Money: What Is It Good For?

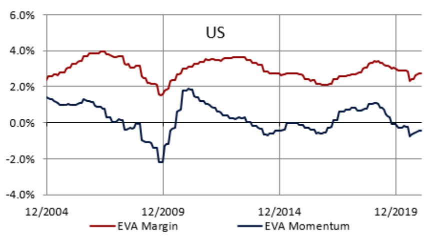
ISS EVA 2021 Market Outlook

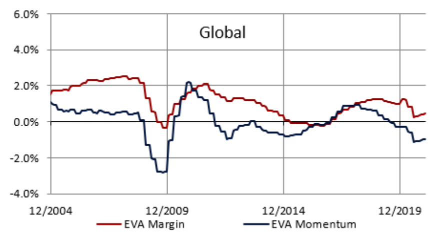
Global markets went through one of their most volatile years in recent history in 2020 as they faced extreme challenges with the COVID-19 pandemic, global social unrest, coupled with devastating wildfires, and geopolitical uncertainty. Yet somehow markets finished the year in positive territory and in many cases at all-time highs.

Equity Index	Jan 1st - Feb 19th	Feb 19th - March 23rd	March 23rd - Year End	2020 Full Year
SP 500	5.1%	-33.8%	70.2%	18.4%
Russell 2000	1.6%	-40.7%	99.1%	20.0%
EAFE Index	-0.8%	-32.7%	62.0%	6.3%
EM Index	-0.9%	-31.2%	74.0%	18.7%

Source: Bloomberg Financial LP

Markets experienced the above performance despite our EVA Fundamentals (EVA Margin & EVA Momentum seen below) having moved decisively lower during the year in the US and Globally. EVA Momentum, blue line below, measures the growth rate of EVA in each period. When EVA Momentum is negative firms are destroying incremental EVA (remember more EVA is always better). What is encouraging, and partially why our view for 2021 includes a bit of optimism, is that these measures seem to have formed relative bottoms in July/August 2020 and have now begun to recover slightly.





Don't Fight the Fed

So, what has driven this performance? *Money - stimulus money to be exact*. When we consider the global money in 2020, we note that supply skyrocketed in March/April 2020 as coordinated central bank action was put in place to catch many parts of the economy that were in free fall. This stimulus was necessary. It was used to help offset the impacts of the shutdown/lockdown measures that were enacted to try to prevent the spread of the very deadly COVID-19 virus. Unfortunately, the lockdown measures were not as successful globally as hoped and heading into 2021 it appears that more stimulus is needed and being planned in many advanced economies.

Source: Bloomberg Financial LP

Key Summary:

Global EVA Fundamentals struggled throughout 2020 given the myriad of issues pressuring markets and impacting key drivers. Currently the embedded expectations of the market are elevated signaling that a material recovery and reopening will take place in 2021. These elevated valuation levels are the largest driver of our cautious outlook for 2021. As our research team looks through the EVA lens to identify key drivers, risks, and opportunities, the major concern is related to the recovery taking longer than expected which may in turn lead material downside from today's market.

Our team is also in part optimistic for 2021 given that EVA fundamentals have already begun to improve (beginning in August 2020). Coupled with the view that a continued acceleration of vaccination rates, accommodative monetary policy, lack of available investment alternatives, and low inflation targets are all also likely, we can see a scenario where the market can sustain elevated valuation levels throughout 2021.

