July 2011

Back to Normal?

As keen students of financial history, we have spent time over the years trying to gain a better understanding of what drives markets over longer periods of time and have identified several fundamental factors that tend to result in market outperformance:

1. Higher quality businesses outperform lower quality businesses.
2. Dividend paying companies outperform non-dividend paying companies.
3. Value stocks outperform growth stocks.

Despite the prevalence of these factors over a full market cycle, there are often periods of time when these themes fall out of favour. The post-financial-crisis period is the most recent example of this phenomenon.

Since the market bottomed in March 2009, the subsequent run-up in global equity markets has been dramatic, with the S&P/TSX returning 89% from trough to peak; a significant rally by any measure. This period has been referred to as a "junk rally" or a "dash for trash." The market environment over the past couple of years has been dominated by low quality, low yielding, and higher risk businesses. High quality dividend paying stocks have been left behind in a great rally that some market observers consider to be the most speculative since 1932.

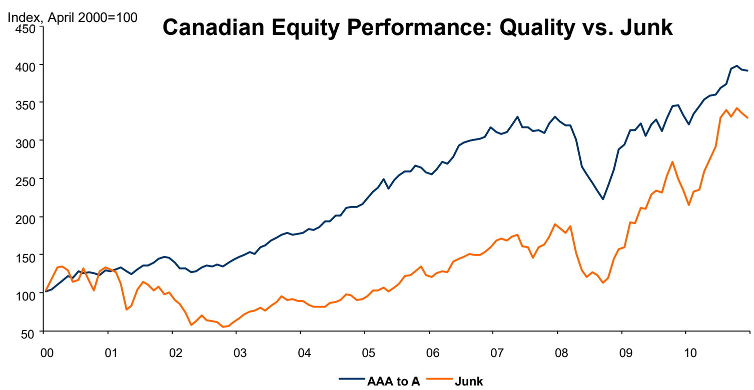
The junk rally we have experienced over the past few years is not atypical following a significant market decline. Low quality stocks often fall the hardest during a market contraction but tend to rebound sharply when investors' appetite for risk returns. The initial rallies are often led by companies with weak fundamentals, fragile balance sheets, and poor earnings quality. The current low interest rate environment and massive government stimulus has also provided a favorable environment to help prop up these businesses. However, if history is a guide, junk rallies tend to be short-lived (average duration of 10 months) and are often followed by long periods in which higher quality businesses return to favour.

At Sionna, we tend to use history as a guide for the future. At any point in time, our best guess for the future is that stocks will revert to their mean. After a prolonged junk rally since the financial crisis lows, we are starting to see early signs that investors' risk appetite is diminishing and higher quality, dividend paying companies are regaining their market leadership. In light of the junk rally and the recent contraction in equity markets over the past few months, we thought it would be helpful to put the post-financial-crisis period in a historical context.

Quality Matters

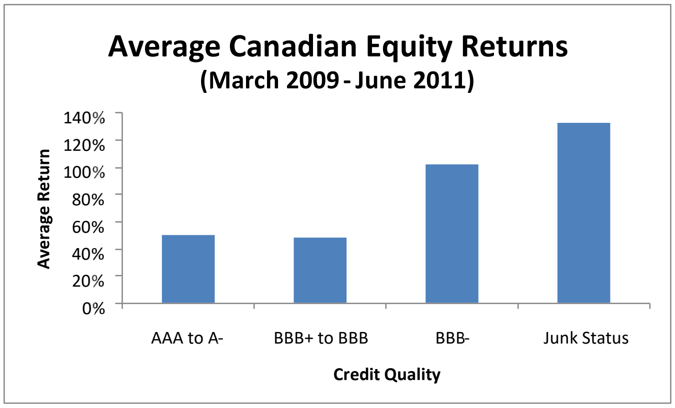
In most aspects of our lives, quality matters. After all, given the choice (and the same price), most people would prefer a Bentley over a Buick. In investing, the same phenomenon holds true. Over time, high quality companies, defined as businesses with strong balance sheets and solid underlying fundamentals, have tended to outperform lower quality companies. This makes sense when you consider that the earnings of high-quality stocks tend to be less volatile than those of low quality stocks and hold up better in both good and bad environments. In addition, the strong financial position of higher quality businesses helps them weather the storm during times of economic distress.

