DM Portfolio commentary

3rd QUARTER 2016

Relatively speaking ...

The third quarter wasn't supposed to go this way. July opened with stocks still reeling from Britain's wholly unexpected decision to part ways with the EU and the feeling was widespread that this episode would mark a definitive tipping point in the market's path. As it happened, though, equity benchmarks defied expectations, with the S&P 500 and TSX gaining about 4% and 5%, respectively, over the three month interval.

Those who bemoan the market's recent success point to the fact that stocks are "expensive" and that each upward tick in prices only makes them more so. To be sure, no one wants to overpay for an asset and traditional valuation measures, such as the market's price / earnings ratio, definitely reside in the upper portions of long term bands. Statistics taken on their own, however, can produce spurious conclusions and it's quite possible that too little regard for context is currently leading some market watchers astray.

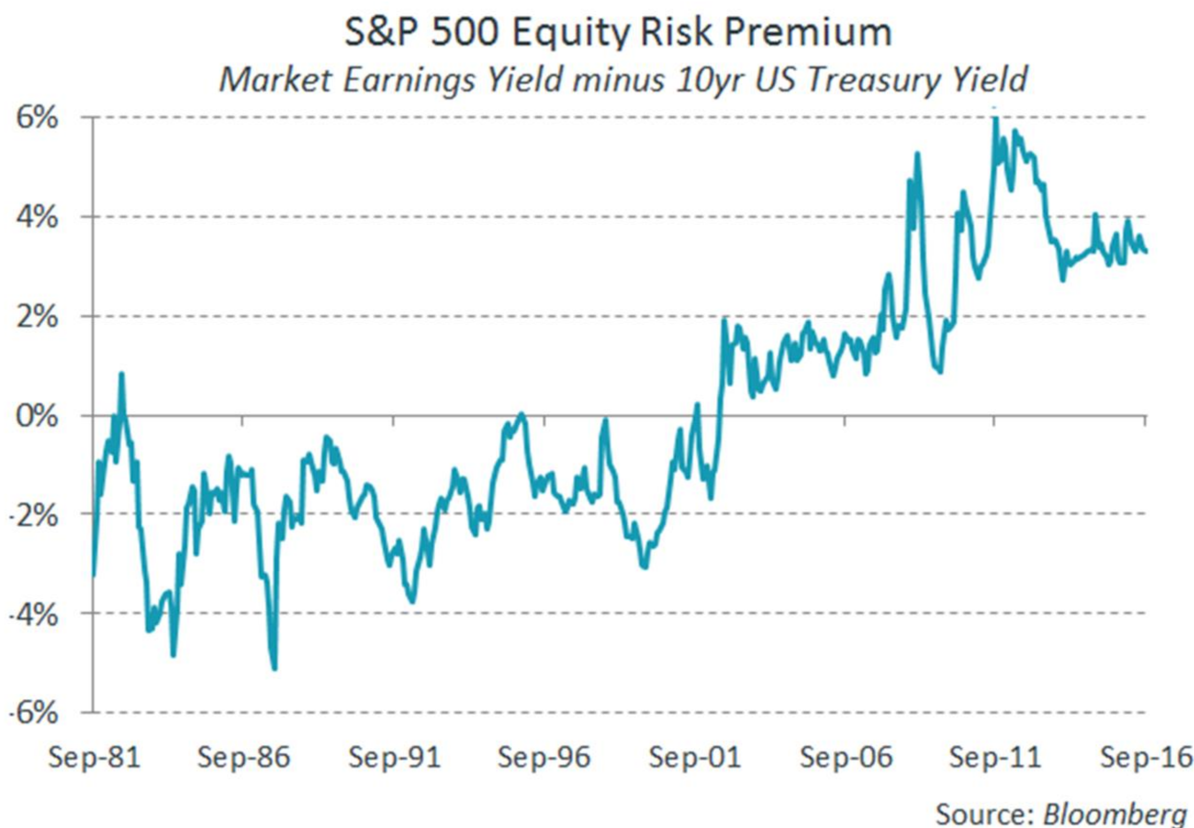
In life, almost any potential decision is first evaluated against the option to do nothing. If one is considering moving a child to a new school, putting a pool in the backyard, or having a bum knee surgically repaired, the first comparative questions are likely to be: *How will she fare if she stays where she is now? How much do we enjoy our property as it is?* and, *Can I manage over the coming year without going under the knife?* Likewise, a corporate management team considering buying out a competitor, building a new plant, or ramping up a salesforce, will initially judge the potential costs and benefits of these choices against baseline forecasts for how the company will perform if things are left unchanged.

