SOUNDBITE

November 2022

Sionna's "Triple Threat" Stock Pick for the Capitalize for Kids Event

Kim Shannon's script from the Capitalize for Kids Investors Conference.
Click here to watch a video of Kim's presentation.

We likely would all agree that a great stock pick is one that demonstrates above-average expected returns, which compensates for any perceived risk taken. However, in a declining market, like we are seeing today, investors tend to have more aversion to possible risks than usual. But does that loss-aversion instinct serve investors well? As contrarian value investors, we are trained that opportunities lie "where dragons are" and that buying when fears are rampant, especially because of ephemeral risks, is often where big opportunities can be found.

After a tough decade of growth outperforming, some investors began to question value investing; however, we have recently seen a shift back towards value and I intend to argue that now is an opportune time to invest using the value approach. Further, I will seek to convince you that investing in a perceived "triple threat" pick can be a sensible course of action when you dive into the fundamentals.

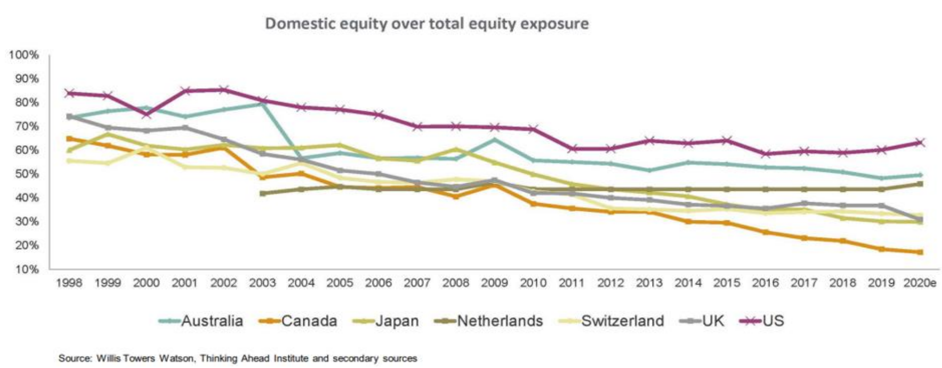
We believe the best opportunities can be found in a "triple threat" stock that is perceived by the market to be risky:

- **An overlooked, recently underperforming market**. Investors may believe the environment offers below-average returns or is riskier so should be diminished or avoided – causing it to be under-owned
- **A beaten-down sector.** Also holds low expectations for an imminent recovery, ideally today in an economically sensitive or cyclical sector.
- **A washed-out security**. Trading below its long-term norms and the market is concerned over potential business challenges.

Strategist, Don Coxe, suggests the best investment ideas are never on the front page (where all known info is likely already priced in). The emerging insights and ideas are on page 16, the back page, these ideas are not yet reflected in the collective consciousness. The countries, sectors and securities that appear risky and untouchable are often where the best ideas can be found. The best returns come from a country/sector/stock going from "washed-out" to simply returning to normalized historical levels.

Let's start with an overlooked, under-owned market…

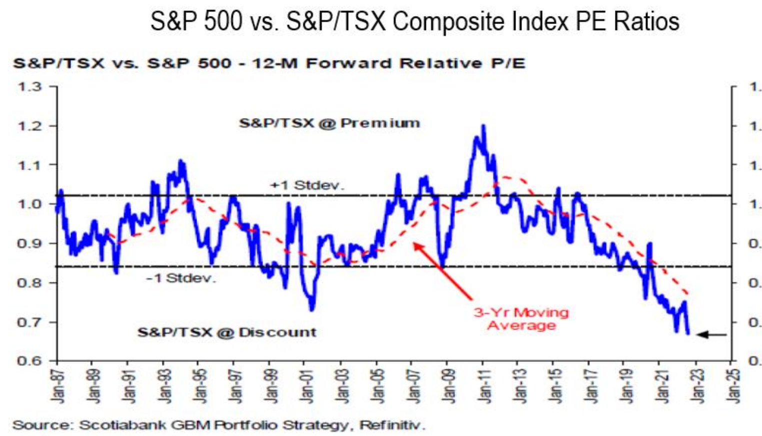
Canadian Public Equities Held by Pension Funds in Canada



