

The Middle Way

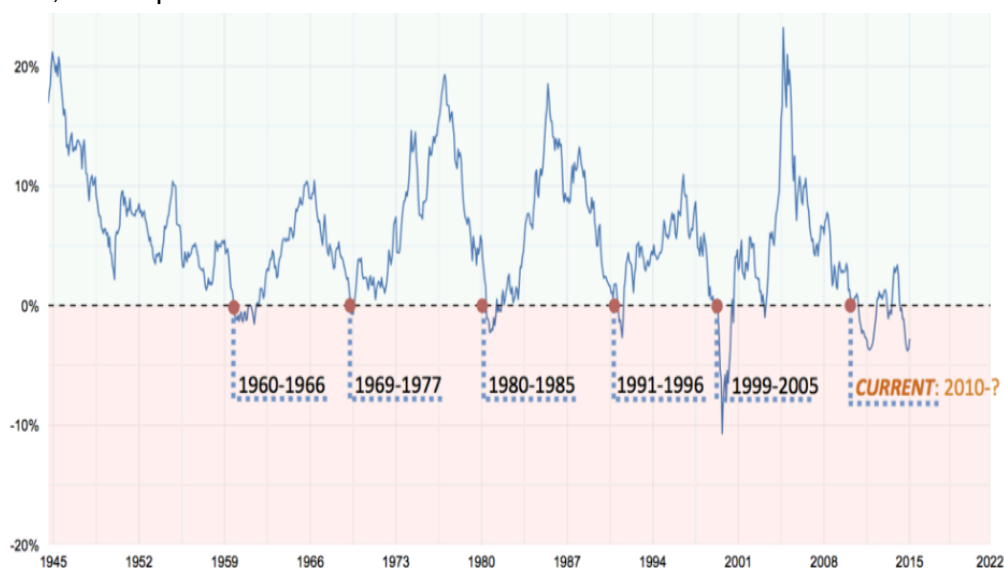
Buddhists have a term, *middle way*, which refers to the human tendency to explore extremes (for example, austerity versus indulgence) until centeredness is found by achieving a balance between the two. It suggests the path to wisdom is to aim for the middle way, and it is this path of moderation that leads to insight. It's a caution against indulging extremes.

How have we seen this practice apply itself to financial markets?

Money and markets are human constructs; a reflection of our psyche and natural tendency to test extremes. We see individual stocks, sectors and markets collectively flow from one valuation extreme to the other with only brief and fleeting rational moments of this “middle way.” Reversion to the mean, a tendency for securities to get pulled by financial gravity towards their intrinsic value or mean, is an example of “the financial middle way” and a fundamental component of value investing.

There have been a few recent examples of investment extremes:

1) **Underperformance of the value style.** As you can see in the chart below, since 1945, growth has briefly outperformed value six times. However, each time value has had a significant and prolonged recovery. We’ve already started to see this trend reverse with value outperforming growth in 2016, and expect to see it continue.

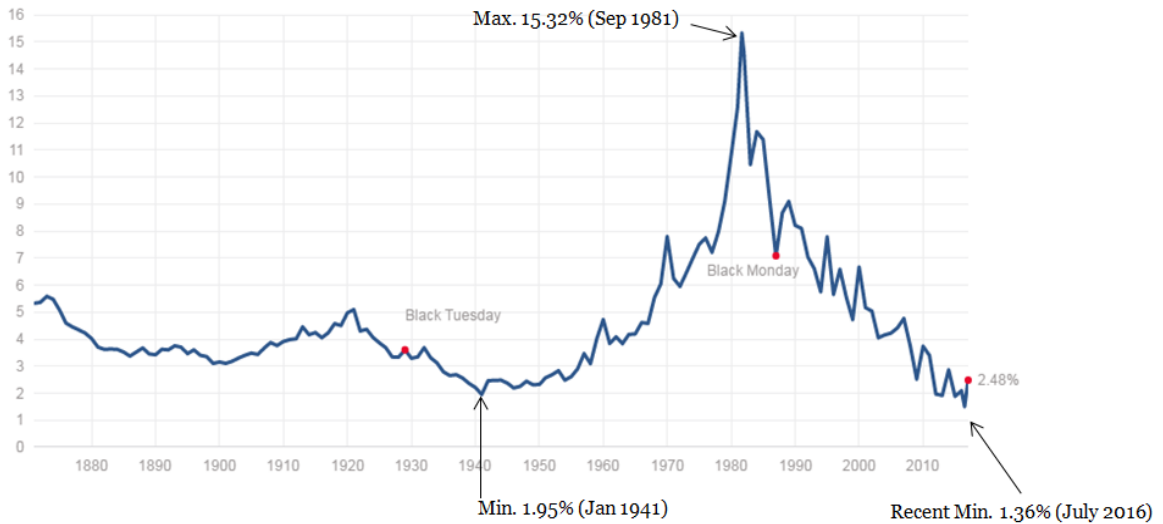


■ Value vs. Growth (annualized 5 year rolling value outperformance)

Source: Euclidean Technologies

2) **Record-low bond yields.** We recently experienced record-low bond yields: the U.S. 10-Year Treasury rate was 1.36% in July 2016, and the Government of Canada’s 10-Year Benchmark Bond yield fell to 0.95% in September 2016. We expect them to bottom over the next few years and then rise closer to their historic long-term averages.

10-Year Treasury Rate
(percent)

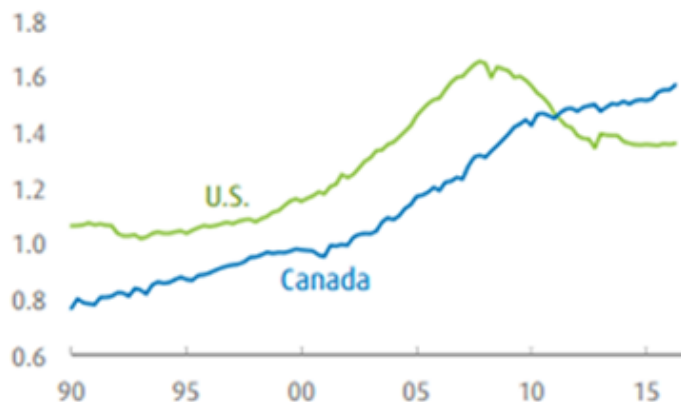


Source: U.S. Treasury, February 1, 2017

3) **High debt levels.** Household debt in Canada has been steadily climbing since 1990, and more recently reaching historical highs. While this trend has not yet changed course, we would expect it to eventually drift back down to more normal and manageable levels.

(ratio to personal disposable income)

Household Debt Ratio



Source: BMO Economics, Haver Analytics

Pursuit of the middle way (or reversion to the mean) rarely occurs immediately. Patience is required, tested and, ultimately, rewarded as it has been in the past.

The Sionna Team



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

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