The following chart looks at the performance of large cap stocks on the S&P/TSX Composite since 2000. Companies are grouped according to their credit rating, a proxy for the quality of the business. AAA represents the highest credit quality and junk status identifies the lowest credit quality businesses. Over time, businesses with higher credit quality have performed better than their lower quality counterparts.



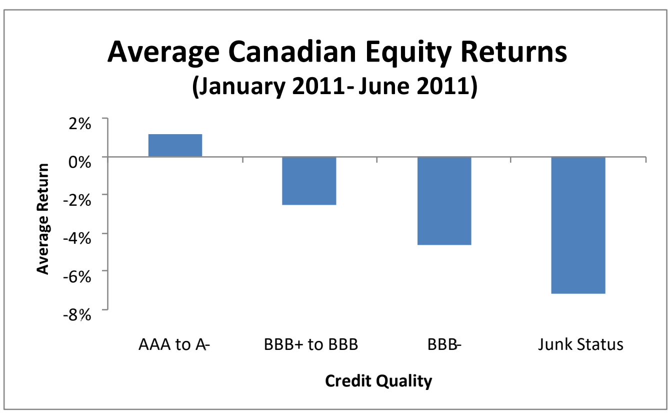
Source: Merrill Lynch, Sionna

Despite the importance of identifying “quality” in the investment process, there are often periods during a market cycle when “junk” is all the rage. Since the market bottomed in March 2009, lower quality businesses have dramatically outperformed their higher quality peers. When we examine the average Canadian equity returns over the past couple of years, companies classified as “junk status” have returned 132% whereas AAA rated companies returned 50% over the same period.



Source: Sionna and Bloomberg

In 2011, however, we have started to see a reversion to the mean; high quality businesses are holding up well in a difficult environment and "junk status" businesses offering little in the way of downside protection. On a year-to-date basis, the lowest credit quality stocks have experienced a negative return of 7% while the highest credit quality stocks have been able to post a modest positive gain. This is how we expect the market to behave over the long-term.



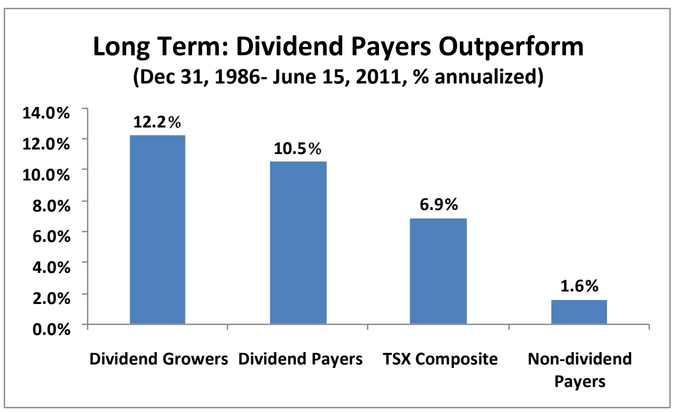
Source: Sionna and Bloomberg

<u>The Importance of Dividends</u>

One of the common misconceptions in investing is that capital gains account for the vast majority of equity returns. The reality is that dividends contribute anywhere between 40% and 70% of an investor's total return, depending on the time period. Numerous empirical studies have demonstrated that higher dividend yielding stocks produce attractive returns both in relation to the broader index and when compared with non-dividend paying stocks, over long measurement periods. In addition, these studies suggest that dividend paying companies have generated their returns with far less volatility than non-dividend payers.