Source: LetkoBrosseau, Canadian Pension System's Divestment of Canadian Equities: The Canary in the Coal Mine, March 2022

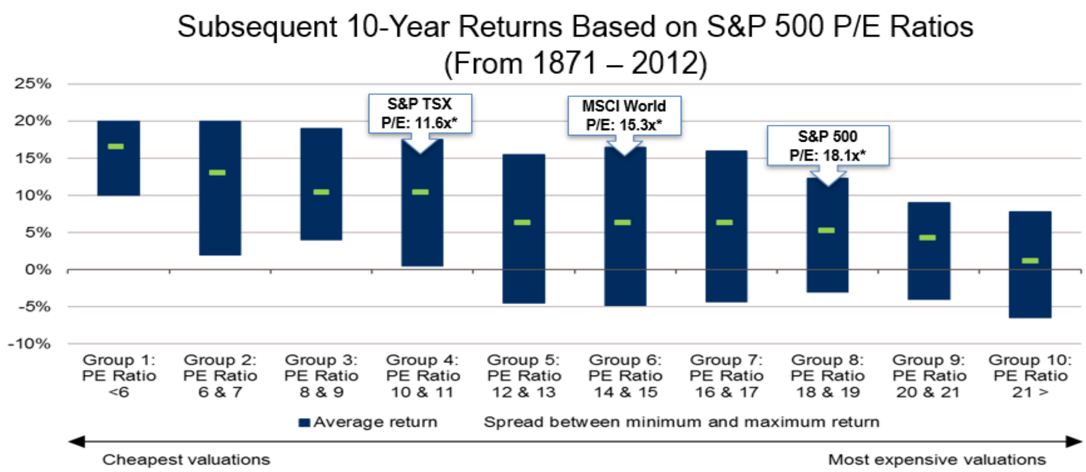
One of the major current investing themes, is a shift to Global investments to the detriment of local domestic investing. This has occurred in every domestic market except for the U.S., which currently represents approximately 70% of global cap weighted benchmarks. You may be as surprised as I was to learn that Canada today is the fourth largest country weight in MSCI World Index at 3.5%, outranked only by the U.S., Japan at 5.8% and UK at 4.1%.

Canada has apparently seen the impacts of the move towards global more than other major developed nations, with Canadian pension funds holding just a 4% weight today. This, despite Dimson, Marsh and Staunton's analysis of over a century, that the Canadian market offers above-average, long-term returns and below-average, long-term standard deviation as well as numerous home country advantages.



Source: Bloomberg. August 2022

As shown above, the Canadian market is the cheapest it has been relative to the U.S. in over 40 years, at 2 standard deviations below normal, which suggests a reversion to normal is inevitable. The last time Canada was this cheap, Canada outperformed fairly consistently over the next 11 years. The cheapness is further confirmed by a P/BV approximately half of the S&P 500 level and a Canadian dividend yield roughly double that of the U.S. Further, history teaches us that the cheaper a stock, sector or market is, the greater the long-term return often is.



Graph: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge). As at September 30, 2012.
**Source: FactSet, as at September 30, 2022. S&P 500 PE (CAD).*

In the above graph, the histograms on the left offer the highest average returns, which are only earned by buying the cheapest P/E multiples. The bars on the right are the lowest average returns earned by buying the most expensive stocks. We plotted where today's expected returns are likely to be for Canada, the World and the S&P 500. Canada is the cheapest market with an expected return of around 10%, global offers about 6% or 7%, while the U.S. offers just 5%. Further, as shown below, inflation above 4% seems to support Canadian returns.