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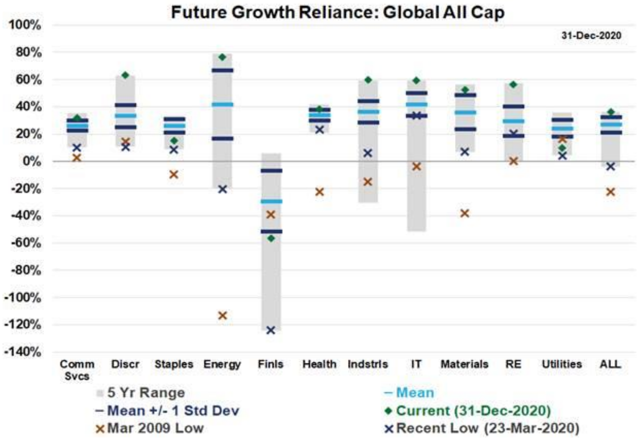
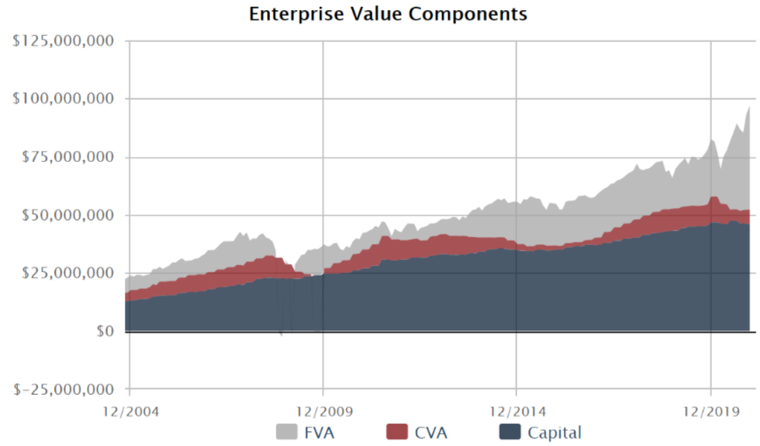
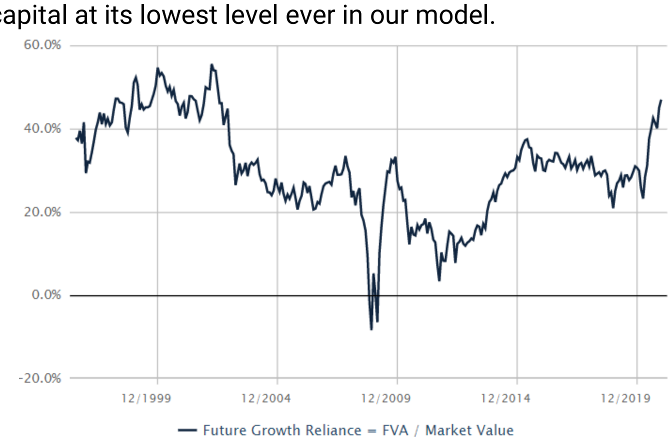
Embedded Expectations





Above we highlight the relative levels of Future Growth Reliance (FGR) which is our measure of the embedded level of future EVA growth today for each sector globally. The chart shows a few representative datapoints to highlight where current exceptions sit in relation to previous ranges and key dates. The green diamond is todays level of FGR (measured on Dec 31, 2020) The two "X" marks, one red and one blue, represent the level of FGR at the market bottom in March of 2009 (red) and in March of 2020 (blue). The grey shaded area is the range that FGR levels have registered over the last 5 years and the blue bars represent the 5 year mean and 1 standard deviation above and below the 5 year mean levels. As you can see across nearly all sectors the green diamond sits near the top of the range. The two exceptions are Utilities and Financials. These elevated levels imply that not only is a recovery already expected, but growth in EVA beyond 2019 peak levels is expected as well.

