EVANS | INVESTMENT | COUNSEL

ANNUAL REVIEW 2019

Index	Q4 2019	2019
S&P/TSX Composite (C$)	3.2%	22.9%
S&P 500 (US$)	9.1%	31.5%
S&P 500 (C$)	7.0%	25.2%
MSCI EAFE (US$)	8.2%	22.0%
MSCI EAFE (C$)	6.1%	16.2%
FTSE TMX Universe Bond Index (C$)	-0.9%	6.9%
C$ / US$	1.3243 to 1.2988 (+2.0%)	1.3642 to 1.2988 (+5.0%)

**** Index returns are total returns, including dividends.***

LOOKING BACK ON 2019

As the 2010s ended, stock markets around the world closed off on a high note. In local currency terms, the S&P/TSX Composite, the S&P 500 and the MSCI EAFE returned 23%, 31% and 22% respectively during the year. This came straight on the heels of a sudden and steep market downturn at the end of 2018, which left equity prices around the world at a short-lived low point.

Equity markets reached record highs on a routine basis this past year. At the same time, we find it interesting to look back on just how far market sentiment swung in the course of twelve short months. At the trough, on Christmas Eve of 2018, many market prognosticators were calling for a deepening bear market (a drop of at least 20% from peak to trough), quickly accompanied by the onset of a recession. Over the recent past holidays, the narrative has distinctly shifted. The trade tussle between the U.S. and China has simmered down, central banks around the world have become less hawkish and many now expect a continuation of a decade-long bull market.

As the direction of the markets continues to be a prime topic in the financial news, we continue to profess, as we always have, that we do not have a crystal ball. Moreover, we believe that neither does anyone else. We do however believe that it is wise to be more cautious and vigilant during times when prices and exuberance are high. As such, we are less sanguine about return prospects for equities today compared to this time last year when broader sentiment about returns was decisively negative.

A “GROWTHY” DECADE

Continuing the trend from years before, a handful of stocks were the chief drivers of equity index prices in 2019. The outsized return contributions of these stocks led to a deepening divide in performance between the indices, which are capitalization-weighted, and the average stock within the indices. Last year, the Russell 1000, a capitalization-weighted index of the 1000 largest

publicly-traded companies in the U.S., returned 31% while the average constituent within it returned 7% less. This skewed distribution of returns has led to the index generating a cumulative return that was a whopping 23% in excess of that of the average stock over the last five years.

In particular, the capitalizations of the largest technology companies have made some of the greatest gains. Apple and Microsoft, two stocks out of the 500 total companies in the S&P 500, accounted for 15% of the index's total return in 2019. Similarly, in Canada, Shopify, a fast-growing cloud-based e-commerce company, itself accounted for about 8% of the S&P/TSX Composite's total return for 2019 after its stock price nearly tripled in a year (interestingly, Shopify's market capitalization has now eclipsed that of BCE's).

The bifurcation that we saw last year completed a decade of substantial outperformance of "growth" stocks versus their "value" counterparts. In all, the record is as follows: the Russell 3000 Value index returned 203% cumulatively compared to the 306% of the Russell 3000 Growth Index over the past decade. This 10-year scorecard stands in sharp contrast to the 20-year record in which the Russell 3000 Value index returned 302% cumulatively compared to 176% for its Growth counterpart.

A decade of mostly uninterrupted compounding at high rates has resulted in some unprecedented market capitalizations. It gave birth to the first trillion-dollar companies: Apple, Amazon and Microsoft. Apple's market capitalization has grown so much even as the market capitalizations of oil and gas companies have shrunk to such a degree that, incredibly, the company alone is larger than the entire energy sector of the S&P 500 combined.

Of course, a decade of outsized performance of high growth stocks does not mean that many of these companies are undeserving of the prices to which investors have raised them. On the other hand, the exuberance for fast growing companies has been a rising tide that has lifted not just strong boats but also leaky boats with far more dubious business models. Throughout this long running bull market, plenty of companies have been appraised with stratospheric valuations all while perpetually burning more and more cash and having no realistic prospects of ever turning a profit.

VALUE AND GROWTH: TWO SIDES OF THE SAME COIN

In our view, buyers of companies that ignore future earnings prospects should not be confused with growth investors – they should be more aptly described as speculators. Ultimately, shareholders do not profit from revenue growth, or worse yet potential revenue growth; they get back only what a company produces in earnings over time.

That a company's future earnings is the chief determinant of its value means that the conventional line delineating the two colloquial styles of investing, "value" and "growth", is irrelevant. Warren Buffett once said that the term "value investing" was redundant and that all investing should be value investing. Growth, and more specifically profitable growth, is a critical variable in determining a company's worth.

