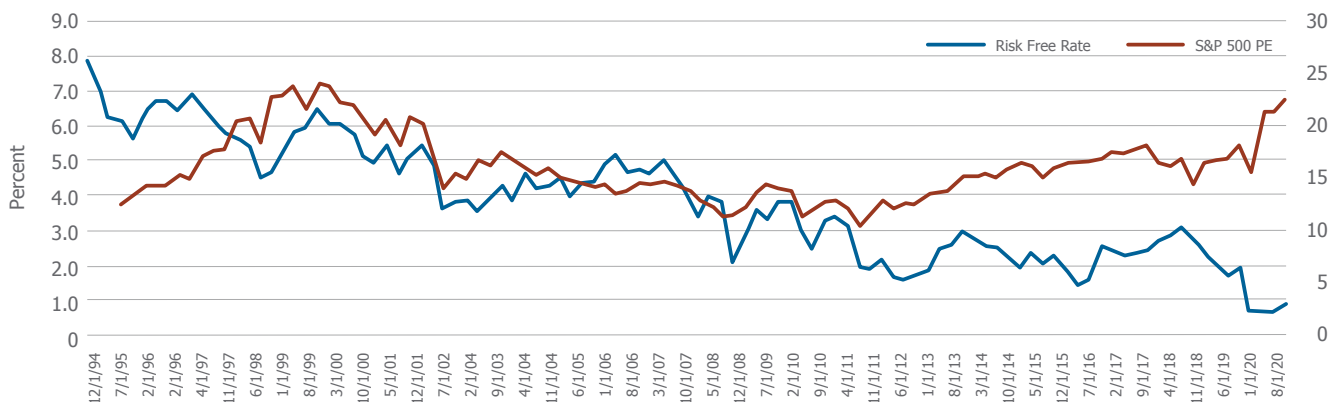
wondering whether equities can continue to generate positive returns. These concerns are based in part on the rapid increase in price-to-earning (P/E) ratios, which, when viewed in isolation, do seem to suggest that the market is broaching over-valued levels.

Given that signal, the urge to tactically allocate away from equities is strong. However, when we look at the facts and consider valuations in the context of the global macro environment, we find the case for maintaining long-term investment strategies is still stronger.

Using the popular Gordon Growth Model, the current price of a stock equals the present value of anticipated future earnings. The interest rate one uses to discount those earnings has a significant impact on the results.

$$\text{CURRENT PRICE OF STOCK} = \text{PRESENT VALUE OF ANTICIPATED FUTURE EARNINGS}$$

CHART 1
S&P PE vs Risk Free Rate



Source: FactSet

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When evaluating stock prices, investors tend to forget a crucial variable: interest rates. Low levels of risk-free interest rates—driven by any combination of low inflation expectations, buying activity by

Central Banks or other macro-economic factors—will cause P/E to increase. That's exactly what we're seeing today.

Low Interest Rates Can Lead to High P/E Ratios

To demonstrate the sensitivity of P/E ratios to interest rates, we can calculate P/E ratios under different assumptions for the broad market. Consider the following scenarios:

- When the risk-free rate is 4%, the equity risk premium is 5% and the earnings growth rate is 3%, the P/E ratio for the market is 16.7. Those inputs are close to historic averages, as is the resulting P/E ratio.
- If the equity risk premium and earnings growth rate remain unchanged, but the risk-free rate declines from 4% to 1%, as it is now, the P/E would now be 33, higher than current levels.

So when trying to determine if stocks are overvalued at current levels, it's necessary to consider P/E ratios not just in aggregate, but also in the context of the interest rate environment. We can do this by using price and earnings expectations for this year to compute the implied growth rate of the market and sectors, and

comparing them to historic averages. Using this methodology, we find that, at current prices, the implied perpetual growth rate for the broad market is actually quite muted, both on an absolute and historical perspective.

CHART 2
Implied Growth Rate – S&P 500



Source: FactSet

What does this mean? Given extremely low interest rates worldwide, we believe investors should not be overly alarmed by P/E ratios on global equity markets. In fact, in spite of current valuations, we see some attractive opportunities. For example, as we enter 2021, the Growth versus Value valuation differential

remains stretched. In particular, the European Value sector is trading at levels that imply negative earnings growth in perpetuity. Is it reasonable to expect that companies in the European Value sector will decline by 50% over the next 20 years, or that these companies will be on the verge of extinction? We don't think so.

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Investors can take advantage of these opportunities by adhering to investment and risk management fundamentals. Our equity sub-advisers are accessing opportunities within their respective markets by focusing on companies with sound, competitive business franchises with strong balance sheets, whether they be growth stocks or value, large or small. Fixed income portfolios are allocating capital using similar criteria and finding opportunities in corporate debt, especially in the lower bands of the investment-grade sector and the higher bands of the below investment-grade sector.

Given global macro-economic conditions, we see no reason to expect any dramatic increase in interest rates in the next 12-24 months.

In that environment, we believe that at current price levels, equities would remain fairly valued and attractive relative to fixed income.

But make no mistake, volatility and uncertainty continue to rule the day. Since we know that periods of underperformance can occur, we continue advocating exposure to a broad range of return drivers. Consistently applied, that approach benefited our investors in a tumultuous 2020, and will continue doing so going forward.

As important as portfolio returns are to our investors, we recognize the equal importance of generating a corresponding social and ethical return without compromise. We've discussed the financial opportunities available to investors. We see opportunities of equal magnitude for investors to advance our Catholic mission. In particular, we believe we can increase the impact of our Catholic Responsible Investing by enhancing our ability to implement our principles into our portfolios.

We all understand the basic concept of negative screening in a portfolio: do no harm. But we must recognize that avoiding harm is not enough. We are also called to stop harm. However, moving from the relatively simple process of negative screening to a more positive approach, stopping harm requires a deeper understanding of companies and their practices. Getting to that understanding requires a more sophisticated level of analysis that allows one to better measure the alignment of companies to Catholic values.

This difficulty in measuring corporate alignment with Catholic principles is one of the key reasons investors have struggled to implement more positive screening into their portfolios.

CBIS employs both negative screening and efforts to effect positive change by working directly with companies to improve their policies and practices. While we are proud of the impact we've had through our activist ownership, we know we can do more.

Accordingly, CBIS has spent the last year working tirelessly to tackle the issue of how to effectively measure the alignment of companies to Catholic social teaching. Today, we are pleased to announce a significant accomplishment. As Peter Drucker once said, "You can't manage what you don't measure."

With the debut of our new Catholic Score, we can now measure the alignment of companies to Catholic principles, and more effectively manage the alignment of your investments to the Catholic faith. Stay tuned for much more information as we roll out the Catholic Score in 2021.

In the months to come we will also be studying and implementing insights from The Vatican's "Journeying Towards Care for Our Common Home" into our investment process. The important document provides new direction to assist us in our ongoing discernment of what companies and securities should make up our portfolios, and which should be excluded. This is a continual process at CBIS, and we look forward to sharing the results with you during the coming year. We are not alone in this endeavor. Most of you are aware the USCCB is also undertaking a review of its responsible investment guidelines, and we look forward to integrating their deliberations into our discernment.

Thank you all for your support as we navigated a turbulent 2020, and we look forward to serving you in 2021 and beyond.



John W. Geissinger, CFA
Chief Investment Officer, CBIS