Perspective on performance of asset classes in inflationary periods

Real total annualized returns during when inflation exceeds 4% (including start of recessions)

	Periods 1972M12-1974M12	1976M12-1980M03	1986M12-1990M10	2002M06-2005M09	2006M10-2008M07	Average	Other periods
Copper	-6.7	2.5	12.6	32.9	-0.6	8.1	9.7
Gold Bullion	49.5	41.5	-6.2	10.8	11.0	21.3	-2.2
10-year treasury total return index	-8.3	-11.6	1.0	0.7	3.5	-2.9	5.9
S&P 500	-27.9	-5.0	3.0	7.8	-7.7	-5.9	11.4
S&P/TSX	-18.6	16.8	-3.1	13.9	2.6	2.3	6.4
US Broad Nominal $	-12.6	-9.8	-1.4	-6.3	-9.8	-8.0	0.7
US home prices	-1.6	1.3	-0.4	11.0	-16.9	-1.3	1.7
CA home prices	11.6	-2.2	2.5	4.9	3.2	4.0	5.8
Light Crude Oil	66.4	27.5	10.5	26.3	42.4	34.6	-6.6
CRB composite	11.5	-2.5	-1.4	4.5	8.8	4.2	0.3
U.S. yield curve inversion?	YES	YES	YES	NO	YES	-	-
Annualized inflation	10.7	10.4	4.9	3.2	4.6	6.7	3.3
Recession started in the period?	YES	YES	YES	NO	YES	-	-

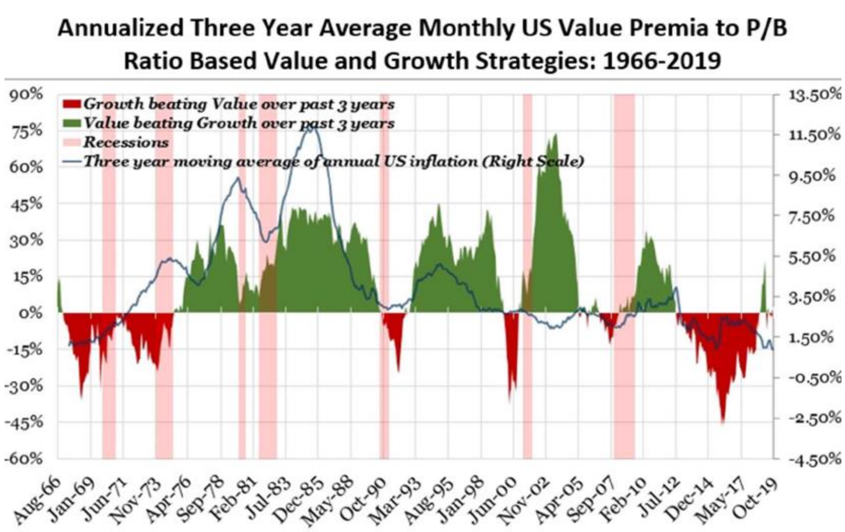
*July 2021 (U.S. home prices as of May)

Source: National Bank of Canada Monthly Equity Monitor. October 2021.

Five periods of inflation since 1970 demonstrate that when inflation is above 4% (core inflation is generally deemed today to be roughly 5%), Canada significantly outperforms the U.S. Likely because commodity-oriented sectors tend to do well.

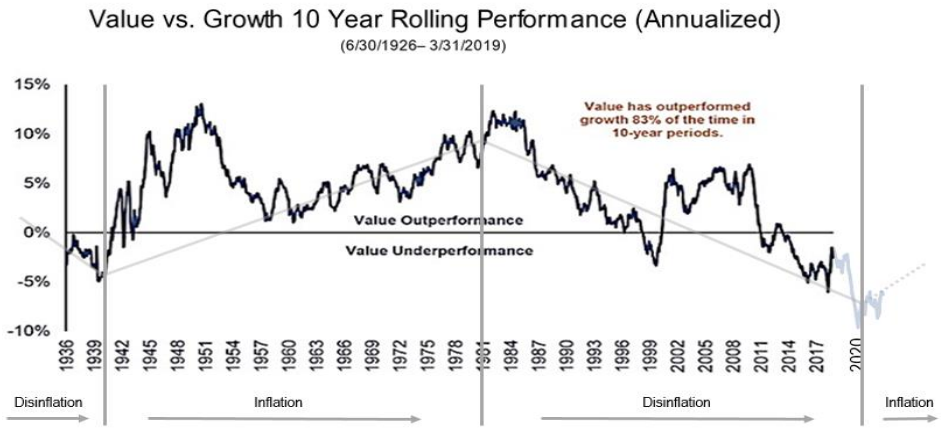
Shifting focus now from Canada to the value approach….

