Sionna Insight

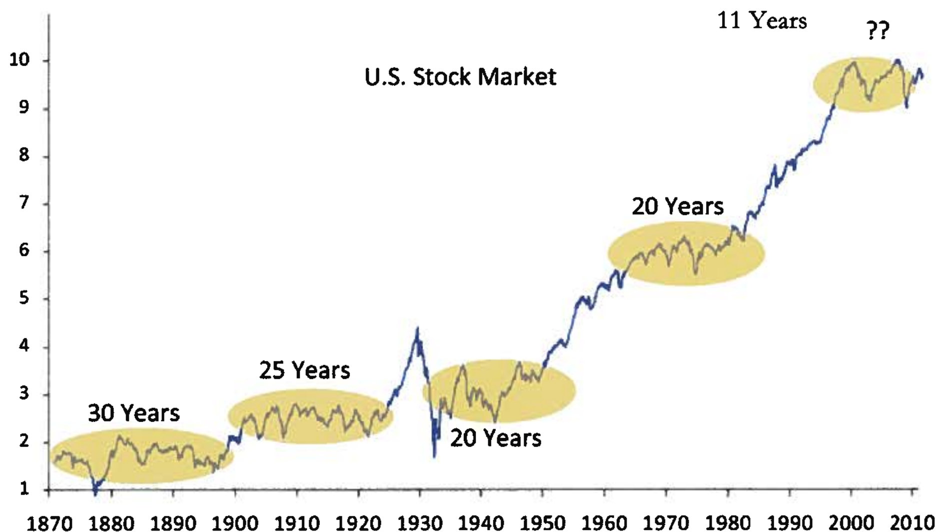
Who is Afraid of the Stock Market Revisited

Summary

In 2007, I wrote "Who is Afraid of the Canadian Stock Market" to suggest to investors that the then-current mania for non-domestic equity exposure was overdone. History suggested that during a sideways market, Canada was likely to be a relative outperformer. As history predicted, Canada has consistently performed in the top third of the 18 major markets every year since 2000.

Today, after more than a decade of below-average equity returns, investors have been reducing their allocation to equities, even though equity valuations have fallen to long-term averages and dividend yields have risen. Although we do not believe a bull market is possible from here, financial history suggests that investors with a long time horizon will likely achieve better returns in equities (probably 6% – 9% annualized) than in most of the alternatives. Jacob Fugger the Rich (1459-1525) would suggest that investors take profits and trim the asset class that has risen the most (fixed income and real estate for Canadians) and invest the proceeds into the weakest asset class (equities) to bring their asset mix back to their ideal risk-reward trade-off goal.

Range-Bound Markets are Typical

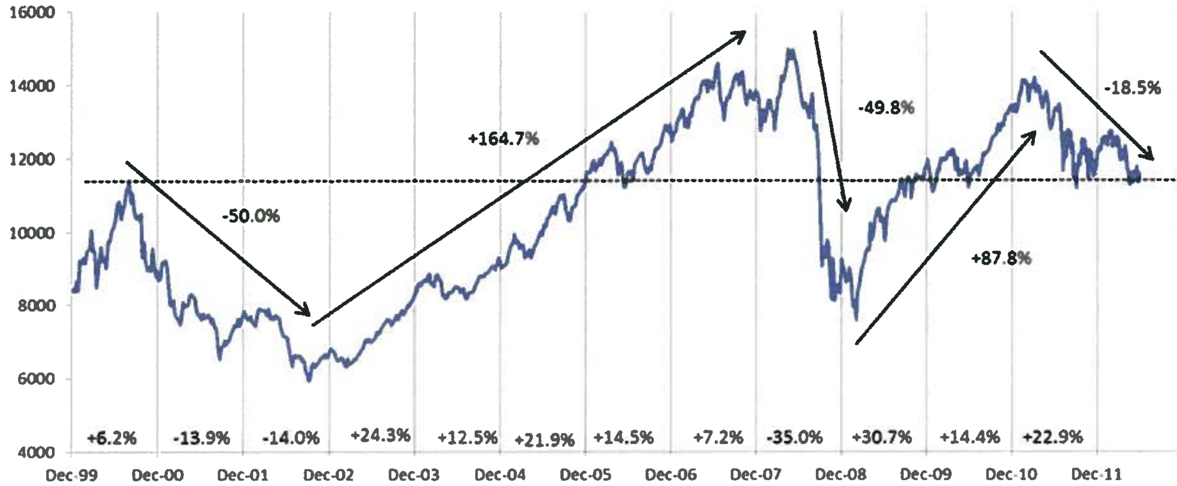


Source: Prof. Robert J. Shiller as at Oct 31, 2011. U.S. stock market data includes composites created by Prof. Shiller from 1870 to 1923 and then S&P Indices from their inception in 1923. Past performance is not a guarantee of future results.