Companies with strong prospects for earnings growth may well be undervalued at price-to-earnings multiples that fall outside the conventional “value” boundaries. In the same vein, companies that are thought to be conventional value companies may not be. Companies may sell at discounts to their book values yet generate inadequate returns on that book value or produce unending losses. Though such companies are currently valued at discounts to their book values, they may be more appropriately appraised at even larger discounts.

As investors, we much prefer buying great companies at reasonable prices to buying mediocre companies at great prices. We value the higher certainty of a company with enduring competitive advantages that should continue to strengthen over time over a middling company with prospects that are uncertain or that are likely to decline. However, we are also highly cognizant of the prices that we pay for them and refuse to pay outlandish prices for even the best businesses. We believe that this discipline in adhering to our philosophy and process has resulted in a portfolio of companies that are 1) selling at cheaper prices as measured by price-to-earnings (P/E) multiples; 2) are more profitable as measured by return on equity (ROE); and 3) are in better financial condition as measured by net debt to equity as shown in the table below.

Evans Investment Counsel Portfolios Compared to Market Metrics at December 31, 2019

	Canadian Equities		U.S. Equities		International Equities		Consolidated	
	Evans Canada	S&P/TSX Index	Evans USA	S&P 500 Index	Evans EAFE	MSCI EAFE Index	Evans Equity	Blended Benchmark
2020E P/E	11.2x	15.1x	14.7x	18.5x	12.8x	15.0x	13.2x	16.6x
2021E P/E	10.5x	14.0x	13.3x	16.7x	11.6x	13.9x	12.0x	15.2x
10-Year ROE	13%	9%	15%	14%	16%	9%	14%	11%
Price/Book	1.4x	1.8x	2.7x	3.6x	1.5x	1.7x	2.0x	2.6x
Net Debt/Equity	47%	61%	12%	74%	0%	63%	21%	67%
Dividend Yield	2.8%	3.0%	1.7%	1.8%	3.1%	3.4%	2.4%	2.5%

GOOGLE: A VALUE STOCK

An example of a company conventionally thought to be firmly in the growth camp but one that we also think of as a solid value investment is Google (which recently changed its corporate name to Alphabet)[1]. We first started buying Google in 2012 when the stock was trading at a multiple of 21 times earnings. Though this may have been thought to be expensive at the time, Google’s earnings per share have grown from $17 to roughly $50 in the years since. Compared to the roughly $350 price we initially paid for Google, the $50 in earnings that we currently receive would have deemed Google as an incredible value opportunity.

Importantly, Google generated such a large increase in earnings by reinvesting very little incremental capital. While the vast majority of businesses require significant reinvestment of capital to grow volume, Google saw exponential increases in volume on its search engine with little additional capital investment necessary. As the most dominant search engine in the world, a business with natural monopoly characteristics that also sells a crucial service, Google also

[1] *Some clients may not own Google due to timing.*

commands a strong degree of price discretion. Combined, these two forces helped to triple revenues and earnings per share from 2012 to 2019; Google has subsequently used these funds to expand into new nascent businesses, its budding hyperscale cloud business chief among them.

Since our first purchases, Google's stock price has quadrupled – and yet we still believe that the stock presents a sound investment opportunity. At today's price, Google is trading at 23 times this year's expected earnings all while holding an additional $175 per share in cash. We feel now, as we did in 2012, that such a multiple is a decent price for a truly dominant company with entrenched and growing competitive advantages, earning highly attractive returns on capital and with a long runway ahead of it to continue growing at high rates.

RESETTING EXPECTATIONS FOR THE NEXT DECADE

The 2010s produced excellent returns for investors in U.S. stocks. In local currency terms, the S&P 500 returned 256% cumulatively or 13.5% annualized since 2009, an outstanding return. This was far ahead of the returns of equity markets elsewhere in the world: the S&P/TSX Composite and MSCI EAFE each cumulatively returned 95% and 81% (7% and 6% annualized) respectively in the decade.

Many gain comfort from ever-rising prices, but we view the currently elevated valuations through a sober lens instead of through rose-tinted glasses. Investors too often base predictions on the future by looking at the recent past and are all too eager to pile on after markets have risen for a long time. Given current valuations and low interest rates, we believe that prospective returns for many asset classes going forward will be far more modest than what we have experienced in the decade just concluded.

We believe that sound investment opportunities continue to exist, particularly internationally, and will continue to strive to find them. In doing so, we stress the importance of trusting in processes. We will not follow others into investments just because they have recently done well and we will not engage in things that we believe we cannot understand or reliably predict. Instead, we will continue to stick to the investment process that has always worked for us: firstly, to find businesses that we can understand, preferably those with strong and enduring advantages, and secondly, to buy them at appropriate prices.

Thank you for investing with us and for your continued confidence,

The Evans Team