Gratifyingly, as outlined in the following chart, when inflation is above just 2.5%, the value style begins to outperform, which we have seen since last November when the market began to price in that inflation was not transitory. Prof. Athanassakos of the Ben Graham Centre for Value Investing demonstrates that over the last century when inflation was moderately elevated, the value premium over growth was 11%.



Source: George Athanassakos. Ben Graham Centre for Value Investing. Oct. 2021

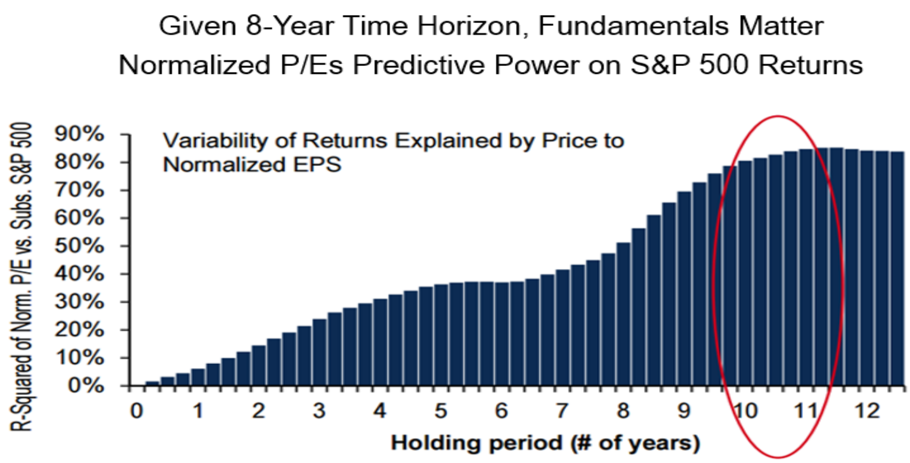
This turn from disinflation to inflation leading to value outperformance is also seen in Fama and French.



Source: Eugene Fama & Kenneth French. Ronald Blue Trust. 2019.
2019-2022 is an estimate by Sionna based on S&P 500 Value and S&P 500 Growth Index Data.

Fama and French's famous comparison of the value versus growth style over the last century, shows that the current period of transitioning from disinflation to inflation is mirrored by the bottoming of interest rates in 1941. The following decade's return to 1951 was an annualized return of 13% – suggesting a similar recent period of underperformance is transitioning back to favouring the value approach.

Markets can get especially noisy as they transition from one regime to the next. Markets are known to be irrational and unconnected to fundamentals in the short term. However, given more time, fundamentals and cheap value can shine through and handsomely pay investors.



Source: Bank of America Merrill Lynch. Strategy Snippet. The Most Contrarian Theme: Long-Term Fundamental Investing. March 2017

So now that you know what contrarian market and style we are choosing to select from, it's time to select a challenged sector…

Given the current environment, with a looming recession, sticky inflation and lingering supply issues dominating investors' minds, we thought a cyclical, economically sensitive sector would be a good contrarian choice. As value managers, our choices are formed from the bottom up. So, before we reveal the sector our stock is in, we thought we would share the bottom-up features of our selected stock.

Company	Return YTD (%)	Return 1-Yr (%)	TTM P/E (%)	Forward P/E (x)	P/BV (x)	P/S (x)	Dividend Yield (%)	D/E
A	-35.0	-35.3	21.6	6.8	1.3	0.4	3.3	0.5
B	-24.8	-14.7	10.2	6.3	0.8	0.5	1.4	0.3
C	-24.5	-24.5	28.0	3.4	0.6	0.2	2.3	1.1
TSX	-12.4	-9.0	11.7	11.0	1.8	1.7	3.1	2.0

Data as at October 7, 2022.