We calculate FGR using three components, Capital, Current Value Added (CVA), and Future Value Added (FVA) (above right). The formula is FVA/(Capital + CVA + FVA) so it measure the percentage of the total enterprise value that is attributed to future EVA generation at any given time. There are different ways that FGR can go up, given the way the math works assuming all other things equal – if CVA shrinks (lower profitability today) FGR will go up as FVA backfills the loss of CVA. That is what is happening today. CVA moved from $11T prior to the market correction down to $6.2T today a decline of nearly $5T, while FVA moved from $24T to begin the year up to nearly $45T today. That difference is what is driving FGR to post financial crisis highs today. The final component to this equation is Cost of Capital. In the EVA framework, the value of a firm (or market) is equal to capital + the present value of EVA, discounted at the cost of capital. Rising/falling risk free rates increase/decrease the overall cost of capital, which, in turn, impacts valuation in two ways: 1) it changes the value of future EVA, which is the profit after both operating costs and the opportunity cost of employing capital (EVA = operating profit – capital*cost of capital); and 2) it changes the cost of capital used to discount future EVA. Today we measure cost of capital at its lowest level ever in our model.



Date	CVA	FVA	Capital
1/31/2020	$11,087,523	$23,867,900	$46,790,654
2/29/2020	$11,091,176	$19,174,567	$46,782,287
3/31/2020	$8,668,647	$14,935,971	$46,222,289
4/30/2020	$8,644,155	$20,593,270	$46,055,400
5/31/2020	$8,594,929	$23,387,414	$45,925,174
6/30/2020	$4,602,165	$29,742,284	$47,505,820
7/31/2020	$4,935,099	$33,060,753	$47,415,258
8/31/2020	$4,968,850	$37,049,980	$47,384,999
9/30/2020	$5,451,697	$35,062,646	$46,295,472
10/31/2020	$5,773,715	$33,363,186	$46,232,224
11/30/2020	$6,030,386	$41,124,814	$46,195,391
12/31/2020	$6,195,847	$44,665,712	$46,028,519
2020 Δ	-$4,891,676	$20,797,813	-$762,135

Higher cost of capital impacts valuation

$$\downarrow \text{Value} = \text{Capital} + \frac{\text{EVA}\downarrow}{\text{Cost of Capital}\uparrow}$$

Lower cost of capital impacts valuation

$$\uparrow \text{Value} = \text{Capital} + \frac{\text{EVA}\uparrow}{\text{Cost of Capital}\downarrow}$$

PRVit Rankings & Sector Performance

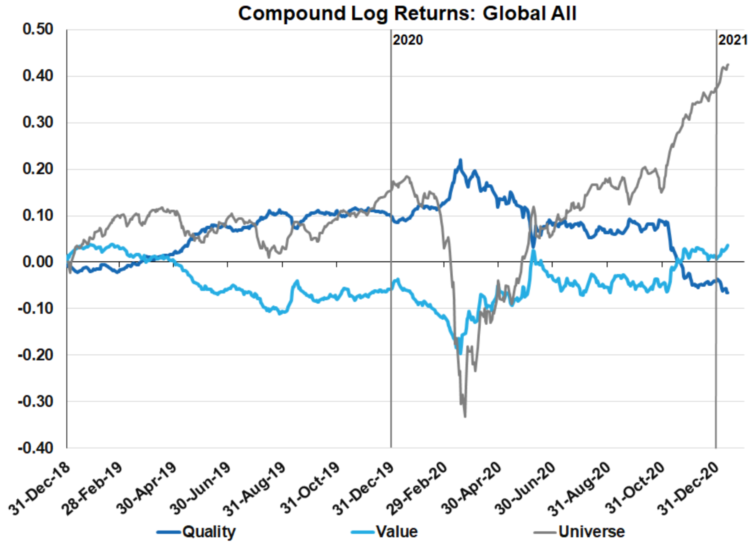
In the below breakdown of each sector PRVit, Quality, and Valuation scores show the framework is agnostic to Quality vs Valuation and works to balance the two. Financials are the strongest PRVit sector by far as high Quality and relatively cheap Valuation present a very favorable picture. The one outlier on the downside is Health Care currently at extremely high Valuation levels are not offset with Quality. Much of this has been driven by a strong rally driven by COVID-19 response and increased demand.

