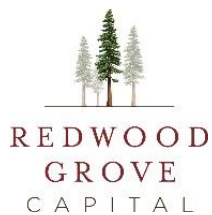

January 15, 2018

VALUE INVESTING OPPORTUNITY

In 2017 we saw the lowest equity volatility since 1986, and Growth continue to trade at a historically high premium as it extends one of its longest streaks of outperformance. We believe Growth's outperformance will not continue unabated and we believe that Value is primed for success in the coming years. Value stocks have outperformed Growth stocks by 4.4% annually over the past 90 years[1] and have outperformed Growth in roughly three out of every five years over the same period. In the coming years, as quantitative easing slows, we expect a reversion to the mean.

This expectation is reflected in our portfolio, which enjoys low valuations and solid growth prospects relative to S+P 500. Our 20 holdings are currently priced at a weighted average Price to Earnings multiple of 14x NTM with estimated sales growth of 8% over the next three years. In contrast, the S&P 500 Index sells for 18.4x 2018 earnings, with an expected three-year sales growth rate of 6%. The portfolio is also diversified with exposure in 9 of 11 S&P Sectors, with the largest positions in Technology (21.5%), Healthcare (15%) and Financials (12.5%).

While we look at a wide range of ratios and metrics to determine a company's valuation, when looking out multiple years we believe that sales growth is the best indicator of a company's prospects. Sales growth is easier to forecast and less impacted by short-term events. Earnings, however, can temporarily mislead investors as they fluctuate due to short-term increases/decreases in margins, one-time events, and write-offs. The recent tax cut is a good example. We, like the majority of investors, expect the reduction in corporate taxes from 35% to 21% to increase earnings for companies. However, over the long term we expect most of that benefit to be competed away. So once we've accounted for secular declines, a focus on long-term sales gives a better insight into a company's prospects over the next three to five years.

Growth of Sustainable Investing

2017 was the second warmest year on record, behind only 2016. This continues the period, started in 2001, during which the planet has seen sixteen of the seventeen warmest years. Recent forest fires in California have led to the loss of over $12 billion of market value for PG&E and Edison. New York City is suing the five largest producers of fossil fuels, seeking damages for the city's costs to adapt to climate change. The Bank of England's 2017 "Financial Stability Report" said that since the 1950s, the frequency of weather related catastrophes has increased six-fold, making previously insured assets uninsurable.

So it is not surprising that investors are increasingly concerned with climate change risk in their investment portfolios. In 2016, $331 billion was invested in Environmental, Social and Governance (ESG)

[1] Bank Of America Merrill Lynch, Value Vs Growth, Michael Hartnett. June 2016

strategies, representing a 55.1% compounded growth in AUM over the past three years. Given the investor focus on ESG, financial institutions are creating products to meet this demand.

Sustainability themed managers typically rely on ESG data from aggregators (i.e. Sustainalytics/Morningstar, MSCI KLD, Thompson Reuters) to incorporate sustainability into their investment decisions. In total, there are over 100 ESG data aggregators. Many are associated with large financial institutions that, for a fee, will provide both ESG scores as well as the underlying data. Some investment managers will incorporate a summarized score into their investment analysis by investing in companies with high scores. Other investors will analyze the underlying company data, to make their own assessment. Regardless, the data collected and provided by the ESG aggregators is the underpinning for many sustainable investment funds. The development of material, quantifiable and comparable metrics is the key for large-scale adoption of environmental factors into mainstream investing. Unfortunately, the latest research confirms that aggregators rely on data that is problematic and mainstream investors rightly remain skeptical.

In 2017 Amir Amel-Zadeh from Said Business School and George Serafeim from Harvard Business School conducted a survey of 413 "mainstream" investment organizations to better understand how investors view and use reported ESG information. The results affirmed our concerns about ESG and sustainable investing today. First, 63% of investors believe ESG data is material to investment performance. But when pushed on the economic materiality, investors focus on reputational and brand risk, two factors most investors already include in fundamental analysis.

The survey also found that the biggest challenges to using ESG data were "lack of comparability," "lack of reporting standards," "quantification of ESG information," "lack of timeliness' and "concerns about the reliability of reported information." Other than that, Mrs. Lincoln how was the play? The reasons for the concerns are not hard to determine. The data is not standardized, audited or consistently disclosed. As a result, it is easily manipulated by the reporting corporation. One can only imagine the range of methods for determining Net Income if companies were free to account and report it any way they wanted.