Historically, after major bull market runs, stock markets typically become range-bound and experience a volatile sideways market with numerous pessimistic and optimistic periods, finally exiting the sideways period 15 to 30 years later, at about the same level where they began. By then, the underlying march of economic progress has resulted in enough earnings growth that the starting price level that was once egregiously expensive is now a bargain on a Price to Earning (P/E) basis and the

market has the potential to then progress through a lovely bull market period, beginning from much lower expectations.

Canadian Sideways Market



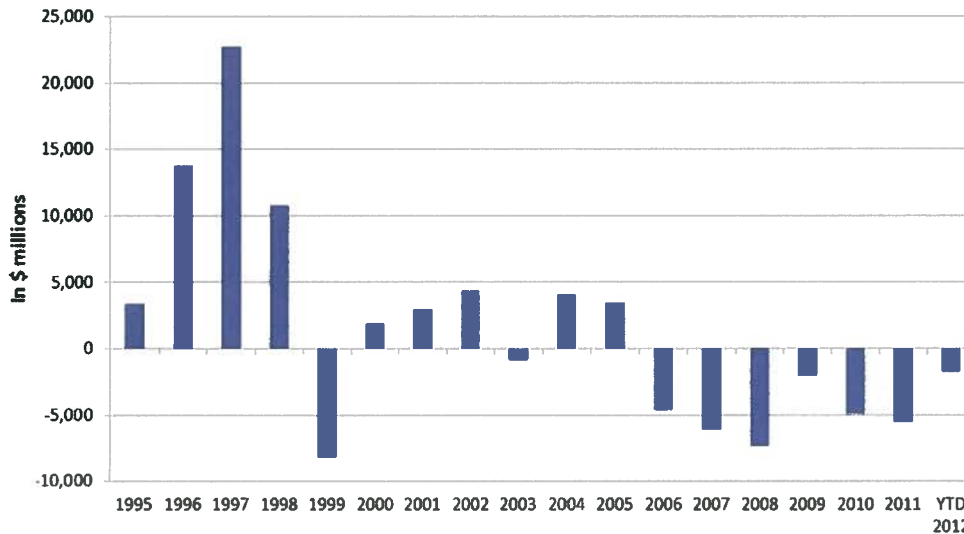
Date	Index	P/E	P/B	P/S	Yield
Sep-00	11,388	33.7	3.2	2.0	0.8
Jan-06	11,388	19.1	2.7	1.6	1.9
Jul-10	11,388	17.6	1.8	1.6	2.8
June-12*	11,388	13.2	1.7	1.5	3.1

** June 25, 2012*

Source: Bloomberg

Our current sideways market began with a bull market peak of 11,388 in September 2000, and trading at a P/E multiple of 34 times. As of June 30, 2012, the market is at 11,597 and P/E multiples are a much more reasonable 13.6 times. Since humans remain as emotional as ever (ensuring that the market stays irrational), we can continue to use market history as a reasonable guidepost for what might be expected to occur next. Market history suggests we will experience at least three more years of sideways markets and that we should expect single-digit P/E multiples before a new bull market can ensue. Further, because commodities tend to rally in sideways markets, the Canadian stock market typically does relatively better, on average, than other major developed stock markets.

