Sionna Investment Managers®

SOUNDBITE

Monday September 10, 2012

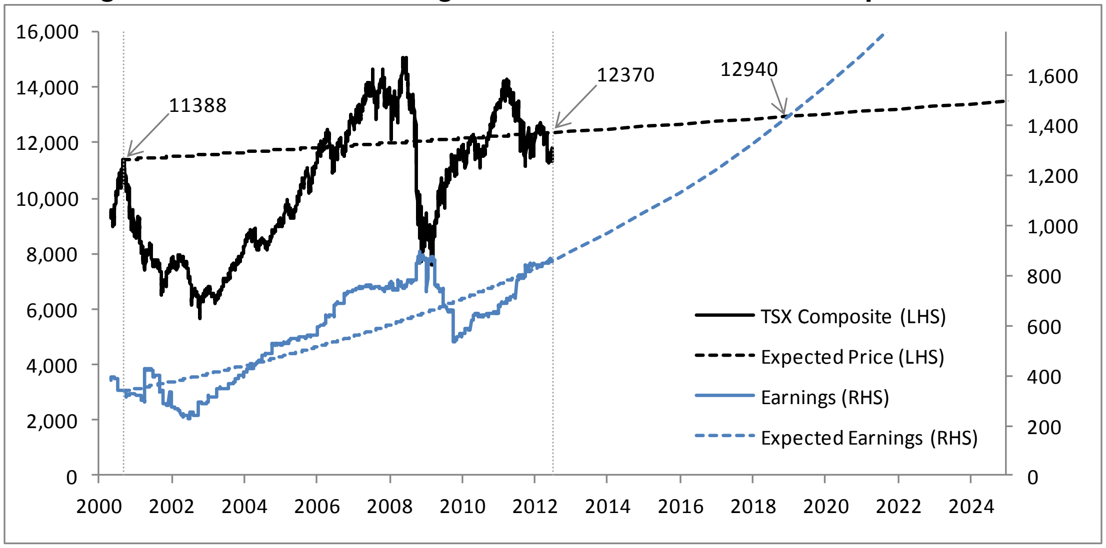
Good morning,

History tells us sideways markets are far more common than secular bull runs. Sideways trends occur immediately after a bull market and last for at least 15 years. They tend to end with single digit P/E ratios, as corporate earnings catch up to price levels. The current sideways market that we happen to be in began in September 2000. The question we hear a lot is, *How much longer until P/Es get to single digits?*

In *Active Value Investing – Making Money in Range Bound Markets,* contrarian investor Vitaliy Katsenelson describes the typical growth trajectories of historical sideways markets. His research suggests that on average, range-bound markets exhibit capital growth of 0.7%. Applying this annual growth rate to the S&P/TSX Composite since 2000, the Index should currently be sitting around 12,370. If we assume that level represents fair value, any market dips below 12,370 indicate a "buy".

Katsenelson also found that earnings growth averaged 5.6% in sideways markets. However, since the beginning of this current sideways market, the S&P/TSX has exhibited 8.2% earnings growth, far higher than expected. Using 0.7% to extrapolate the annual capital growth of the market (P), and 8.2% for annual earnings growth (E), we can project the approximate price and earnings level of the S&P/TSX Composite Index starting at the beginning of the sideways market (Figure 1). Using these projections, we arrive at point where these two figures result in a P/E of approximately 9 times (market price of 12,940 and earnings of 1,400).

Figure 1: Price and Earnings Levels of the S&P/TSX Composite Index



Using the above growth assumptions and plotting the corresponding ratio of price to earnings of the S&P/TSX composite over this time frame, illustrates the expected P/E ratio into the future.

Figure 2: P/E Ratio in the Sideways Market

From Figure 2 we see that if these growth prospects are consistent, the P/E ratio, currently at just under 14 times, will drop to 9 times by 2019. Our calculations therefore suggest that this sideways market could very well reign for at least another six years.

But take heart, this doesn't mean that there won't be opportunities to make money over the next several years. Valuations continue to come down and some high quality companies are coming into buy territory.

One contributing factor, which we cannot comprehend, is how many investors continue to discard high quality equities as they flock instead to low yielding bonds, seemingly content to accept lacklustre returns. With solid companies available at attractive valuations, Sionna is getting the chance to build new positions or add to existing weights in good business that both continue to grow and, in general, pay a *sustainable* dividend.

So Sionna is not pessimistic about this sideways market forecast. For active investors like us that do their homework, we expect the next six years will provide opportunities to generate value-added returns for clients.

The Sionna Team

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