Sionna Investment Managers

INSIGHT

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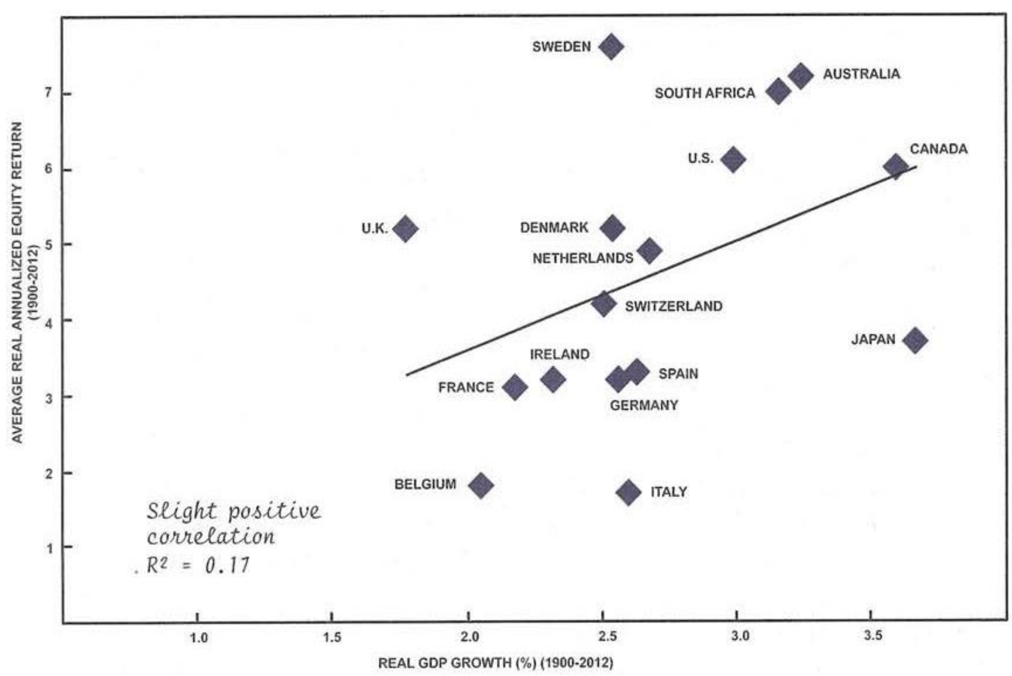
**Big-Picture Thinking**

"Macro Value Investing is the study of how individuals have interacted with financial markets in the past, in order to encourage rational decisions in the future." – Kim Shannon

When I first started in the industry, one of the more popular styles of investing was top-down stock picking; where you made an economic forecast, decided which sectors were going to benefit and then tried to buy the quality names within that sector. Effectively, this approach required investors to focus on the short term; they predicted what economic trends were underway and then adjusted their portfolio accordingly. Value managers generally didn't, and still don't, believe that the economy could be accurately forecasted in general, and they definitely didn't believe that it could tell you how to invest. It still surprises us that today that when most individuals talk about investing, they immediately want to start talking about the economy instead of individual companies.

A very interesting analysis by Bank Credit Analyst supports value managers' skepticism of using the larger economy to make investment decisions. Covering 115 years of GDP growth across 16 different major markets, the analysis (shown below) illustrates the correlation between GDP (the economy) and stock market behaviour. Overall, the correlation between the two is a mere 17%; we would suggest that this level of predictability isn't really going to help you make excess returns in the market.




Source: The Bank Credit Analyst as at November 2012.