The lack of data controls has predictably resulted in highly variable data. This can most easily be demonstrated by the lack of correlation between ESG scores by the various data aggregators. A 2016 paper titled "Do Rating Firms Converge? Implications for Managers, Investors and Strategy Research?" by Aaron Chatterji et al. at Duke University showed that, even after adjusting for stated differences, there was very little correlation among the top six ESG data providers. In fact, the top two, MSCI and Thompson Reuters were negatively correlated. In other words, a good score by MSCI was more likely than not to indicate a bad score by Thompson Reuters. Markets are made based on different projections for future earnings, but there is very little disagreement around historical earnings. In the ESG space there is little consensus over who has done a good job historically and very little analysis over who is making meaningful progress. So as an investor looking to build a portfolio that includes managing the risk and opportunities associated with climate change, it's unlikely that you will get it from an investment manager that outsources its research to ESG data providers.

ESG managers and data aggregators are not to be blamed for the quality of the data. Many of them are working in good faith to develop a standardized framework. And to date there is limited support from corporations to develop a truly auditable, standardized set of metrics. But investors should be mindful that many financial institutions are building financial products to meet a growing demand on the back of data that is simply not sufficient. And as a result, those products' portfolios may not be more sustainable.

The Redwood Grove Difference

So where does that leave investors today? At Redwood Grove, we are focused on the economic impacts of climate change. We recognize the limitations of the currently reported data to help us evaluate which companies are best prepared for a low carbon economy. We work with academic resources, environmental NGO's, and companies' public statements (sustainability reports and financials,) to better understand climate change's impact on different industries as well as to determine which companies have competitively advantaged themselves for the low carbon economy. Broadly speaking, we evaluate four main economic drivers; the changing regulatory environment, the physical effects of a warming planet, changing consumer behavior, and technological advancements in energy production. These themes enable us to frame the impact climate change will have on different industries as well as which companies are competitively advantaged.

As an example of our research, we monitor which companies are using an internal price on carbon. In October of 2017, Carbon Disclosure Project put out a report showing that 1400 companies globally use or plan to use a price on carbon. But as we dug deeper we learned that only 607 companies price carbon today with prices that vary from $1.19 to $150 a metric ton. Less than a third, only 189 companies, use carbon price as a metric to help them hit GHG reduction targets. And finally, 40 of those companies use a price on carbon where it matters most: when making capital deployment decisions. The Center for Climate and Energy Solutions (C2ES) helped Redwood Grove to better understand how those 40 companies used their price on carbon to make capital decisions. It is great that 1400 companies use, or plan to use, an internal price on carbon. However, to understand a company's competitive positioning and the subsequent economic implications, we believe one must also understand the price they are using and how it is being incorporated, if at all, in critical company decision-making processes.

While we look for information from many off-Wall Street sources we also look to the companies themselves. We have found that corporate declarations of sustainability may help a company's brand image but are not always substantive. Many companies have long, colorful sustainability reports with no clear meaningful goals. We search for material public commitments, like GHG emission reduction targets, from management teams, to telegraph an understanding of the unique risks climate change poses for businesses. We continue our research by looking for confirmation of those commitments in the same companies' financial documents (i.e., 10K and 10Q). In our view, management teams that are truly concerned about the economic impact of climate change will discuss their concerns and strategic goals them in their legal filings. Finally, we consider a company's lobbying efforts. While few companies lobby on behalf of the environment, many will push for policies that contradict their stated public commitments. Looking at Washington activity, corporate filings and public statements helps us find company strategies truly aligned with their own sustainability.

Our investment thesis is that those companies embracing the change to a lower carbon economy have a major long-term advantage. Ideally, a company provides evidence of its commitment to a low carbon economy in its capital deployment and its research and development. Companies we've discussed in past letters such as Google, Ameresco and GM come to mind. They are pivoting to better position themselves in the transition to a low carbon economy. A name we added this month, Disney, attracted our attention due to a recent sell-off and their strong sustainability stance. Our research revealed that Disney applies an internal carbon fee that ranges from $10-20 per metric ton to encourage a reduction in GHG emissions

by 50% in 2020. They also use a shadow price of carbon when deciding to allocate capital for new projects including global construction and IT projects. According to C2ES, “the shadow price complements Disney’s carbon fee and drives investment in low carbon research and development and clean technologies to improve the company’s energy efficiency and resource savings.” Since the future for pricing and regulating carbon is uncertain, this is an inefficient part of the market and deserves attention from a long-term and value-oriented approach. This thoughtful approach to carbon pricing risk, as well as, its attractive valuation metrics, made Disney an add for our portfolio.

If you have any questions, please do not hesitate to reach out to us at IR@redgrovecap.com