October, 2016

Hitting the Gym: Pumping Iron in a Downturn

Building muscle is not easy. I should know – I've been lifting weights for several years now, but you wouldn't be able to tell just by looking at me. I'm still the same stick figure I was in high school. Nonetheless, it's a fun and grueling hobby, one that I find strangely calming and meditative. A slow journey for sure, but I've committed to it for the long term; images of body-building legend, Arnold Schwarzenegger, at his prime, remind me to stick with it.

One of the greatest paradoxes I've ever encountered is the mechanism by which muscle grows. In order to build it up, you must first break it down. With each successive flex with the dumbbell, you're creating micro-tears in your muscle fiber. That's all weightlifting really is – using heavier and heavier weights to intentionally tear up your muscles (maybe that's why it's called "getting ripped"). The miracle starts to happen when the body sends new cells to repair the injury. The cells fuse with the injured fibers, becoming new strands to replace the damaged ones.

But they don't stop there. In order to protect the body from future trauma, the new strands grow thicker and more numerous than the last. That way they can't get damaged so easily the next time around. It's like rebuilding levees after a flood; you always build them higher than the last time. Now that the muscle is stronger, you need a heavier weight to break it down. Break it down, build it up, but bigger. And so on. Session-by-session, making the muscle "grow" over time.

I think the concept of overcompensating or "recovering stronger" is beautiful. Nassim Taleb, a famous author, trader and statistician, calls this feature anti-fragile. He describes it as "an ability to benefit from shocks; to thrive and grow when exposed to stressors." This is distinct from resiliency, which is simply being able to withstand the stressor. In addition to withstanding the stressor, the anti-fragile actually improve.

Nature is rife with anti-fragility. It is a necessary mechanism that allows species to adapt to hostile and unpredictable environments. Even organisms as small as bacteria can develop resistance to antibiotics after repeat exposure. But what about business? Investors often talk about resiliency – for instance, a company that maintained positive cash flows throughout the financial crisis. However, it is much less common to identify and measure anti-fragility. Certainly no investor I've heard of talks about a Price-To-Anti-Fragility Ratio.

As it turns out, some companies do demonstrate elements of anti-fragility. We've found that such companies typically share key features like business stability, ample cash flow or balance sheet capacity and a courageous and contrarian management team. We get very excited when we find these. Good companies strive to maintain the business going through an economic trough. Great companies actually emerge from the other end stronger.

One common way companies can do this is through the use of opportunistic acquisitions. Take for example CGI Group, a Quebec-based company that provides IT-related services to major corporations around the world. It's a large-cap name that has been on our radar for a long time, but we were only recently able to add the company to our portfolios. In 2012, at the nadir of the European debt crisis, CGI made the acquisition of a lifetime by buying a massive, troubled competitor based in the U.K. Many investors chastised them for this move, claiming it to be too large and too thorny. But after several years of hard work, CGI turned it into a winner. Now, the company has a large platform with which it can support the growing European market. During a time when most companies were reeling from losses, CGI managed to not only recover, but also grow.

Another hard-hitting exercise is repurchasing stock. When sentiment on your company is deeply negative (as sometimes is the case when dealing with Mr. Market), astute capital allocators have created value by repurchasing shares. Great Canadian Gaming Corporation, an operator of casino and entertainment facilities and one of our core small-cap names, has eliminated a quarter of its public share count over the last decade. Even though company fundamentals are incredibly stable, the stock has reacted negatively to customer spending patterns and provincial changes to the gambling industry. The company's CEO Rod Baker took each of these opportunities to buy back shares at depressed valuations. In the most recent Alberta-centric downturn alone (the company has major properties in that province), management repurchased and cancelled 10% of shares, giving the remaining investors a larger piece of the pie.

The methods I've discussed above sound relatively straightforward, but can be hard to execute. In order to position for business expansion in the bad times, a CEO must exercise great conservatism and foresight in the good times. But, most managers struggle in bad circumstances. Companies lack the appetite to expand while debt and equity markets are collapsing. Management must have abs of steel to grow while the rest of the world is shrinking. In some cases, short-sighted investors will criticize management for making such decisions! I suspect this is why anti-fragility is such a rare occurrence in the business world.

A well-rounded investment portfolio also needs to exhibit anti-fragility. By that, I mean it needs to include stocks that inherently benefit from volatility. It is one of the key elements of downside protection. In our portfolios we have put together different stocks that benefit from different stressors. Portfolio stressors can include market declines, deflation, oil price shocks, etc. Suncor is a large-cap name that, despite its oil-driven nature, benefits from oil weaknesses because it has the ability to buy up distressed competitors. Fairfax uses financial instruments to hedge against deflation, as necessary, to cover its liabilities. Including a company like Fairfax in our larger-cap portfolios therefore provides some insurance (no pun intended) against market downdrafts.

Then there are the businesses that are outright counter-cyclical; businesses that sell more products, or add customers, when the barbell gets heavy to lift. A mid-cap company we hold is Boardwalk REIT, which owns apartment properties in Western Canada. In a deteriorating economy, consumers generally have less disposable income to buy a house, so they opt for an apartment rental instead. On top of that, existing tenants are less likely to move out since apartments are one of the most affordable forms of housing. This is exactly what happened in

Alberta during the recent oil pullback. In fact, the apartment rental business is one of the few niches of the real estate industry that actually gets stronger in a housing downturn.

And finally, anti-fragility is part of Sionna's culture. If we make mistakes, we have to be willing to not only admit them, but learn from them. That way, we know how to avoid them in the future to emerge stronger. As an organization, we have to be ready to learn and adapt.

I think our friend Arnie put it best, "Strength does not come from winning. Your struggles develop your strengths. When you go through hardships and decide not to surrender, that is strength." As investors (and bodybuilders), Sionna will seek to continue to grow stronger. Rep-by-rep, workout-by-workout, our team and our portfolios will continue to pump iron.

Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please email Kelly Battle at kelly.battle@sionna.ca or call (416) 203-2732

