April 2018

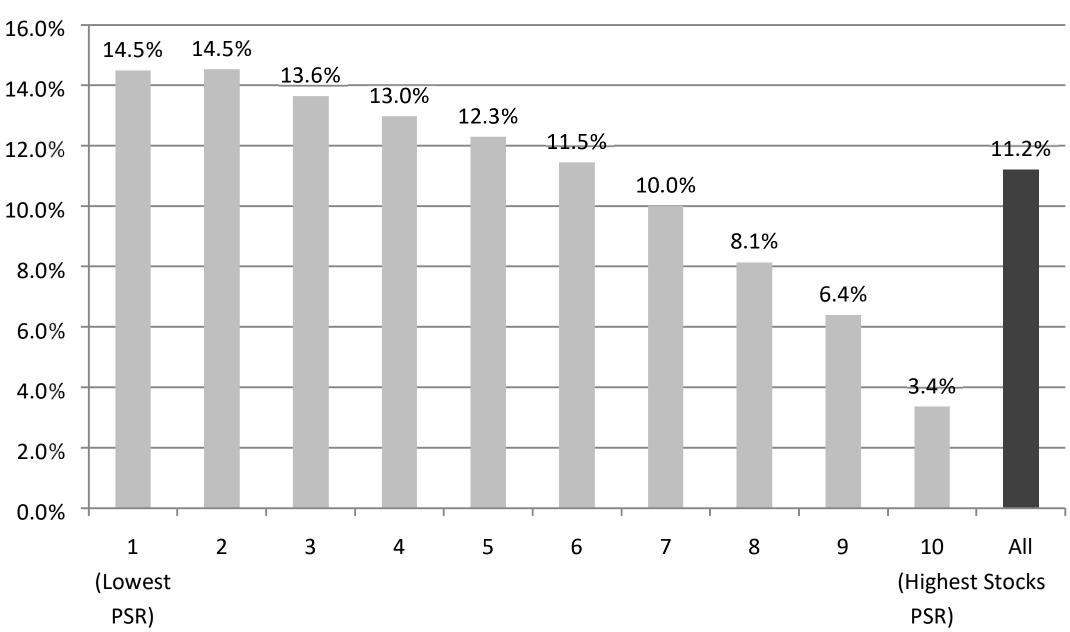
Don't be Fooled by the P/S

It has never been easier to spread a message to the masses. Turn on the television and chances are you will find "facts" being scrutinized, so much so that consumers are willing to pay for high-quality, investigative journalism. The New York Times, for example, experienced an increase in subscriptions following the U.S. election in 2016 and has seen its stock price more than double in that time. Sionna is familiar with the investigative process as we have always felt the need to dig beneath the surface when looking for investment ideas. One topic we have been investigating recently is the robustness of the price-to-sales ratio ("P/S ratio") as a tool to unearth investment ideas.

We believe that, over the long term, the starting valuation level of stocks is the best indicator of future returns. James O'Shaughnessy, a well-known American investor, found that over the long run the P/S ratio is one of the most consistent predictors of future share price performance. In his book *What Works on Wall Street*, O'Shaughnessy wrote, "Low price-to-sales ratios beat the market consistently over time."

