October 2019

Value Investing: Art vs. Science

Some say value investing is both an art and a science. It is an art because successful investing requires judgement honed from experience, an understanding of history to recognize patterns and the emotional fortitude to shield against psychological biases. After all, the quality of a business cannot be reduced to a single objective score. Likewise, the assessment of management teams requires an understanding of their past actions and incentive structures; no single metric can objectively score management. Investing is also a science because cold hard analytics can be applied. However, when investors focus too narrowly on any single metric, there is a temptation to rush to judge the attractiveness of a security or portfolio. For example, our portfolio's reported price-to-earnings ratio (P/E) is modestly higher than the market's P/E currently. A casual observer might conclude that our portfolio lacks "value characteristics". This is far from the truth.

While a low P/E is generally a quick and reasonable measure of a stock's attractiveness, analyzing this ratio singularly is what the prominent investor Howard Marks calls "first-level thinking". After all, anyone with access to the internet can search for low P/E stocks and invest in them. Value investing is more than that. Value investors must delve deeper. Let's investigate why investing in "low P/E" stocks involves more than meets the eye.

The numerator of P/E is price, and it's intuitive that paying less than the intrinsic value of something is desirable. The denominator, earnings, is the trickier part of the ratio to analyze because of two reasons. First, a company's earnings are susceptible to economic and industry-specific cycles. Second, reported earnings are based on accounting rules that may not accurately reflect a company's actual earnings. These two factors can misrepresent the true earnings power of a company and thereby skew the P/E ratio.

Factor 1: Cyclical Forces

Let's examine the cyclical issue first. If a company is operating at the bottom of a cycle, current earnings will be low and the P/E ratio high. In this instance, a high P/E doesn't signify this stock is expensive. In fact, the opposite may be true. The nature of cyclical forces is that they cycle! This means lows are followed by highs and vice versa. Investing in a company with a temporarily high P/E in this case is very much value investing. A current Sionna holding, oil and gas pipeline servicer ShawCor, fits squarely in this category. The company's trailing P/E is currently 19 times whereas we estimate the normalized P/E for the company is much more attractive at roughly 10 times.

A company facing temporary operating issues is another form of a cyclical force. When Empire, the owner of Sobeys grocery stores, faced challenges integrating its Safeway acquisition, the reported P/E was above 30 times. Since our calculated normalized P/E was about 9 times, we snapped up the shares opportunistically. Our investment in this temporarily distressed situation was textbook value investing despite a high reported P/E.

Factor 2: Accounting Rules

The second factor to consider has to do with accounting rules. The nature of rules is that they are rigid and standardized. Depending on the situation, this could impact the representation of a company's earnings. For example, accounting rules state that intangible assets with a defined useful life (such as intellectual property and customer relationships) must be amortized over time. Amortization is reflected in the income statement as an expense, but it does not actually affect a company's cash flows. The accounting rule was meant to ensure financial statements capture a proportion of an infrequent expense and spread it out over multiple periods. For instance, if a company purchases a machine for $100 that lasts for 10 years, $10 is expensed each year as depreciation to reflect the machine being "used up" over time (until it needs to be replaced).

However, sometimes intangible assets hold their value because ongoing expenses (such as research and development or marketing) act as incremental investments back into those assets. As such, these intangible assets are not "used up" over time and a lump-sum future replacement is not required. Since accounting rules still mandate that an amortization expense be recorded, reported earnings unduly understates a company's earnings power.

Another example of accounting rules skewing earnings is when "gains and losses" flow through the income statement. If a company periodically recycles capital by buying and selling assets, the lumpiness of the associated gains and losses can cause reported earnings to swing. These swings mask what may be stable growth in underlying earnings.

And then there's Relative Value

There are also instances when we invest in companies that have a higher than average P/E because of the superior quality of the company. What defines quality? Generally speaking, industry structure, competitive positioning, the resiliency and defensiveness of the business, the management team and the level of indebtedness are amongst the factors that determine quality.

Our ownership of Dollarama is a good example of our relative value approach in action. Dollarama is the largest dollar store in Canada and has a strong brand. Management has a solid track record of operations. And the company is a staple that is resilient through economic cycles, which adds to the defensiveness of the stock. In a downturn, we believe this stock fortifies our portfolio and protects on the downside. Given these qualities, Dollarama trades at a higher P/E than the market. This makes sense as the market represents the average quality of all companies and Dollarama is an above-average company. We had the opportunity to purchase the stock when the company faced short-term operational issues and its P/E was low relative to its historical average.

At Sionna, we're thoughtful about our portfolio's P/E but we're not consumed by it. When it is higher than the market, we dig deep to understand the reasons why. We look at the valuation for each company and, where appropriate, adjust for cyclical and accounting factors to arrive at our normalized P/E for the portfolio. Similar to using different valuation methods to estimate a company's intrinsic value, we use other measures to assess the attractiveness of our portfolio. This includes assessing a portfolio's expected return, risk exposures and defensiveness.

While there are quantifiable metrics to help our assessment, they are combined with qualitative research that uses history, experience and our team's diversified knowledge base. It is here where the art and science of investing intersect. As Albert Einstein said, "The greatest scientists are artists as well".

Gary Chow, CFA, MBA
Equity Research Analyst
Sionna Investment Managers

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