September 2020

An Overlooked Opportunity Right on our Doorstep

Canadians tend to be a boast-avoidant and somewhat self-deprecating nation. Even when attempting to define our elusive 'Canadian-ness' we often define ourselves for what we are not, rather than assert what makes us unique. Stock market valuations are a mélange of financial fundamentals and human perceptions, including our modest national self-perception, which in turn influences our perception of the TSX. Too often we allow our Canadian market to be dismissed as too small, too resource weighted, too cyclical, too idiosyncratic and thus too risky to be considered a core investment.

But, let's examine these prevalent perceptions and see what hidden opportunities we can find:

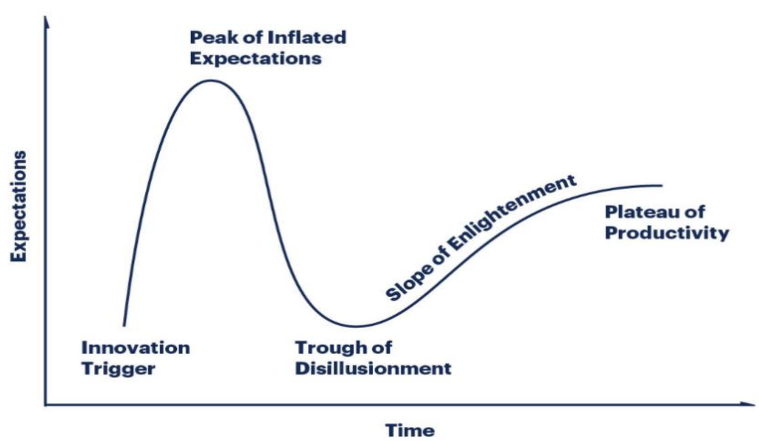
Hype in the Market

A New York Times bestselling book "Factfulness" by social scientist Hans Rosing, touches on why our perceptions about the world are often wrong and should be tested more frequently by examining facts. His work examines common human instincts developed since the hominid era, which lead us to erroneous assumptions in our modern era. He famously posed simple perceptual questions to intelligent audiences like the IMF and Davos, such as, "Are more people today dying of natural disasters than previously?" He knew from his work that they would predictably answer incorrectly. He captured our rough, often dramatic impressions and starkly compared them to known facts to prove our perceptual failings.

As an investment manager, I immediately saw that he was also proving the case for value investing and reversion to the mean through an examination of social science. Contrarian value managers have learned assuming things are not as extreme as the speculative crowd perceives, will often lead to a payoff over time. A more balanced truth is eventually revealed through time and fundamental facts.

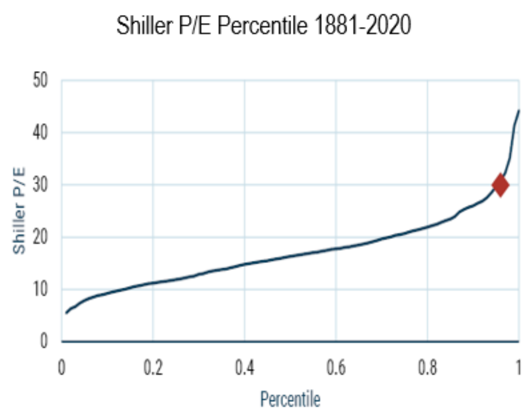
Further, this phenomenon can also be expressed visually, by the well-regarded technology consultant Gartner, which has trademarked "the life cycle of hype" into the representative visual image below.

Gartner Hype Cycle

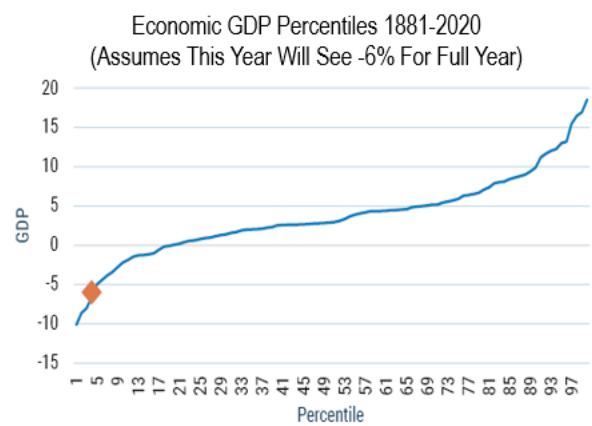


Just as for technology innovations, this chart can also represent stock market speculative excess – how excitement over novel developments can get overrun by inflated expectations. This excitement eventually leads to deflated hopes as the market develops a recognition of a limitation that leads to a trough of disillusionment. Finally, investors accept the emerging true reality of the development, and more correctly value the innovation. A common failure of inflated hopes for a new technological enhancement is an expectation that acceptance and adoption of this new product will happen more rapidly and widespread than it actually does (the 1975 forecast of paperless offices comes to mind).

Since 2009, global equity markets have seen consistent valuation expansion, resulting in a record-long recovery. Today, high multiples paired with low earnings expectations due to COVID suggest caution is warranted with this extreme disconnect between fundamentals and valuation.



Source: Shiller



Source: Global Financial Data

Source: GMO. Reasons (Not) to be Cheerful. August 12, 2020.

