Is Now the Time to Increase Allocation to Canadian Value Equities?

by | **Kim Shannon**

The recent shift from disinflation to inflation presents many similarities to the early 1940s, which was a period of outperformance for value stocks. The author discusses where to find value opportunities to help position Canadian pension funds for future success.

I spent the mid-1980s studying for the (then relatively unknown) chartered financial analyst (CFA) exams and designation in the still-nascent field of institutional investing. Much of the CFA program at that time offered lessons on operating in a rising rate environment, the challenge of the prior 40 years. I was additionally an analyst at an insurer and assigned to "roll" maturing short-term T-bills. Back then, short-term notes earned juicy 13% yields. This was not long after Paul Volcker, then chairman of the Federal Reserve, had finally broken the back of runaway inflation expectations in 1981. However, not many believed inflation had been slayed yet. After 40 years of rising rates, understandably, the familiar fear that runaway inflation would return was generally pervasive.

Do Today's Investors Know an Interest Rate Regime Shift Has Occurred?

David Foster Wallace famously introduced the idea that "fish don't know they're in water," highlighting that the most obvious, ubiquitous and important realities are often the hardest to see and accept. Regime changes are similar. It will take a while for institutional investors to accept that a change from a 40-year disinflationary period to an inflationary period has occurred and thus impacted valuation opportunities. Professional investors typically have a 30- to 40-year career, and the age profile of the average professional tends to skew young as many investors are brought in from school, then self-selection and a winnowing process result in just a handful of seasoned professionals.

The CFA Society Toronto, the world's largest society of CFA charterholders, currently classifies just 10% of its members older than the seasoned age of 50—So less than 10% of these professionals have more than 25 years of experience, while 90% of the population started their careers after 1998.

Takeaways

- *Recency bias* is a well-known thought pattern that gives greater importance to the most recent event rather than to an earlier one and may help explain why so many investors still expect a "soft landing" and a hasty return to 2% inflation targeting.
- Institutional investors who actively study financial history can see that inflationary periods are inevitably followed by disinflationary periods (and vice versa), such as the period from 1981-2020, where interest rates ultimately softened.
- Lessons from history suggest investors should rebalance their excess allocation to growth down to an underweight—or at least a balance with value.

Based on these statistics, only a small number of current managers experienced the 2000 dot-com mania and subsequent bust. None have seen inflation rise above 3.5%, as they have only witnessed interest rates falling to 800-year historic lows, even declining to negative yields in some countries. These "fish" know and can operate well in a disinflationary environment. But they are just starting to adapt to today's inflationary world, which will likely take some time.

Recency bias is a well-known thought pattern that gives greater importance to the most recent event rather than to an earlier one. Broadly speaking, roughly 90% of investment professionals have only experienced a disinflationary period. Central bankers only suggested that the current inflation levels may not be transitory toward the end of 2021—contrary to what was originally thought. Recency bias may help explain why so many investors still expect a "soft landing" and a hasty return to 2% inflation targeting.

However, investors who actively study financial history can see that inflationary periods are inevitably followed by disinflationary periods (and vice versa) and are more likely to accept the changed reality. With this informed ability to "see around corners," they can anticipate change and adapt their portfolios accordingly. They tend to surmise how best to adapt to the emerging reality and can thus earn a running start for their investments.

The period from 1981-2020 was, in fact, a disinflationary period where interest rates ultimately softened. Although rates declined immediately, it took until the 1990s, when rates fell below 7.5%, for equity investing to become attractive again since, historically, equities overall see an average long-term return of 9.5%. Around 2011, equity investors learned that as rates fell dramatically, the present value of growth stocks' future earnings increased, allowing the growth style of investing to earn excess returns. Assets shifted into the growth style and alternative asset classes.

Then the shock of COVID-19 affected everything in early 2020. COVID-19 lockdowns, stimulative federal policies and supply disruption were dramatic enough shocks to start an inflection to rising inflation and rates. Other events transpired—Inflation grew dramatically and had, in retrospect, cemented the bottom of disinflationary rates to July 2020.

Not surprisingly, like in the early 1980s, many investors expect a return to the market norms pervasive over the last couple of decades. Further, we have seen an emerging expectation that determined central bankers will be able to rapidly contain inflation below 2% before long and give advantages back to the growth style of investing. This wishful thinking reflects David Foster Wallace's theory, as this new reality requires a new framework of thinking and managing investment portfolios accordingly, especially at an asset-mix level.

A Bank of America study looking at the past 40 years demonstrates that once inflation has risen above 5%, it takes an average of ten years to get inflation to 2% again (BofA Global Research via Redburn, September 2022).

What Does History Suggest?

We must go back 80 years to 1941 to find a similar period where rates shifted from disinflation to inflation.[1] The experience from 1941 to 1951 shows a dramatic advantage to the value style of investing in the immediate aftermath of the switch (13% annualized advantage over growth). Value's outperformance was largely sustained until rates fell low enough in 2011 to begin a long-term outperformance of the growth style, similar to the deflation experience in the 1930s. However, over the century, the overall advantage in returns favored the value style.