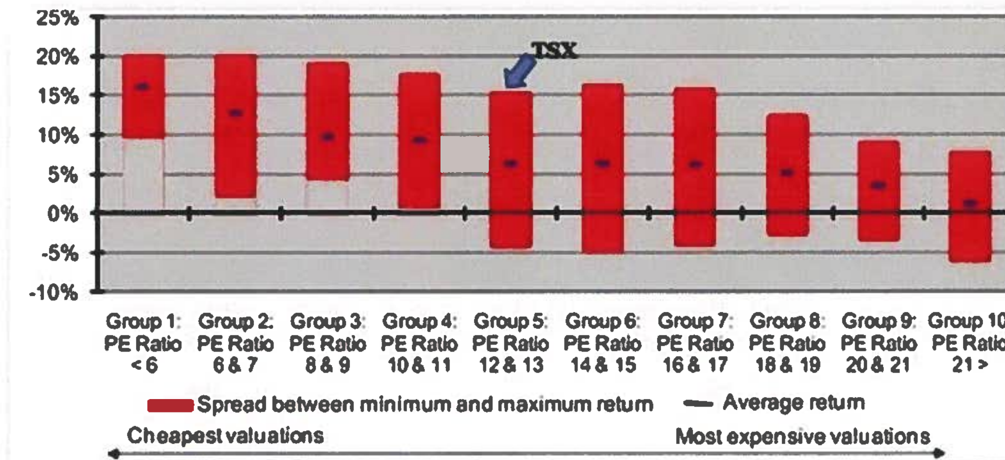
Yearly Net Sales – Domestic Equity



Source: IFIC
Domestic Equity includes Canadian Equity, Canadian Focused Equity, Canadian Dividend & Income Equity, Canadian Small/Mid Cap Equity, and Canadian Focused Small/Mid Cap Equity.

Back in 2000, following a solid equity bull market and its associated high returns, investors in aggregate were feeling optimistic and were willing to pay a rich P/E multiple to play the game of investing. Not surprisingly, flows into equities funds and the asset class in general were significant.

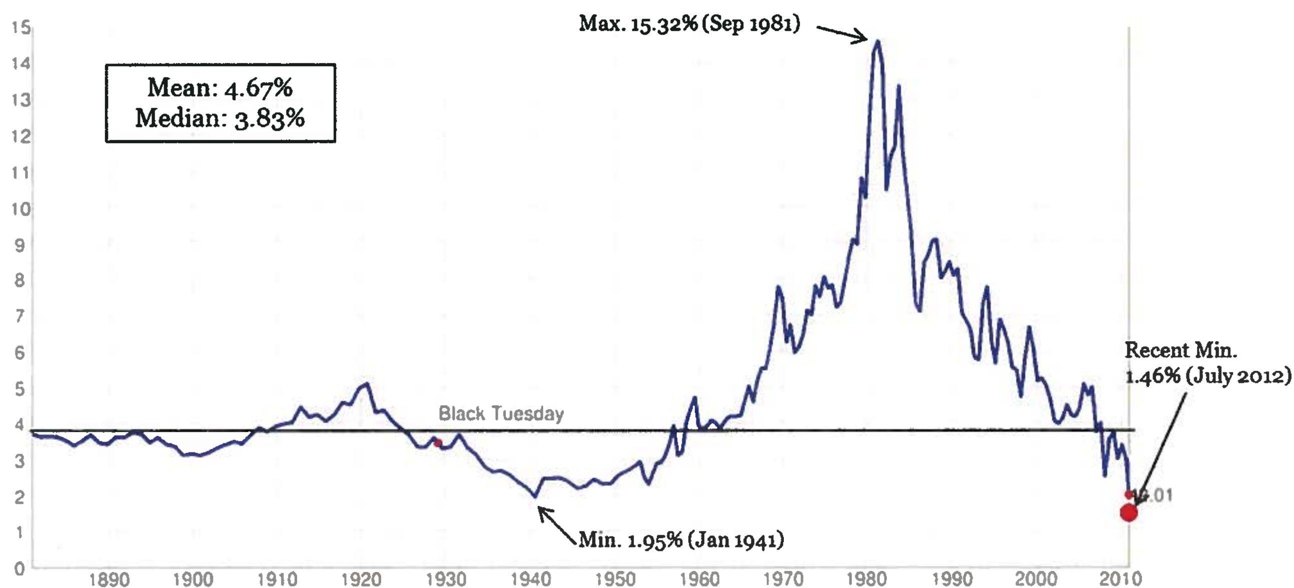
10-Year Forward Real Returns
Based on S&P 500 P/E Ratios from 1871-2010



Source: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge. As at September 30, 2011

However, a review of financial market history at the time would have suggested that when P/E multiples are above 21 (as they were then), the subsequent 10-year equity return is 1% per annum, on average, which is virtually what happened in the U.S. Returns delivered were precisely those forecasted by financial market history: what happened was not extraordinary at all. After the technology stock crash, flows diminished and by 2006, domestic equity mutual funds slipped into net redemptions, a trend that has since continued (this phenomena is also seen in lower allocations to equities (domestic and foreign) for pension funds, endowments and foundations). If financial history repeats itself again, as we believe it will, the current P/E multiple of 13 times suggests a forecasted average 10-year return of 6%; yet investors are doing exactly the wrong thing again by reducing their exposure to equities as an asset class.