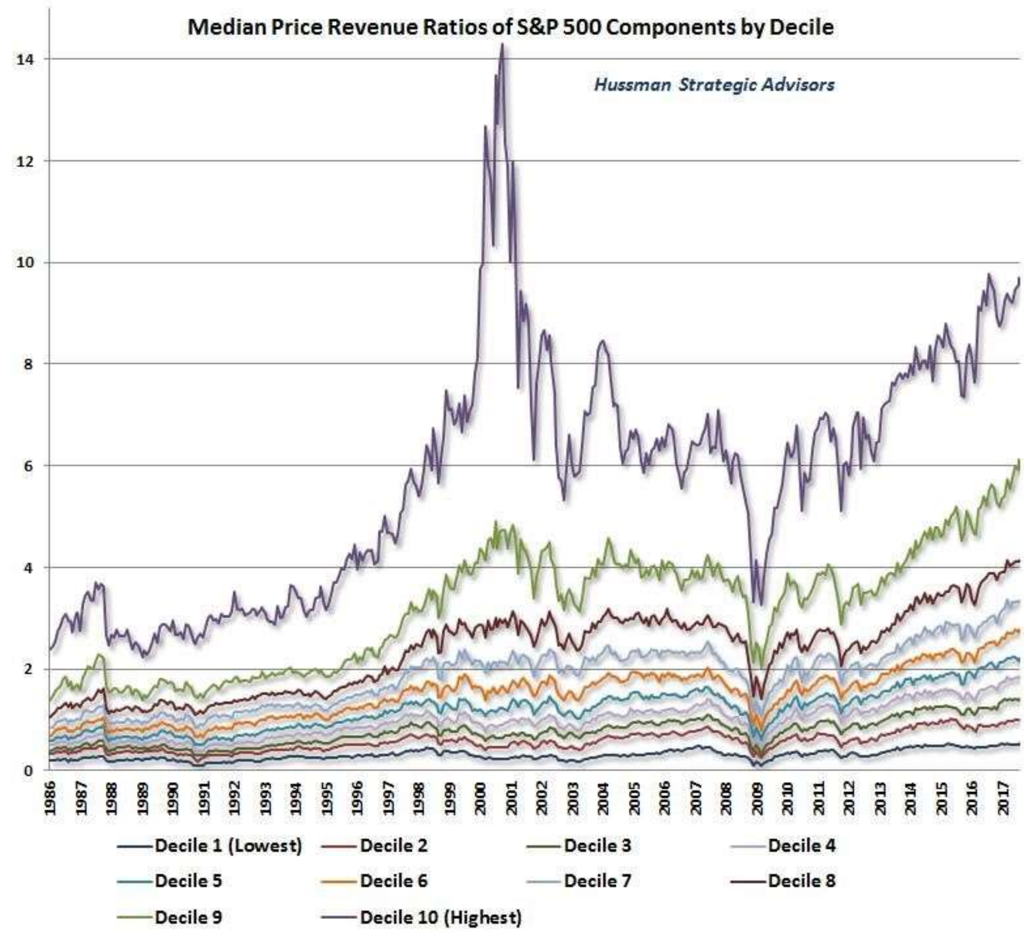
A study completed by O'Shaughnessy between 1963 and 2009 divided a universe of stocks into ten deciles ranked by their P/S ratios. The study found that the low P/S ratio deciles outperformed the high deciles over the 46-year period. The chart below shows that the lowest decile generated an annualized return of 14.5% compared to just 3.4% for the highest decile. To put this in perspective, a $10,000 investment in the low decile would have grown to more than $5 million, versus just $50,000 in the high decile.

Price-to-Sales Decile Analysis of All Stocks Universe, 1963-2009 – Compounded Annual Return



Source: *What Works on Wall Street: The Classic Guide to the Best-Performing Investment Strategies of All Time (4th Edition)* by James O'Shaughnessy.

John Hussman, an investor who predicted the 2008 financial crisis, is another supporter of using the P/S ratio as a valuation tool. However, Hussman goes one step further with his research. Using data from 1986 to 2017, Hussman broke down the S&P 500 into ten deciles. The idea was to investigate how the current valuation level of each decile compared to its own history. In other words, was the low P/S ratio decile cheaper or more expensive than it has been in the past? Sure enough, the data demonstrated that all deciles are currently at historical highs, which can be seen in the chart below. The only exception is the highest decile, which briefly hit historical highs during the peak of the tech bubble in 2000. This research suggests that even stocks that fall within the low P/S ratio decile are expensive relative to history. Given these elevated levels, the implication is significant downside risk in the market, including those stocks captured in the low deciles.



Source: Hussman Funds.

In a challenging market environment where valuations are elevated, we believe the P/S ratio tends to be one of the most consistent gauges of market-wide valuation levels. The price-to-earnings ratio does not capture valuation levels as well because it is more prone to accounting practices. That said, as value investors, we don't solely choose stocks based on low P/S ratios alone. We also seek companies that have economic moats, strong balance sheets and management teams who are aligned with shareholders. Additionally, we focus on defensive companies with resilient business models. These are all factors that will help protect capital in a downturn. While we can't predict the next downturn, we will continue to follow our steadfast investment approach that has served us well through various market cycles.

Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please call (416) 203-8803