Sector Scores 2021	PRVit	Quality (P-R)	Valuation
Financials	64	60	43
Communication Services	51	54	54
Consumer Staples	50	67	58
Information Technology	49	60	68
Materials	49	45	49
Energy	49	31	34
Industrials	48	49	52
Consumer Disc	47	46	56
Health Care	44	59	70

The below chart highlights how each sector performed in 2020 and YTD in 2021 with Technology leading and Energy lagging the global market during 2020. Across 2020 we saw very strong performance of high Quality but as the year closed (post COVID-19 vaccine announcements) Value factors rallied very strongly (below right). As we open 2021, we have seen a continuation of a Value driven market moves (see below right). These will be key to watch throughout the year.

	2020	2021 YTD
WORLD INDEX	14.1%	1.5%
Energy	-34.4%	9.3%
Consumer Staples	-1.8%	5.4%
Materials	17.1%	5.0%
Financials	-5.0%	4.0%
Health Care	11.9%	2.9%
Industrials	10.1%	2.0%
Consumer Disc	35.4%	1.4%
Information Technology	42.7%	0.0%
Communication services	21.5%	-1.0%

Cheap Value
Expensive Growth
Defensive Quality



Themes and Trends

As we look ahead in 2021, we have identified some key themes and trends that we hope will support the recovery of EVA Fundamentals.

Vaccine & vaccination rates – Across the globe it will be extremely important to monitor ongoing efforts to roll out vaccines to quell the spread and allow for safe and timely economic recovery.

> The S&P 500 has climbed to record highs in 2020 thanks to the vaccine announcements by many pharmaceutical companies globally (Pfizer-BioTech, Moderna, and more). On November 9th, Pfizer and BioNTech presented a vaccine with a 95% efficacy rate. On December 2nd, the vaccine was given emergency authorization by the United Kingdom with the first vaccinations administered nearly a week later. Moderna followed in short order and has reported similar findings and both have made deals to supply their vaccines globally.
>
> Although optimism toward an economic recovery has increased, many risks remain as the pandemic continues to worsen which has caused many countries to once again enforce restrictions. As we discussed in our December 10 report, The Quest for Value, almost all the structural challenges and headwinds that COVID-19 created are in a way lifted with the understanding that a widely available, widely applied, and effective vaccine will bring the world back to a sense of normalcy in 2021 & beyond.

Short term stimulus vs long term inflation – as nations globally continue to face the challenges of economic impact vs health & wellness, many nations continue to impose appropriate restrictions on non-essential activity. These restrictions continue to impact jobless claims and unemployment globally may take many years to overcome, so more targeted stimulus may be needed. However, the massive stimulus plans already approved globally do make inflation an eventual concern pressuring growth.

> In our September report, "Can Global EVA Fundamentals Recover After the Fall", we discuss how the pandemic-impacted macroeconomic environment of top-line sales pressure, elevated unemployment, recessionary forecasts, and global disruption to production and consumption may take years to unwrap. In order to prevent an outright economic collapse, the Federal Reserve and global central banks poured money into stimulus plans to help sustain economic activity as best they could, given these unprecedented challenges. However, as fiscal stimulus has run out and more targeted stimulus may be needed to aid a recovery, the long-term impact of stimulus (printing money) is the eventual inflationary risks that will pressure growth.
>
> Today the global market has very high expectations for future growth in EVA. U.S. inflation has risen to its highest level in 18 months as investors anticipate a robust economic revival in short order given the recent vaccine breakthrough. Given all that, if the vaccine rollout is successful and consumer spending picks back up, inflation (which never really showed up from 2010-2016 with near 0% global interest rates) could creep back into global markets and depending on the Fed and central bank reaction's, may persist in the medium to long-term which could likely lead to a necessity to raise rates, and possibly spark a rate driven recession.