Canadian Equities: Lower Risk, Better Expected Reward and Remarkable Yield

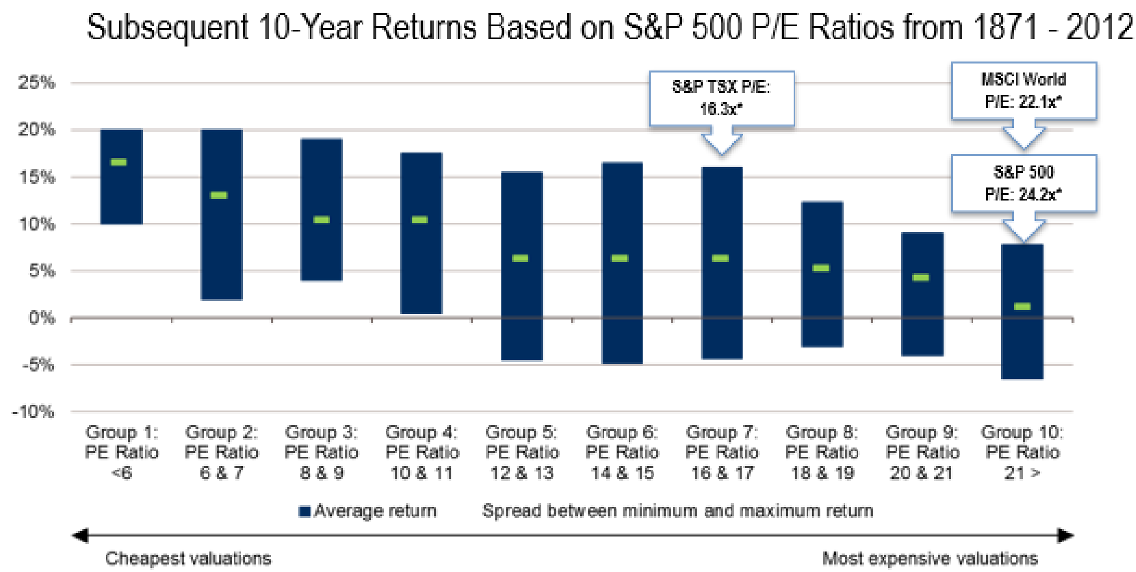
The weight of Canadian Equity in many portfolios has been declining since 2006, usually in favour of global products. However, as the below chart demonstrates, Canada offers a reasonable P/E multiple, with a very attractive relative dividend yield compared to alternative equity regions and bonds. Investors are being paid handsomely to patiently wait for a return to better capital gains.

	1900-2015	January 1, 2000 – June 30, 2020	As at June 30, 2020		
	Annualized Return	Annualized Return	P/E	Dividend Yield	10 Year Govt Bond Yield
S&P/TSX Composite	5.6%	5.7%	16.3x	3.4%	.52%
S&P 500 (CAD)	6.4%	5.4%	24.2x	1.9%	.66%
MSCI World (Gross CAD)	5.0%	4.3%	22.1x	2.3%	-

Sources: Dimson, Marsh, Staunton. 2017. FactSet and Bloomberg as at June 30, 2020. The above returns do not represent the performance of any product or security managed by Sionna and are provided for illustrative purposes only. The performance presented represents historical performance of an unmanaged index. The indices are unmanaged and have no fees. One cannot invest directly in an Index.

Canada Offers Better Expected Returns

The following chart reminds us that the price you pay on entering an investment has a significant impact on the long-term results. The following chart looks at 160 years of U.S. market history and outlines the P/E multiple deciles compared to subsequent 10-year returns. We can see that currently the S&P/TSX is significantly cheaper on a P/E basis relative to the S&P 500 and the world. History suggests that relative to the U.S. and global, the Canadian market is offering a more attractive future 10-year expected return. Meanwhile, investors are additionally receiving a more than 1% richer dividend yield.



Graph Source: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge). As at September 30, 2012.
*Source: FactSet, as at June 30, 2020.

Home Country Advantage Very Compelling Today, With Lower Risk

The home country advantage of investing in Canada is often ignored and overlooked. The below chart outlines that historically, Canada offers attractive returns with lower risk relative to other developed countries.

Summary Statistics of Annual Returns % (1900-2018)			
Series	Geometric Mean	Arithmetic Mean	Standard Deviation
Canada	5.6	7.0	16.9
United States	6.4	8.3	19.9
World Index	5.0	6.5	17.5
World ex-USA	4.3	6.0	19.0
Japan	4.1	8.6	29.3
UK	5.4	7.2	19.7
Europe	4.2	6.0	19.8

Note: Underlying data expressed in U.S. dollars.
Source: Dimson, Marsh, Staunton. 2019. Past performance is not a reliable indicator of future results. The above returns do not represent the performance of any product or security managed by Sionna and are provided for illustrative purposes only.

Reversion of Canadian Dollar to Average Level Could Add a Tailwind to Returns

Further, Canada's weaker-than-normal currency level has been providing stimulus to other market returns. The average Canadian dollar parity is around US$0.83, currently we are sitting around US$0.75. A weaker Canadian dollar tends to help international returns; however, a move closer to average could depress future international returns.

U.S. Dollars to Canadian Dollars

Source: Bloomberg.

Contrarian Opportunity – Better Expected Return with Remarkable Yield

Often, the best investment opportunity is not where the crowd is focused. We believe the overlooked and inexpensive Canadian market with a richer dividend yield offers solid odds of outperforming in the next decade.

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