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Sustainable Returns

North American stock market returns over the past year have been great. Regardless of whether you are an optimist or a pessimist, it is constructive to think about where these returns have come from, and ask oneself, is this sustainable?

Equity returns over a single period can be broken down into three components:

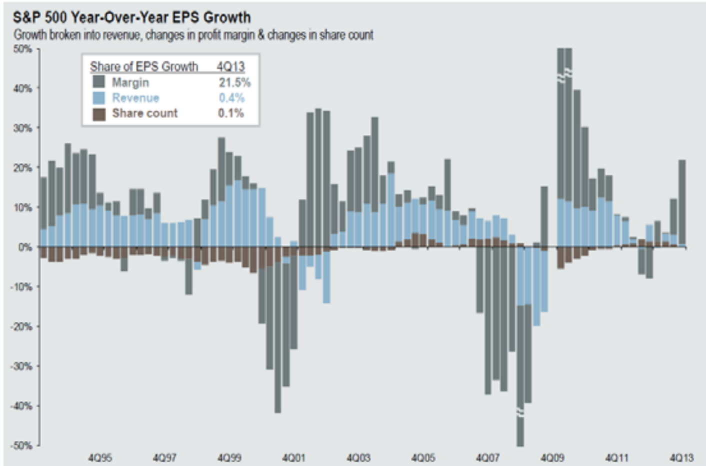
$$R_S = \text{Income return} + \text{Nominal earnings growth} + \text{Repricing}$$

Source: Investment Insights July 2002; Barclays Global Investors

Further decomposed, income return consists of dividends and cash from share repurchases, while nominal earnings, inflation and real earnings growth. Multiple repricing is the percent change in Price to Earnings(P/E) multiple over a given period. In their 2002 study of long-run prospects for the stock market, Grinold & Kroner, established that P/E repricing is the most volatile component, followed by real earnings growth. Income and inflation were found to be relatively stable components of equity returns over time.

When it comes to valuation multiples, bears point to a cyclically adjusted Shiller P/E of 25.6x compared to the long-term average of 19.1x, and argue there is 25% downside in the market to get back to average valuation levels. Bulls revert to the 15.2x S&P 500 Forward P/E at the end of the first quarter in comparison to the 20 year average of 14.9x and ask, 'What, me worry?'. Irrespective of camp, both would agree multiple repricing, on top of record profit margins have been key drivers of equity returns over the past few years. Correspondingly, with valuation expansion our caution levels have risen because of the reduced margin of safety.

In light of this, the market needs to continue delivering operating results and earnings growth in order for this bull market to continue. Turning our attention to earnings growth, we recognize that lately, margin expansion not revenue growth has been the engine. In the historic S&P 500 EPS decomposition chart below we see that in Q4 2013, profit margin expansion dominated EPS growth while revenue contribution was meagre. Going forward, to generate reasonable returns these factors need to get even better. Frankly, we are uncertain whether the US economy will accelerate further, as some signs would indicate, or if there will be a reckoning for this low interest rate fueled risk asset repricing.



Source: Market Insights as of Mar 31, 2014; J.P. Morgan Asset Management

From a security selection perspective, whether this bull market continues or corrects, the best policy is to focus on long-term sustainable growth. Companies with the ability to grow earnings through economic cycles will be able to compound their way through time periods of multiple compression as well as benefit during positive repricing periods. Investments without this attribute are more susceptible to the twofold impact of negative returns from both earnings declines and valuation contraction during the tough periods of the market cycles. Recently reported, core QV holding Canadian Western Bank (CWB) is a prime example of a business that has grown through numerous cycles.

In 2014 CWB is targeting revenue growth of 10 -12%. This seems plausible because total loans have grown at a 16.5% per annum pace since 2004. More compelling from a downturn perspective, in 2009 CWB was able to grow loans 7%, while maintaining a less than 0.20% provision for losses as a percentage of total loans. This was three times less than the larger Canadian banks. Since 2003, EPS has grown 12% per annum, from $0.75 to $2.36 in 2013. Trading at 13.9x expected earnings and 4 year average ROE of 16%, CWB has less repricing risk and higher expected growth than the Canadian market at 15.7x earnings and 4 year average ROE of 14%.

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