Don't Fight the Fed – lessons learned from 2010-2019 – a low cost of capital is good for equity markets

> The longest U.S. stock market bull run came to an end after nearly 11 years as a result of the COVID-19 pandemic. Relative to the 10-year bull run in the 1990's, this period of growth was fueled by the longest period of near 0% interest rates. Low interest rates make bonds (debt in general) less attractive, and access to capital markets easier for corporations. Generally, as investors globally are looking for returns/chasing yields, they are driven to sought out investments in the equity markets which inflated equity prices.

Corporate tax reform (rolling back the 2017 tax reforms that lowered corporate tax rates) pressuring profitability

The Tax Cuts and Jobs Act was approved on December 22, 2017 and made changes to depreciation, deductions, and other tax items. Amongst other major changes, corporate income tax which was reduced from 35% to 21% and a corporate alternative minimum tax was repealed. The Biden administration has proposed a 28% corporate tax law which may ultimately impact valuation levels within the EVA framework as EVA is Net Operating Profit After Taxes (NOPAT), less a cost-of-capital interest charge that prioritizes returns for the lenders and shareholders. In other words, EVA is sales, less all operating costs including taxes and depreciation, less a fully weighted cost-of-capital interest charge on all assets or capital used in business operations. Therefore, given any potential increase in corporate tax rate broad-based valuation will fall. The proposed tax law also includes a tax penalty for corporations with overseas operations that sell products back to America. If enacted, this would discourage outsourcing and heavily influence those with meaningful offshore manufacturing.

Regulatory Reform & Progress –Climate change, ESG regulation (green new deal et all), minimum wage

The pressure is rising for companies across the globe to incorporate sustainable investing into their existing investment strategy as shareholders and regulators have become increasingly aware of ESG risks and opportunities. In the U.S., the trend toward ESG investing in 2021 is likely to accelerate because of heightened public awareness and as the new administration plans to adopt policies to enforce environmental and social change. The incoming administration has outlined its plans to tackle climate change by joining the Paris Climate Agreement again amongst many policy goals that align more closely with reaching lower emission targets and a more sustainable future. Additionally, investors continue to pour money into ESG related strategies as demand grows from both institutional and retail bases. The link between ESG and materiality continues to grow, and our team continues to focus on that as well. Our study published in 2020 shows a clear link between highly rated ESG firms that also have high levels of EVA Margin and outperformance. Look for these trends to continue to persist in 2021 and beyond.

ESG Performance	12-Mo Returns (%)						Standard Deviation (%)						Sort	Median Value	
	EVA Margin						EVA Margin							EVA Marg.	ESG Perf.
	1	2	3	4	5	All	1	2	3	4	5	All			
1	14.6	12.9	5.5	6.8	4.2	9.1	7.3	8.5	9.2	13.8	26.5	10.3	1	0.12	50.9
2	11.3	11.7	9.5	9.6	6.2	10.5	10.1	10.5	7.3	8.2	14.3	8.6	2	0.04	32.0
3	11.6	7.5	8.5	6.2	2.6	8.5	8.2	7.1	7.1	12.5	18.2	8.2	3	0.01	22.0
4	8.8	6.3	4.2	1.1	2.0	4.3	11.2	6.8	8.3	13.2	15.7	8.9	4	-0.03	15.8
5	8.3	10.0	3.6	1.4	0.3	4.0	10.1	9.8	11.0	14.9	13.3	9.9	5	-0.26	10.0
All	8.9	9.2	6.6	5.8	0.8		10.7	9.4	9.8	13.9	13.6		All	0.01	22.1

Source: ISS ESG Corporate Rating data, ISS EVA (Investor Express), and FactSet. Back-tests are run with FactSet Alpha Testing.
Notes: Securities sorted every three months. The cumulative returns in the graphs are geometrically derived. Equal-weighted annual returns are shown in the table. Data is from December 31, 2013 through September 30, 2019. The data for the sorts includes US stocks $250 million or greater in market cap within the ISS ESG and ISS Investor Express databases.

The final theme we have identified is reopening and with that comes a major unknown just how the world is going to progress in the next 6-12-18 months etc. The outline below is our view on how the impact is being valued and embedded in the expectations of the market going forward.