There are three comparable stocks in this sector, and in the above table, you can see all the stocks have performed 10-20% worse than the overall benchmark, and have cheaper valuations and less debt than the Index. All good attributes for a value-oriented investor.

Our pick is "Stock A" – a TSX-60 listed stock, with operations in 28 countries. It should be a recognizable name to everyone in the room, as it is a world-class player, and fourth largest in its industry globally. I want to underscore that it competes globally and yet is cheaper than the TSX Index, which is cheaper than the MSCI and cheaper still than the U.S. It is a cheap stock, in a beaten-up sector, in an overlooked and unloved market. A perfect triple threat!

This past week it was easy to find challenging headlines related to this stock's sector…the auto sector. Negative headlines keep new investors wary, despite the bargains, and cause existing investors to capitulate their holdings and add to price pressure. We thought the auto parts industry had a number of well-known challenges to make it a good sector to find hidden value opportunities in. And news headlines are emerging regularly to support the current market pessimism.

But, this pessimism helps create asymmetrical opportunities, and potential above-average future returns.

As of October 14, 2022

As value managers, we expect stocks to revert to their normalized levels. In Stock A's case, it has fallen 48% from its recent high, so if it returns to that recent high of $126, it earns a 94% capital only return. If it takes 5 years to return to $126, Stock A would see a roughly 22% total return – an "all-star return". Lastly, even if it took 10 years to return to the $126 level, the average return would be modestly over 10%, close to the typical long-term return in the market. Curious yet?

So, what is stock A?

Sionna's triple threat is auto parts supplier Magna International.

Our estimate of intrinsic value for this stock (based on normalized earnings) is 46% over the next two years, or 23% per annum, but if it does return to its prior highs, it could be a total return of 100% over 2 years. We do not yet have a full position in the name – in a worst-case scenario, we believe this stock may decline to $52 (a 20% decline), so we have left some room to buy at this level.

As risk-adverse investors, we like to have "wide eyes" to the possible risks or challenges facing a stock. In our opinion, the largest risk to Magna is inflationary impacts on input costs (depressant on margins) and affordability (a challenge for sales). However, central banks seem to be resolved on managing this issue and Tiff Macklem, Governor of the Bank of Canada, has moved faster and farther on this front – earning a lower 10-year government bond yield and slightly trailing inflation compared to the U.S.

We believe the next largest challenge for Magna is the expectation of an economic recession. The current debate is whether it will be a "soft or hard" landing. Once it's officially called, some of the betting will likely shift to debating when a recovery will begin. Lastly, the ongoing war between Russia and Ukraine is keeping concerns regarding energy supply and costs top of mind and impacting Magna's sizable manufacturing and sales in Europe. Chip supply issues could last longer than hoped, so a turnaround may take longer…patience is required.

Things often appear darkest before dawn

Magna has a long history of innovative engineering excellence, forecasting where the "puck is going" and ensuring the company is on the leading edge of new trends. This is demonstrated by Magna's flexibility and indifference today in producing parts and components for either traditional internal combustion engines or electric engines (it makes parts for over 11 electric vehicles including Mercedes, BMW, Fisker and Ford). I want to note that Magna's forecast P/E is a bargain basement 7x while Tesla, a market EV darling, is at 37x, in our book this spread will revert and we suspect Magna's return will be a beneficiary. Finally, with the recent lack of availability of critical auto parts, long wait times for new vehicles, the average age of U.S. vehicles at 12 years, and high employment, we expect sales will hold up better than some investors fear. Additionally, moderate debt can help us buy time if this takes longer than we hope.

In 1979, Business Week featured a cover with the heading, "The Death of Equities", which was published shortly before the great 1980 and 1990's Bull Market run. It is the bleak "Chicken Little" mindset at market bottoms that help to create the sizable opportunities and returns that follow for long-term investors. Buying in the most overlooked market, in an economically sensitive sector and focusing on a stock that has experienced compressing earnings may seem like a foolhardy choice as we await the NBER to declare a recession. But history shows us very frequently that short-term fears can create fabulous long-term opportunities for contrarian value investors.

Kim Shannon, CFA, MBA
Founder and Co-CIO
Sionna Investment Managers