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Catalyst – A Four Letter Word

Sionna is always investigating areas of the market that are unloved and out of favour in search of great bargains. Individual companies, industries and even entire sectors can become inexpensive from time to time.

Sometimes stocks become inexpensive for very real and legitimate reasons such as secular industry changes or financial risk. Other times stocks become inexpensive for more temporary factors such as cyclical industry troughs or negative investor sentiment. Our job, as contrarian investors, is to understand why something has fallen out of favour and to pick out mispriced stocks that offer the best risk/reward profile. For the stocks we believe are mispriced, the real question becomes: How do value stocks unlock their value?

Often the answer is a catalyst. A catalyst can be thought of as any event that shifts the fortunes of a particular stock. According to the Merriam-Webster dictionary:

> **cat·a·lyst** /ˈkatl-ist/ noun 1. An agent that provokes or speeds significant change or action.

In the pursuit of outsized returns over the shorter term, investors often seek out stocks with a perceived future catalyst that has the potential to dramatically improve the outlook for a business.

There are many different broad categories of catalysts, some of which include:

i. Increasing earnings power;
ii. Change in industry outlook;
iii. Change in the management team or company strategy; and
iv. Mergers and acquisitions.

A catalyst can be any event that an investor believes will alter the prospects of the company. The problem is that in many cases, potential catalysts are easily written about, easily understood and can be packaged nicely into a report. Most importantly, they usually make for an exciting story that everyone wants to believe in. Everyone loves a good story.

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"Company ABC is….

…working on the newest and greatest product to be released next year that will triple earnings."
…rumoured to be in the final bidding stages for a huge government project that will double their revenue."
…on the verge of initiating a large dividend in the near future."
…a potential takeover target at a huge premium."

These stories all sound so alluring. However, as value investing legend Bob Tattersall so eloquently put it: "If I can see the catalyst, everyone else can see it and it's already priced in." If there is an exciting, easily understood story about a company, there is a very good chance it is already reflected in the share price and more.

At Sionna, we firmly believe that human nature misprices stocks. Investors buy on good news, sell on bad news and overlook companies not making any news at all. These factors can create attractive opportunities in out-of-favour segments of the market.

For value investors, unloved stocks become the most interesting when all optimism has faded and when there are no longer any apparent catalysts to drive the stock higher. However, there is one very important distinction: inexpensive ≠ cheap, so one must also consider the importance of quality. Cheap implies inferior quality; simply buying cheap stocks is not enough as stocks can be trading at those levels for very appropriate reasons – and can get much cheaper. Value investors must always be weary of value traps, industries in secular change and companies with significant financial risk.

On the other hand, by paying attractive prices for good quality stocks and by having a patient, long-term view, value has a way of unlocking itself. Value investors often don't know what the trigger will be or how long it will take. There are certain events that are ill-defined, hard to predict and often don't form the basis for an investment thesis.

In the second half of the year, two Sionna holdings were the beneficiaries of these hard to predict catalysts: RONA and Loblaws. Both were unloved and out-of-favour, trading at inexpensive valuations. Both had seemingly no catalysts on the horizon.

In the case of RONA, the catalyst was an external force: a takeover bid from a competitor. In the case of Loblaws, an internal force: management deciding to spin-off undervalued real estate assets. The chart below shows the five year price-to-book (P/B) charts for both RONA and Loblaws. In both cases, the companies entered 2012 trading below their five-year average P/B multiple. Because expectations were so low, the announcement of these respective events (highlighted by the grey arrow) had a significant impact on valuation and, more importantly, stock price. This run up in stock price drove RONA above our estimate of its intrinsic value, allowing us to exit the position. In the case of Loblaws, we trimmed our position as the stock appreciated in price, and took some profits off the table.

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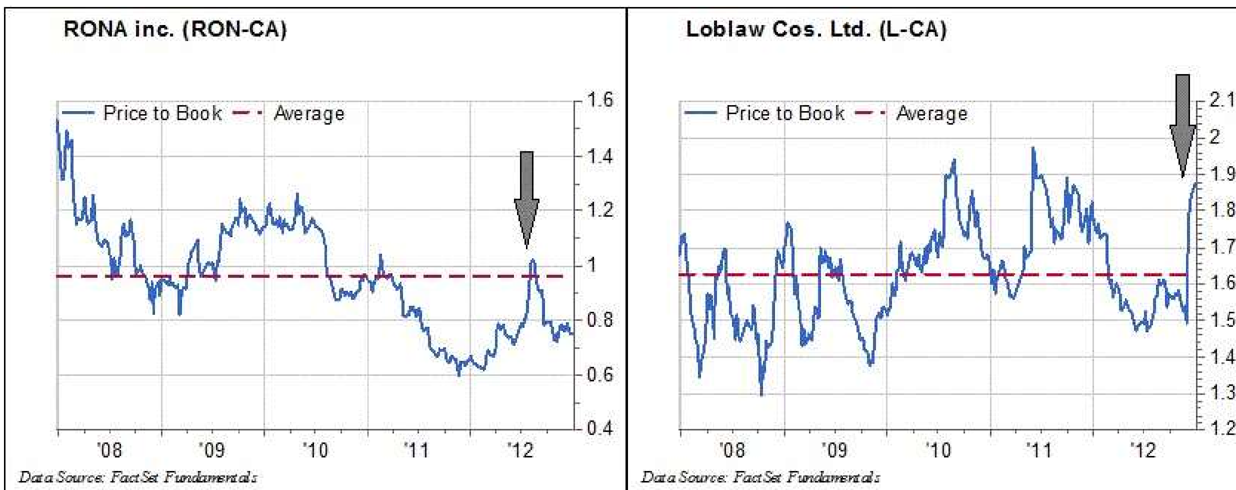

What was attractive to Sionna about investing in both RONA and Loblaws was there was no sexy story, there was no easy fix and there were no perceived catalysts. Sionna recognized that both of these investments exposed us to quality businesses at bargain prices.

Sometimes the best way to win the game of investing is to buy quality businesses at inexpensive prices, have conviction and be patient. Sometimes the cure to inexpensive stocks is just inexpensive stocks.

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