Exposure rates of the Dorval Asset Management Range – 11th December 2020

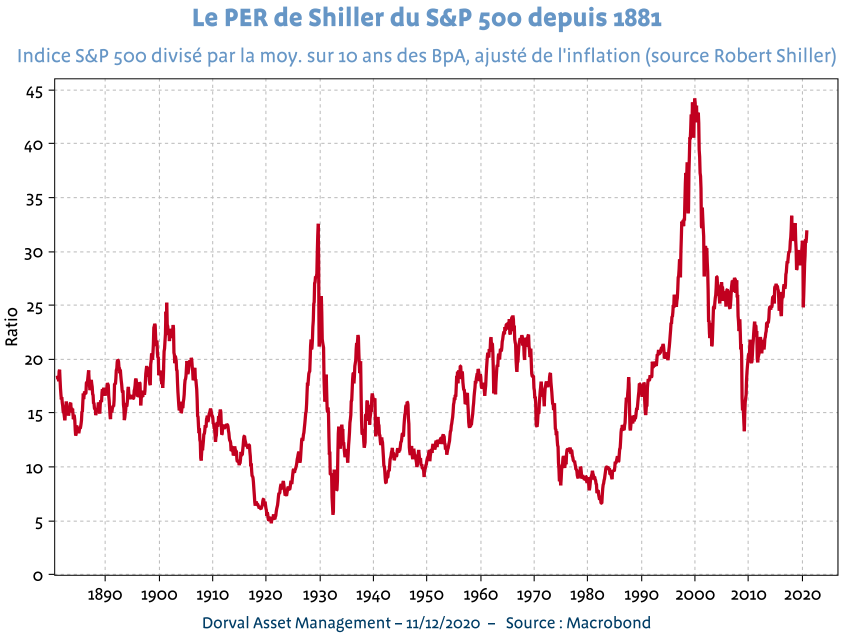
Dear Clients and Partners,

As is their wont after a very strong showing on the equity markets as some indices hit all-time highs – S&P 500, MSCI World, Nasdaq, etc. – investors are looking more closely at valuations. And in usual form, answers to their questions vary as there is no clear-cut method to offer a definitive response. However, we can single out some useful key guidelines if we look carefully and cautiously.

The Nobel Prize for Economics winner Robert Shiller recently took a look at this issue in a brief article co-authored with two specialists for the Project Syndicate site. Robert Shiller is world renowned for having warned investors of irrational exuberance on the stock-market in 2000, making the CAPE concept – cyclically adjusted price-to-earnings ratio – popular during this time. The so-called Shiller P/E compares share prices to the 10-year average for earnings per share, thus smoothing out the effects of economic cycles. Figures for the S&P 500 stretching back as far as 1881 show a record of close to 45 in 2000, beyond its previous high of 33 in September 1929, while the indicator currently stands at above 30 (cf. chart 1).

Shiller P/E on S&P 500 since 1881

S&P 500 divided by 10-year EPS average, adjusted for inflation (source Robert Shiller)

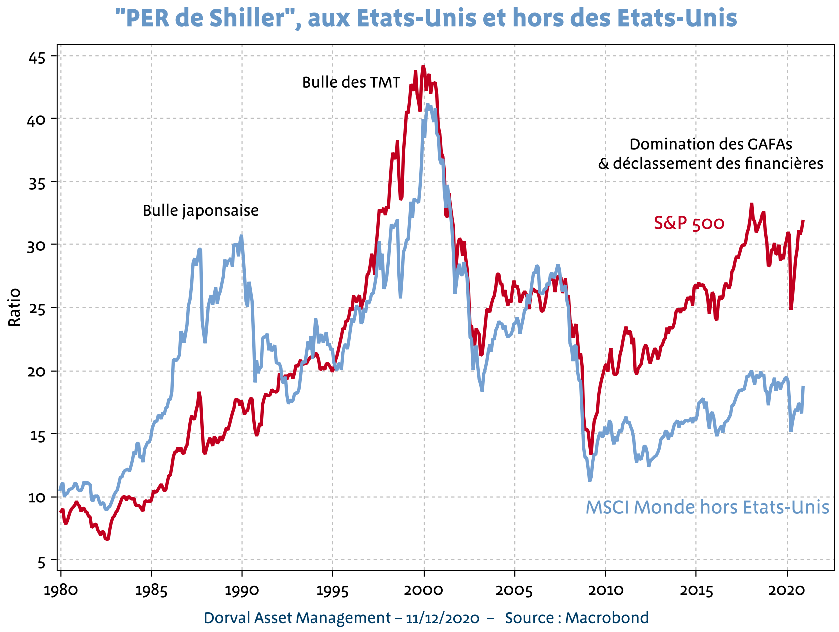


However, in his latest article, Robert Shiller does not draw the same conclusion as in 1999/2000, as he takes on board two key dimensions – in which investors are well versed –

to get some perspective on the situation i.e. the effects of stock-market indices' make-up on the one hand, and very low interest rates on the other hand.