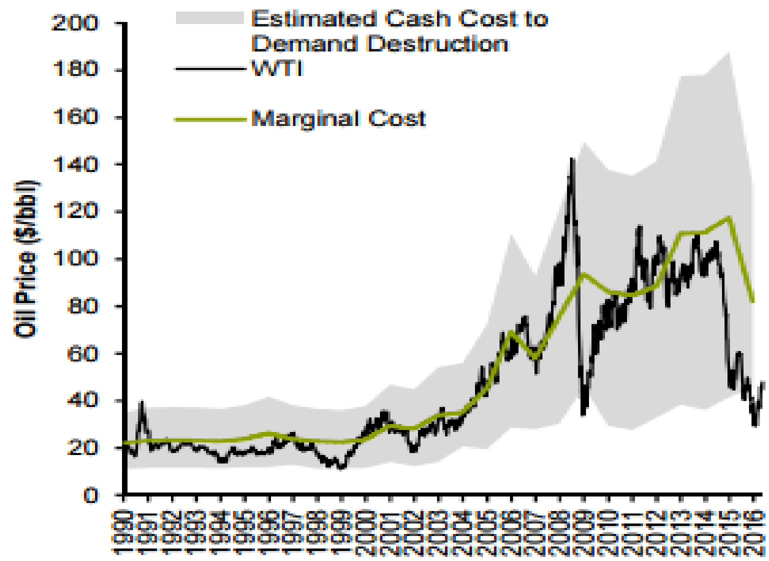
This is not to suggest that the economy should be ignored. There is value in understanding how individual companies will fare through the economic cycle and, correspondingly, how their stock price should reflect the underlying business. It comes down to perspective. We use a long-term perspective when it comes to investment decisions; the same mindset is needed when looking at the economy. Rather than focusing on the current economic conditions and its impact on the stock market in isolation, we step back and look at the bigger picture that historic data creates for us.

Some will argue that the history of capital markets is irrelevant to today's experience: the market moves quicker, there are new products, capital asset pricing models do the valuation work for us, and frankly, we know more than people did 50-100 years ago, so market history has nothing to teach us. We respectfully disagree. While technology has evolved, human emotions, and the ability to keep them in check, have not. By analyzing how emotional human beings have interacted with financial markets in the past, investors are in a better position to assess where we are likely to go in the future. Why? Because money and capital markets are human constructs, so they reflect our emotions as much as they do fundamentals. Philosophers and investors throughout history have analyzed how humans deal with rational thinking, and how much of what we do is actually quite emotional and reactive.

We want to believe the markets are efficient; that they're neat and tidy and easy to understand. We all know that the reality is messier; it's irrational and it's much more volatile than the underlying fundamentals. So stepping back and looking at the fullness of history and how investor behaviour has the ability to influence stock prices reminds us that a few volatile days are just a dot on the long-term picture of history. This is what we refer to as macro value investing – using historic data to help take the emotionalism out of investing and to assess what is likely to happen in the future.

Looking at today's market, there are at least two scenarios where macro value investing has been instrumental in helping us position our investments: the ongoing energy story and the current sideways market.

Let's start with energy. When we study where the price of oil has historically traded relative to where it is today, we gain confidence in our decision to remain overweight energy. At current prices, oil is trading below its marginal cost of production, a level that is unsustainable over the long term. Historic data (see chart below) illustrates that when the price of oil falls to levels where it approaches its cash cost, it rebounds shortly after. Since the current price of oil is closer to the bottom of the cycle, we have positioned our portfolio to benefit from a reversion to normalized levels. Even though we're overweight energy, we remain focused on those companies that meet our investment criteria; quality names with strong fundamentals. Our study of history prepares us for markets such as these, and helps us position client portfolios accordingly.




Source: Company reports, Bloomberg L.P., Bernstein analysis, May 2016.

When we apply macro value investing more broadly, we can see that the market has two distinct phases: 1) bull runs where equity markets experience positive double-digit returns (9%-11%) and 2) sideways markets where returns are closer to 6%. We've been in the current sideways market for 15 years now, and while that may seem like a long time, our historical assessment reminds us that sideways markets typically last between 15 and 30 years. Based on what we've learned using macro value investing, we believe the current sideways market still has two to five more volatile years left to go. Over this time, we expect that market returns should range on average between 4% and 6%, just as they have generated in the past (S&P/TSX return between 2000 and 2015 was 5.5%).[1]

We believe that incorporating a long-term perspective with macro value investing could compel investors to take a step back and use history to help them see the bigger picture. Doing so will help investors to adjust their expectations (if necessary) and set a solid strategy to attempt to do better, regardless of the environment. As John Maynard Keynes once said, "When the facts change, I change my mind."

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[1] For a breakdown of our calculations, and more on sideways markets, watch our Macro Value Investing video from Sionna's 2016 Market Review at www.sionna.ca/commentary/video/.

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