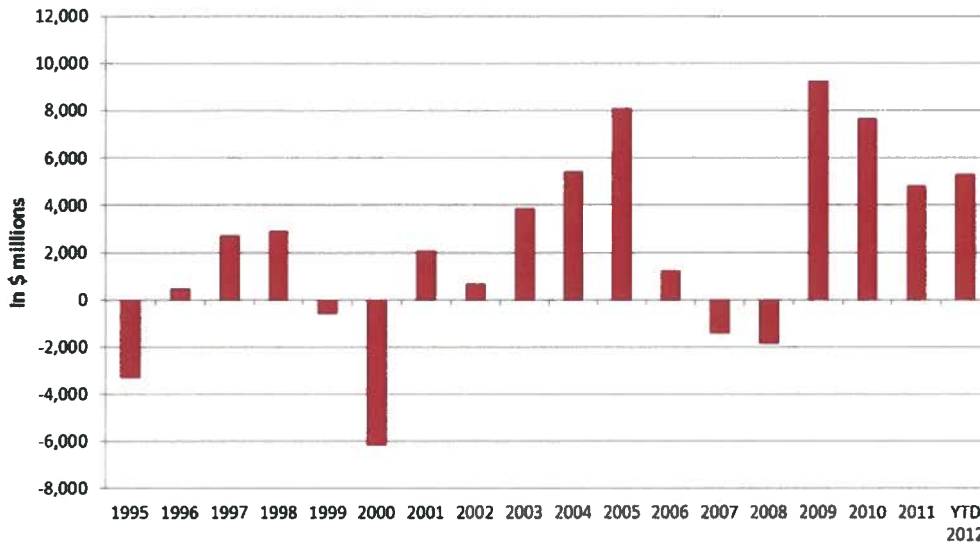
140-Year Lows in Bond Yields Offer Little Haven



Source: US Treasury and Robert Shiller, as at November 1, 2011

After a 30-year decline in 10-year government bond yields to record lows in Canada (all-time low), the U.S. (lowest in 140 years), the U.K. (lowest in 270 years) and Holland (lowest in 500 years), we have witnessed the best 30-year outperformance of bonds relative to equities in history. Investors are again piling into yesterday's story, illustrated below by the rising flow of assets into domestic fixed income. Bond yields may stay low for an extended period, as we have seen in Japan. At some point, however, yields will rise and be followed by a protracted period of below-average bond returns. It appears to us that fixed income has now become the risky asset class.

Annual Net Sales – Domestic Fixed Income



Source: IFIC

Domestic Fixed Income includes Canadian Fixed Income, Canadian Long-term Fixed Income, Canadian Short-term Fixed Income, and Canadian Inflation Protected Fixed Income.

What can we reasonably expect from equities? Short-term forecasts are impossible to get right, but 10-year time horizons tend to weed out "noise" in markets.

After Pain Comes Gain

	Prior 10-Yr Average Annual Return	Average Annual Return	Cumulative Return
Q2 1939 to Q2 1949	-3.65	8.62	129
Q1 1939 to Q1 1949	-2.79	9.12	139
Q3 1939 to Q3 1949	-2.74	7.74	111
Q1 1938 to Q1 1948	-2.54	11.76	204
Q1 1940 to Q1 1950	-1.42	9.65	151
Q2 1940 to Q2 1950	-1.42	12.19	216
Q4 1938 to Q4 1948	-0.65	7.21	101 Worst
Q3 1938 to Q3 1948	-0.10	8.12	118
Q3 1940 to Q3 1950	0.18	12.57	227
Q4 1937 to Q4 1947	0.20	9.61	150
Q4 1939 to Q4 1949	0.23	9.09	139
Q2 1938 to Q2 1948	0.44	9.52	148
Q3 1974 to Q3 1984	0.49	15.58	325 Best
Q1 1941 to Q1 1951	0.71	14.47	286
Q4 1974 to Q4 1984	1.24	14.76	296
		Average 10.76%	183%

Source: Leuthold Group, March 2009. S&P 500.

Above, the Leuthold Group shows the 15 worst 10-year average returns since 1926 and the subsequent 10-year average return. As can be seen in the data, the average subsequent 10-year return was close to 11% and the worst return was over 7%. Today, 10-year governments are below 2% in most places. A potential annualized return (similar to what was achieved in the 1938-1948 period) of 7% in equities over the next 10 years should be very attractive to investors today, yet allocations to equities continue to decline.