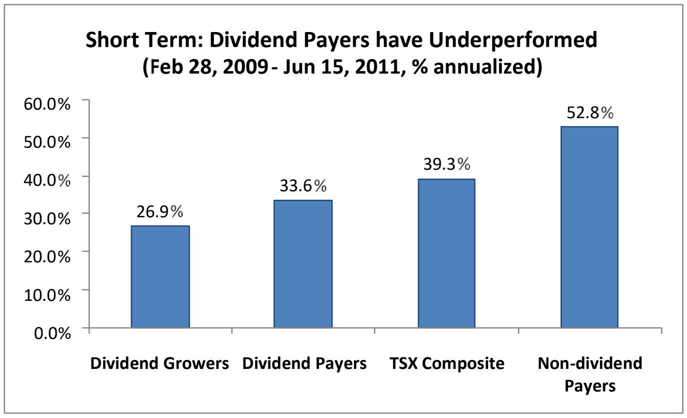
One likely explanation is that a company's proven ability to pay and grow dividends through both good and bad times is a healthy signal to the market of the underlying health of the business and the quality of a company's earnings. Dividend payers also tend to hold up better during market contractions as they have the potential to provide income to investors in an environment where capital gains are lacking.

The following chart illustrates this trend by comparing the annualized returns of dividend paying companies with non-dividend paying companies over the past 25 years. Both dividend growers and dividend payers outperformed the broader index with annualized returns of 12.2% and 10.5% respectively. On the other hand, non-dividend paying companies experienced the worst performance by a wide margin, returning just 1.6% on annual basis.



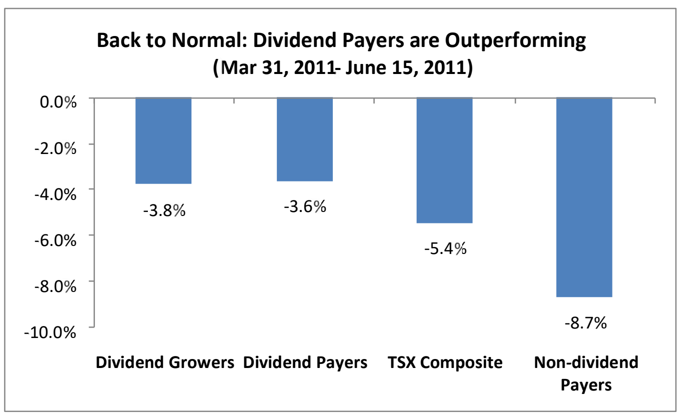
Source: RBC Capital Markets Quantitative Research and Sionna.

Despite the importance of dividends in long-term equity returns, non-dividend paying stocks thrived during the post-financial-crisis period. Since March 2009, non-dividend paying stocks have returned 52.8%, dramatically outperforming dividend paying stocks, whose return was 33.6%.



Source: RBC Capital Markets. Sionna. S&P TSX data.

However, over the past quarter the trend is reversing. In Q2 2011, market leadership started to transition towards companies that are less levered to the economic cycle, have more consistent earnings growth, and pay stable dividends. Of particular note, non-dividend payers experienced the most dramatic decline during the quarter which is consistent with their historical behavior.



Source: RBC Capital Markets. Sionna. S&P TSX data.

Value Wins in the Long Run

Benjamin Graham, the father of value investing, once remarked, "In the short run, the market is a voting machine. In the long run, the market is a weighing machine." We are aware of few (if any) investors who can successfully time the short-term gyrations of the market. At Sionna, we spend our time focusing on the long term, trying to position our portfolios defensively by investing in quality businesses that are trading below their intrinsic value.

Since the post credit crisis junk rally, we have observed that quality businesses have often traded at similar valuations to lower quality companies, a situation that is both abnormal and unsustainable. After all, Bentleys and Buicks should not sell for the same price. While trends rarely revert to the mean overnight, we are encouraged to see indications that high-quality, dividend paying companies are regaining their leadership status. Over time, we expect the market will begin to differentiate between high and low quality businesses again. In the meantime, a disciplined approach to investing focused on valuation, yield, and the quality of the business should be a rewarding strategy for patient investors.

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