Reopening – How does the world go back to normal?

The approval and rollout of the coronavirus vaccine is the first step in a long process involved with ending the pandemic. While some restrictions may ease given current levels of infections it is increasingly less likely that the world will return to normal in the short-term. The more likely scenario is that the negative effects of the pandemic will last well into 2021. The longer these impacts last the harder it will be for small and medium sized businesses to remain open continued to pressure labor markets globally. Other long-lasting implications of the pandemic may include the continuation of global supply chain disruption, potential changes in consumer behavior such as the acceleration of e-commerce adoption, strain on commodity prices, and more. Given where FGR levels are today, it is clear the market expects recovery to be strong, and any prolonged negative impacts or delay in reopening could represent downside risk in the market.

Reopening – leisure & travel – pent up demand with restrictions

The pandemic has disrupted a multitude of industries, but Hotel, Retail, Leisure, and Travel have been hit particularly hard. Restrictions across the globe have prevented many industries from running as 'business as usual,' especially given the sudden halt of tourism as many governments prevented non-essential travel through much of 2020 and again to begin 2021. Although leisure demand has improved toward the end of 2020, substantial progress against the coronavirus will be necessary for restrictions to ease. When that happens, we expect a return to leisure activities to strengthen travel demand and tourism. Although the Travel and Leisure industries may start to experience some of the benefits related to pent up demand as restrictions pullback, it is very unlikely that the full benefits will be realized in the next year.

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We are an independent equity research provider offering investing insights through the use of our proprietary Economic Value Added (EVA) framework. EVA converts accounting profits into economic profits and charges businesses for the use of Invested Capital. EVA is superior to traditional measures of profit because it is comparable across companies, industries, and countries, links to a consistent, transparent valuation framework, and provides a unique, unbiased view of Quality, Value, and Growth.

Our experienced team of analysts offers both fundamental and quantitative company analysis through written research, bespoke research, a stock selection model, an online analytical tool offering +20,000 companies as viewed through the EVA framework, custom screening, and portfolio analysis.

Key EVA Concepts

The value of a firm = Capital + PV of EVA
If EVA is increasing then the intrinsic value of the firm is too, suggesting that market value should follow (and vice versa).

EVA = NOPAT - Capital Charge
EVA is profit after all costs, including the cost of giving shareholders a decent return.

EVA Margin = EVA / Sales
A true economic profit margin covering income and asset efficiency. Our EVA Income Statement examines EVA's line item drivers and offers key insights into business profitability.

EVA Momentum = Δ EVA / Sales
An incremental EVA growth rate indicator and key valuation signal and screening measure. The more positive the Momentum, the greater the growth in EVA, and upward pressure on shareholder returns. Inflections in EVA Momentum are an early and more reliable indicator of stock price inflections.

EVA Shock = Δ EVA Momentum
Changes in EVA Momentum is a powerful signal within our framework, with significant relationship with stock price performance.

Market Implied Momentum (MIM)
The annual EVA improvement required for 10 years to justify the prevailing market enterprise value, expressed as a percent of sales; represents a market implied, long-range EVA margin improvement target.

Future Growth Reliance (FGR) = (Market implied value of future EVA growth) / EV
Measures the % of a company's total enterprise value represented by expectations for future growth in EVA. FGR is key to understanding embedded expectations today and versus history. A low FGR versus history coupled with improving EVA trends indicates that the market is not pricing in the improving business model.

Additional Resources

evaExpress.com (link): Our online offering provides a comprehensive suite of fundamental and quantitative tools utilizing the EVA framework
EVA for Investors (link): A full introduction to the key EVA concepts and metrics
Best Practice EVA (link): A summary of Bennett Stewart's most recent book on EVA, available for purchase on Amazon.com
What Determines TSR (link): Insight into the relationship between EVA and stock prices

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