History Suggests a 6% to 9% Total Return From Here

Median Returns from S&P 500 Stocks, 1900-2005

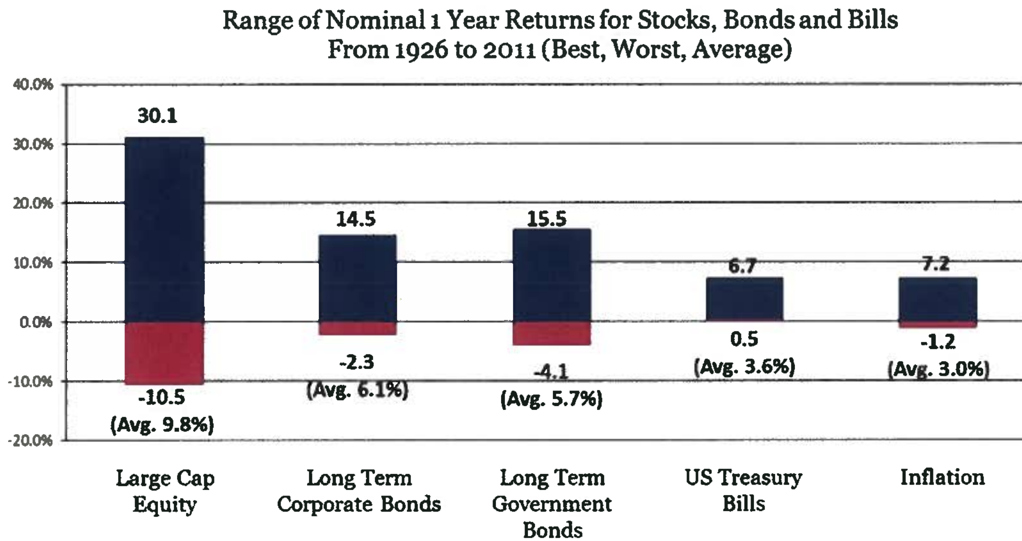
	P/E Based on 1-Year Trailing Earnings			
	Stocks Only		Total Return	
Returns in:	5 Years	10 Years	5 Years	10 Years
P/E less than 10	10.5%	10.8%	16.6%	16.1%
P/E between 10 and 12	8.2%	6.8%	13.5%	12.6%
P/E between 12-16	3.8%	3.2%	8.9%	9.0%
P/E between 16-20	3.0%	2.3%	7.3%	7.1%
P/E greater than 20	4.3%	4.3%	7.9%	8.2%

Source: Vitaliy N. Katsenelson "Active Value Investing – Making Money in Range Bound Markets", 2007

If we use history dating back to 1900, and consider that we currently have a trailing P/E multiple of 13 times, annualized returns should be 3% – 4% from here, ignoring dividends (stocks only), and approximately 9% when dividends are included. The total return forecast of 9% is not plausible however, when we consider that dividends are much lower than they have been historically. So if we assume a stock return of 3% – 4% and add the market's current dividend yield of 3.2%, we get total returns of 6% – 7%. However, if dividend yields revert to more normal levels over the next decade, returns could rise commensurately. In either event, we believe that a 6% – 9% potential return is attractive in the current environment.

Remember that these forecasts are based on index return expectations, but evidence from the last sideways market suggests that active managers should outperform the passive benchmark in such an environment. A 2002 Brandes Institute study showed that in the 1965 – 1982 sideways market, surviving mutual funds (in aggregate and before fees) generated annualized returns of 10.2%, outperforming both the S&P 500 at 7.1% and the Dow at 5.7%.

Equities are Still the Best Hope for Generous Returns in the Long Run



Source: Source: 2012 Morningstar.

Although equity returns can be more volatile in the short term, they have traditionally provided above average returns in the long run. We believe that they provide the best opportunity for investors to create true wealth generation.

The end game of a sideways market is capitulation, a point at which all participants, especially speculators, become so disenchanted with equity investing that they reduce their holdings or exit outright. This movement away from equities leads to bargain valuations which, in turn, begin to set the stage for the possibility of a bull market run. One major signal of capitulation is valuation; specifically, a "single digit" or 6 to 9 times P/E multiple. Another signal is a growing consensus that equities are a poor investment vehicle, something that is probably best demonstrated through major media articles. In 1979, **Business Week** had a famous cover story titled *The Death of Equities* yet, by 1982, a major bull market had begun. The modern equivalent began this spring. On May 23, **The Financial Times** had a full page article titled *Out of Stock* and **The Economist**'s May 19 issue's cover story was titled *The Endangered Public Company*. We have welcomed these articles and the reduction of equity allocation in asset mixes as harbingers of a coming paradigm shift in the foreseeable future.

Wise investors today should be rebalancing their portfolios back to their ideal asset mix, which suggests they trim the excess profits they have earned in fixed income and invest those proceeds in equities. As usual, what should be done may not be easy to do.

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