Looking to the first aspect, the make-up of share indices, Shiller notes that CAPE currently differ significantly from one region to another, unlike 1999/2000 when the TMT bubble (Telecoms, Media and Technology) spread to most regional and national share indices. If we compare the Shiller P/E for the S&P 500 with the MSCI World excl. US ratio, we see that the first figure stands at a historical high, while the second is on a record low (cf. chart 2), leaving investors to face two diametrically opposed conclusions.

Shiller P/E for United States and outside United States



- *Japanese bubble / TMT bubble / Domination of GAFA and derating for financials*
- *MSCI World excl. US / S&P 500*

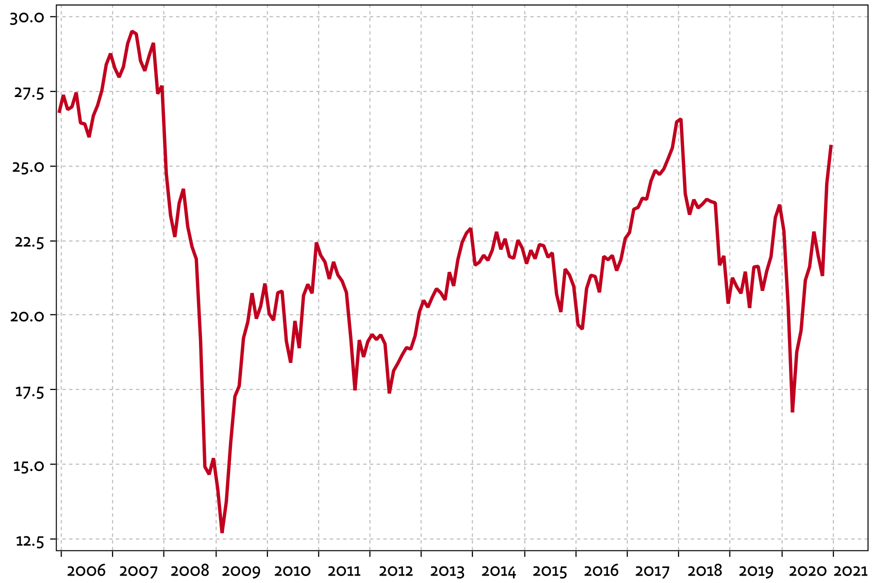
The reasons behind this contradiction are very clear – the S&P 500 with its hefty weighting for superstar companies that have seized the lion's share of world profits (including the famous GAFAM, which account for more than 20% of the index) is trending like a growth stock these days. No other developed markets have encountered the same trend, and European and Japanese indices have actually been hard hit by the financial sector's derating: this sector made up a hefty proportion of these indices just a few years ago, and still ranks as the largest sector, accounting for 18% of the index, which is twice the figure in the US.

Dorval Asset Management has long worked on median figures for a broad universe of stocks to mitigate the impact of indices' make-up as much as possible. Based on Bloomberg data available since 2006, we have calculated the Shiller P/E for each company in the MSCI

World, based on its composition at any given time (currently made up of 1,601 companies). The result (cf. chart 3) suggests that the median valuation for world equities is currently above its average over the past 15 years, but short of its 2007 figure, so there seems to be no call for panic.

Median Shiller P/E for companies in the MSCI World

Médiane des PER de Shiller des sociétés du MSCI monde



Dorval Asset Management – 11/12/2020 – Source : Macrobond & Bloomberg

However, the second question remains on the impact of interest rates. Robert Shiller and many others point to extremely low interest rates to potentially justify higher equity valuations. This seemingly likely idea is well established among a great many analysts, but it is far from self-evident: the influence of interest rates combines with other factors that are often correlated with this situation, including the downtrend in economic growth, and hence in profit growth. Meanwhile, investors can also demand higher risk premiums when the growth context is deemed to be more shaky, and this instability is reflected in interest rates.

Additionally, if long-term interest rates had such a crucial role to play, then European equities should be the priciest in the world as bond yields in the region are in negative territory, but this is not the case. Another striking example is the collapse in Japanese interest rates during the 1990/2000 period, which was also a time of plunging rather than soaring equity valuations. So there does not seem to be a clear-cut relationship between interest rates and stock-market valuations.

We can draw three conclusions from this analysis. Firstly, the valuation for a standard listed company (median) seems a bit high based on the Shiller P/E, but it is in no way extreme. Secondly, there is now a huge chasm between the valuations for winners (GAFAM, luxury goods sector, etc.) and losers (financials, energy) in the changes that have taken place over recent years, as we are witnessing the greatest market dispersion since 2000. Thirdly, bond yields are so low that a fresh sharp interest rate cut is unfeasible, making bonds held in portfolios less attractive from a relative standpoint. We have taken this situation on board in our global multi-asset portfolios and developed equity-heavy portfolios that are highly diversified in both sector and geographical terms, with very low bond duration that we continue to reduce.

Our exposure rates are as follows:

- **Dorval Convictions**: Our exposure rate is 97%.

DORVAL ASSET MANAGEMENT

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