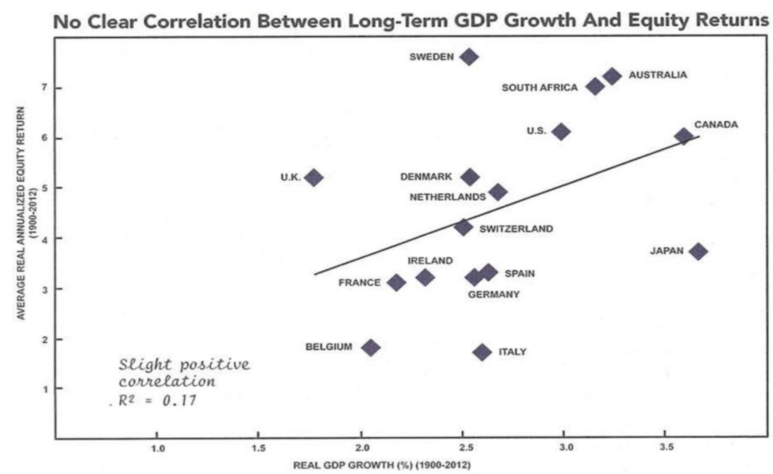
October 2013

Sticking to What Works

After 30 years of falling interest rates, investors have become fixated on the potential impacts that rising rates and the end of quantitative easing will have on the economic recovery and the stock market. Today's investing environment is unquestionably unique which explains the concerns. At Sionna, we view this uncertainty as an opportunity for us to add value over the long-term by capitalizing on the divergence between company fundamentals and exaggerated stock price movements.

The Economy is a Poor Forecaster of Equity Returns



Source: The Bank Credit Analyst as at November 2012

We disagree with the common notion that the economy and the market are inherently connected. According to The Bank Credit Analyst, the economy is not a good predictor of equity returns. Drawing on historical evidence, the chart shown above graphs real GDP growth against equity returns across 16 countries. Dating back to the early 1900s, the findings show that GDP growth and the stock market have not been highly correlated. In fact, economic growth has only explained 17% of market returns.

It is well known that forecasting the economy with any degree of consistency is innately difficult to achieve. However, even if it were simple and repeatable, the study above illustrates that investing according to economic forecasts would not result in consistent outperformance in the market. Therefore, we do not believe economic predictions alone are a useful tool for achieving steady investment returns.

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful"
–Warren Buffett

Despite this evidence, investors continue to react to macroeconomic headlines. Mr. Market cheers when the Fed promises to continue propping up the economy. The opposite is true when the headlines scream “taper” and fear grips the markets. At Sionna, we attempt to avoid all of this noise by focusing on a bottom-up perspective to determine a stock’s intrinsic value. However, we welcome short-term fluctuations since they are often overstated and provide opportunities to add value to our clients’ portfolios over the long term.

To illustrate this point we can look to a few examples. Following the 2008 financial crisis, Sionna took advantage of stocks trading at or near decade-low valuations to initiate or add to various positions at attractive prices. Some examples include Canadian Tire Corporation, Magna, Telus, and Dominion Diamond Corporation (formerly Harry Winston Diamond Corporation). From a bottom-up perspective, these were all high-quality companies whose stock prices weakened during the financial crisis but later rebounded to reflect the their underlying long-term fundamentals.

More recent macroeconomic uncertainty has also provided Sionna with several opportunities across our various mandates. For example, we were able to add to our position in Granite REIT, an Industrial REIT, when the sector reacted negatively to worries of rising rates. Granite is a high-quality operator with global locations and an under-levered balance sheet; therefore, the company is well-positioned to opportunistically acquire quality assets at attractive valuations. Weakness in the real estate sector also provided us with an opportunity to add a mid-cap company, Morguard Corporation, into some of our portfolios. Morguard is a high-quality real-estate company which we were able to buy at a discount to its net asset value. In the large cap space, we have been trimming life insurance stocks as the stock prices have risen ahead of valuations in response to rising interest rates. In particular, we took advantage of selective opportunities in the sector to reduce our exposure to life insurers, in favour of increased weightings in property and casualty insurers, which are more attractively priced at this time. These scenarios provide examples of stock price divergence from company fundamentals, which presented Sionna with a chance to both buy and sell mispriced securities.

During a time when macroeconomic concerns are dominating the newspapers, we believe it is important to remind clients that the economy is not actually a good predictor of stock market returns. Rather, company fundamentals and the prices paid for those businesses will drive long-term returns. Fears about macroeconomic-related issues provide bottom-up long-term investors, like Sionna, with opportunities to take advantage of short-term and often exaggerated price fluctuations to benefit client portfolios over the long term.

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