Sionna Investment Managers®

INSIGHT

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You Can't Judge a Book by its Cover: Perspectives on Judging Investment Performance

There is a famous Zen parable, "We Shall See". In the tale, a series of events occur to a local farmer: his horse runs away then returns with a pack of wild horses, his son breaks his leg then gets passed over during a conscription drive into the army. After each incident, his neighbours offer sympathy or congratulations for his challenge or good fortune. The wise Zen master always responds with equanimity and the comment, "we shall see".

The moral of the story is that few events can be judged accurately as fortunate or unfortunate, or profitable or unprofitable at the time they occur. In many cases, only time will tell the whole story and challenges can often become opportunities and visa versa. The value investment approach has been challenged for a while, with recent weak performance dragging down the long-term annualized result. This weighs on investors' perception, and like the farmer's neighbours, they can be drawn to judgemental thoughts that may mislead them.

A recent book, "Super Forecasters," sought to measure forecasters skills and focused on what made some forecasters much better than others. They concluded that rational thinkers who sought similar examples or most relevant comparison examples for guidance were better at forecasting. When it comes to judging investment performance, we believe instead of focussing on recent returns, investors should seek to look "around the corner" by learning from market history.

Value investors have experienced extended periods of challenging performance in the past: 1930s, mid-1970s, 1987, 1999/2000, 2007/2008 and now. In each prior instance, excess valuations were eventually seen to be unsustainable and collapsed back to more normal levels. Thus, creating opportunities for value stocks, which typically held their value during market declines. Additionally, investors eventually came to appreciate their solid earnings-machine businesses; they were bid up in price and investment returns rose, winning back long-term performance.

Markets typically become very expensive with an increase in speculative participants, with some sectors in particular becoming extremely pricey, leading to narrow expensive leadership in a market. The U.S. market with its current historically high valuations (25x P/E, 2 standard deviations above normal) and narrow leadership with the FAANG stocks is the poster example today. The market cap of all U.S. public and private equities is now at 280% of GDP – much higher than the previous peak of 190% just before the collapse of dotcoms in 2000. Both stock and bond, and public and private markets are at historically extreme levels and are vulnerable to equally substantial declines.

It makes sense today to act in a contrary fashion – moving to less risky, underperforming, less expensive and thus defensive value stocks. And today, Canadian equities are a model for overall reasonable valuations with a historically average P/E multiple (15x) and best-in-class dividend yield.

Canada has one of the cheapest market valuations, but like the U.S., it too has narrow expensive leadership. Shopify at its peak level a few weeks ago (Nov 19) was 7.8% of the S&P/TSX benchmark, up 69.6% YTD, represented 13% of market returns YTD and had valuation multiples that matched or bettered FAANG and Tesla multiples.

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Meanwhile in November, over 70% of Canadian stocks were down 10% from their 52-week highs (10% declines from market tops are called corrections) and over 40% of Canadian stocks were down 20% from their 52-week highs (20% declines from market tops are called bear markets). Yet, as of the end of December, the S&P/TSX Index 1-year return was a solid 25.1%. Just over 3 times Canada's historical average return. Canada's long-term arithmetic return over 118 years was 7%, while the world index over the same time horizon was 6.5% (Dimson, Marsh and Staunton 2019).

All managers' performance is compared to a broad-cap, weighted benchmark, and because of its weighting, its overall level gets tilted to the overpriced popular stocks. This is especially impactful in a two-tier bifurcated market like we find ourselves in again today.

Thus, the lower value, defensive, bottom-up selected, concentrated portfolios have lagged this hot market, but overall have still earned strong absolute returns. While some value managers, like Sionna, are seeing absolute returns that are more than double the long-term historical average, they continue to underperform the frothy Index. However, from experience we often find that moments of "fire" like this create some of the best future opportunities of return (the dotcom bubble and financial crisis come to mind).

Sionna's portfolios consist of thoughtfully selected, fundamentally attractive, solid and defensive businesses with above-average credentials. We use a fundamental quantitative model to screen and highlight opportunities for us to focus our research on and are currently seeing an abundance of stocks (100 in all) that offer total returns of greater than 20% – this is quite uncommon. Currently, Sionna's portfolios on average are at a 17% discount to our internally calculated intrinsic value, suggesting a possible return of 20%.

As we bring in the new year, we continue to see solid value names trading at bargains. We believe these value stocks offer the potential for much better future expected returns than many of the richly valued "disrupters" and "compounders" out there.

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