With equity investment, the *do nothing* default involves avoiding the risk and volatility of stock ownership by instead allocating capital to a guaranteed, or "risk free", asset. Fortunately, the depth and visibility of the government bond market, along with the availability of equity data, allows us to make a basic comparison of these alternatives with relative ease. Going back to the price/earnings ratio mentioned above, if we flip this fraction around to put earnings over price, we are presented with a measure known as the "earnings yield". In other words, a stock trading at $20 which has earned $1 per share over the past year would carry a trailing p/e ratio of 20x and an earnings yield of 5%. Naturally, how we feel about a given earnings yield will be heavily influenced by what else is available in the marketplace, and in particular the return offered on risk free assets. To properly gauge relative attractiveness, something called the "equity risk premium" can be calculated – as its name would imply, the ERP gives us an idea of how much extra compensation stocks might be offering to account for their higher risk and is simply the difference between equity earnings yield and the yield offered on a government bond, usually in the 10 year maturity range.

As you can see from the graphic on the following

page, the ERP over the past 35 years has been all over the place, having been decidedly negative for about two decades and then moving into positive territory around the turn of the millennium. Based on what investors are paying for stocks now vs. what 10 year government bonds currently offer, the ERP looks fairly attractive against where it's been over the very long term.

Now, the favourable state of this relationship could certainly come under pressure if one or both of the following occur: aggregate earnings drop significantly from current levels, or interest rates make a concerted and meaningful move upward. Without wading too deeply into the details, though, we don't assign a high probability to either of these happening in the foreseeable future. First, corporate income growth has already been stalled in an interim trough and many strategists are calling for a recovery from this mini "earnings recession" in the quarters to come. Though the extent of this forecasted profit rebound remains to be seen, economic conditions certainly don't point to an imminent downturn in earnings. On the interest rate front, some increase from current levels is probable (and we have seen a slight rise from the summer's record lows), but even the mighty US Federal Reserve is having difficulty putting its rate-hiking plans into action and so it's hard to imagine that any near term move will be particularly troublesome.



Source: *Bloomberg*

Taking the consideration of ERP a bit further, if we think back to the late 1990s when investors were paying exorbitantly for corporate earnings on dreams of stratospheric internet growth and

leaps in telecommunications technology, they weren't necessarily foolish for accepting a broad market earnings yield of 3% on its own; rather, they were foolish for doing so when risk free government bonds were paying more than double that. Today, though, no such attractive alternative exists and given conditions around the globe and the weight of economic evidence, it seems unlikely that one will emerge anytime soon.

By judging stock valuations in a vacuum, without considering what else is or isn't available, many investors have missed a nice move in the market so far this year. With several of the companies in our equity mandates posting strong earnings growth in recent months, hiking dividends, buying back shares, and spending capital to expand and acquire competitors, we feel very positive about the outlook for our portfolios. Given the aggregate backdrop described above, we also aren't especially concerned that they'll be sideswiped by a general and prolonged market downturn. When a new client starts with Dixon Mitchell, it's not uncommon for him or her to ask "is now a good time to invest?" Though it's little more than a guess to say where markets are headed in the short term, the healthy risk premium offered by North American stocks at the moment leaves us inclined to respond: *It looks like as good a time as any!*