Further, professor George Athanassakos' research concurs and demonstrates that when inflation is 2.5% or better, the value style outperforms growth by 11% in rolling three-year periods.[2]

Canadian Equities: Still Relevant for Your Portfolios

Another central investing theme we continue to see is a shift to global investments to the detriment of domestic investing. This has occurred in every domestic market except for the U.S. market, representing approximately 70% of global cap-weighted benchmarks. Surprisingly, at the end of 2022, Canada was the fourth-largest country weight in the MSCI World Index at 3.5%, outranked only by the United States, Japan at 5.8% and the U.K. at 4.1%.

Canada has seen the impacts of the move toward global more than other major developed nations, with Canadian pension funds holding just a 4% weight today.[3] This trend is occurring despite Dimson, Marsh and Staunton's conclusion that over a century, the Canadian market has offered above-average, long-term returns and below-average, long-term standard deviation, as well as numerous home country advantages. The Canadian market is the cheapest it has been relative to the U.S. in over 40 years, at two standard deviations below normal, which suggests a reversion to normal is inevitable (Scotiabank GBM Portfolio Strategy, Refinitiv, 2022). The last time Canada was this cheap, Canada, as measured by the S&P/TSX, outperformed the S&P 500 by approximately 9% and the MSCI World Index by roughly 8% over the following 11 years.[4] The cheapness is further confirmed by a price-to-book value (P/BV) approximately half that of the S&P 500 level, and a Canadian dividend yield is 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 potential return often is.

Allocating Portfolios During a Regime Shift

Markets can get especially noisy as they transition from one regime to the next. Markets are known to be irrational and disconnected from fundamentals in the short term. However, given more time, fundamentals and cheap value can shine through and handsomely pay institutional investors. Lessons from history suggest institutional investors should rebalance their excess allocation to growth down to an underweight or at least to a balance with value. In the century of data from Fama and French, value has compellingly outperformed growth 80% of the time in ten-year periods. The last decade has been a shift of assets into growth and speculative assets. It appears institutional investors are still reluctant to reconsider reallocating assets back to value—Perhaps this is recency bias at work? Southeastern Asset Management, a respected value manager, shared its analysis of the variability of assets from 13F SEC Filings of similar value managers over time. AUM for value peaked in 2006 at $371.1B and had fallen to $148.9B at the end of 2021, a decline of 59.8%.

However, like in the early 1980s, many institutional investors who do not recognize the regime change largely appear to be discounting underperformance as temporary. Some justify inaction with comments that perhaps the revaluation has primarily occurred, and thus it is too late to switch. But as we all know, the early bird often gets the worm (and the most excess returns). Several value managers delivered strong positive results to investors in 2022, a negative return year for the market overall. If this outperformance is sustained, then investors' resolve to stick with what worked the prior decade will likely dissolve. When growth assets are replaced with value assets, the supply of growth assets rises and that of value assets falls. Correspondingly, the demand for value assets rises and prices rise until an equilibrium of the two styles is reached.

Currently, institutional investors' low allocation to value supports the bargains that value institutional investors are still finding in the market, creating an opportunity for the value-style investor to take advantage of. We expect this advantage could be present for several years.

We are cautiously optimistic that the 1941-1951 outperformance of value of 13% annualized relative to growth over the decade may be something we could see again today. Like the rate change in 1981, a major shift in valuation has occurred. It took a while for the collective of investors to accept and adjust back then, and the same is happening today. The early adopters get the largest advantage, followed by the solid advantage of the next adapters.

Last year was a great running start for those noticing that a regime change had occurred, and there is even more to come.

Endnotes

1. 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.
2. George Athanassakos. Ben Graham Centre for Value Investing. October 2021.
3. LetkoBrosseau, *Canadian Pension System's Divestment of Canadian Equities: The Canary in the Coal Mine*, March 2022. www.lba.ca/wp-content/uploads/2022/04/Invest-in-Canada_Presentation_EN_01-04-2022.pdf.
4. FactSet and Sionna Investment Managers, 2022.

BIO

Kim Shannon, M.B.A., CFA is the founder and co-chief investment officer of Sionna Investment Officers, one of the largest independent investment firms led by a woman. She joined the industry in 1983 and has received numerous awards, including Morningstar Fund Manager of the Year (2005), the RBC Canadian Woman Entrepreneur Award (2007), Canada's Most Powerful Women: Top 100 Award (2007, 2017), the Rotman Women in Management Association Top 10 Award (Entrepreneur, 2015) and the Rotman Alumni Lifetime Achievement Award (2021). Shannon was also inducted into the IIAC Investment Industry Hall of Fame in 2022. She is active in supporting her community and serves on many boards and investment committees.