Market Commentary
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TETREM CAPITAL MANAGEMENT

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Blue Chip Opportunity

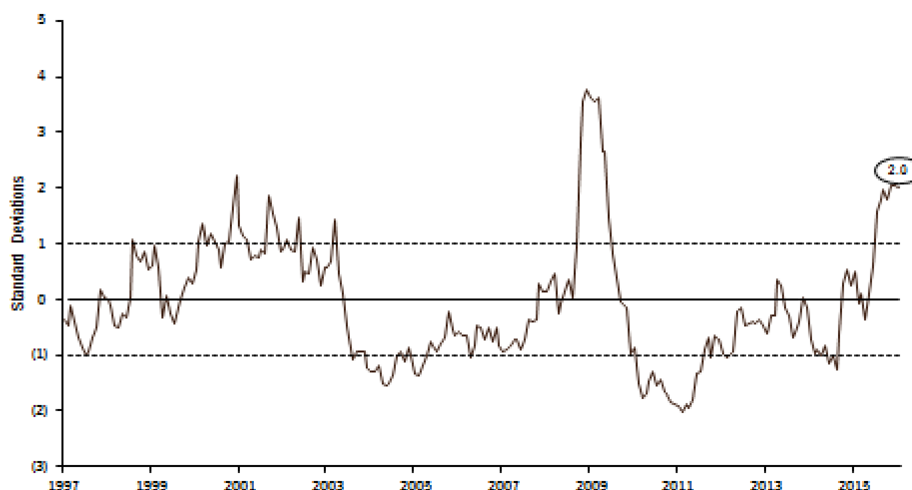
As we enter 2016 a sense of somberness has descended upon the capital markets. Investors are concerned that the U.S. bull market in stocks is coming to an end as China falters, energy prices fall to levels almost unimaginable 18 months ago, and global growth is stuck in neutral. Market volatility has picked up as investors react emotionally to every new economic data point, bouncing between hope and despair. One must be mindful that part of the investment experience is for markets to fluctuate, sometimes violently. I have been investing professionally for over 25 years. During this period there have been at least three bear markets and too many market corrections to count. The triggers of volatility have varied. In the last 15 years alone we have experienced the collapse of a galactic-scale bubble in technology/media/telecommunication stocks only to witness the market recover and then face the largest financial crisis since the 1930s. Emerging markets have advanced nicely over the past three decades but the landscape is pockmarked with both crises of confidence and real economic pain. In all instances, equity markets have *eventually* gone on to new highs. The key lesson I have learned through these times is the importance of having a disciplined investment approach that avoids emotional decisions, particularly when market stress is elevated. When uncertainty reigns, discipline and process overcome.

As our readers are aware, we pursue a value approach to investing here at Tetrem. This has served us and our clients well over the years. Coincident with rising uncertainty around economic growth, value stocks underperformed the market in 2015, leading to questions about the efficacy of the value approach. This was most evident in the U.S. market where the Russell 1000 Value Index declined by 3.8% while the Russell 1000 Growth Index rose by 5.7% (2015 total return). For perspective, at the peak of the technology bubble, growth had outperformed value by 90% over the preceding three years. Once the bubble started to deflate in March 2000, value stocks did exceptionally well over the ensuing three years. In fact, over the course of the full six-year period, value outperformed growth by 27%, and with much less volatility — a classic case of the tortoise beating the hare. The point of this analysis is not to say that there is currently a bubble in the stock market as, from our perspective, one does not exist. Rather, we are pointing out the divergence between the share prices of a few high growth companies and the broader market, which in turn is creating an investment opportunity in value. In 2015, a small group of stocks kept the S&P 500 Index in positive territory. The "FANG" stocks (Facebook, Amazon, Netflix and Google) primarily drove this dynamic. Absent these stocks, rather than posting a small gain, the S&P 500 Index actually lost 5% in 2015. Momentum investing, whereby one simply buys the stocks with the best recent price appreciation, has been the top performing strategy. Like a game of musical chairs, this

strategy works for a while, but the market gets narrower and narrower as fewer chairs are available. We have seen this game play out before, and when the music stops the cycle will reset and value will matter once again.

Canadian equities faced a similar dynamic over the past two years. While Canada escaped the financial crisis relatively unscathed, the collapse in commodity prices has created real economic pain and equity values have suffered the consequences. And herein lies the opportunity. An important quantitative measure that we track is the dispersion of valuation between the cheapest 20% of the market relative to the overall market (Figure 1). The value opportunity arises when the spread between these two expands: the wider the spread, the bigger the opportunity. Statistically, the value opportunity now exceeds its historic average by more than two standard deviations, a level from which value stocks have historically performed well relative to the market. Economic angst has depressed the valuations of many good companies in Canada to a level where they are now, simply put, very cheap. The elastic band of valuation dispersion is stretched and appears ready to snap back.

Figure 1 Valuation Dispersion - Canada



Source: Empirical Research Partners. As of December 31, 2015

Over the long term the stock market does a reasonably good job of valuing companies based on fundamentals. However, over the short term, particularly when emotions take over, market prices diverge from fair value. Value investing is all about taking advantage of this dynamic. Successful

value investors seek out situations where market prices are at a discount to fair value, thereby investing with a margin of safety. Additionally, they avoid overpaying for rosy, momentum-driven scenarios. Substantial academic research has highlighted the efficacy of value investing, yet most investors pay little more than lip service to a value approach. This is because it is difficult to maintain a value discipline, particularly when the strategy lags the market, and popular momentum stocks in particular. It is not easy to be contrarian and buy what is out of favour when the daily news flow is negative and emotions are running high. Yet this is exactly when value investing is at its best. The value opportunity exists simply because investors create it. If investors were truly rational and unbiased at pricing securities, stocks would always trade at fair value with limited volatility. But that is not the case. Fear and greed drive markets. Value investors need to be skeptical when others are greedy and greedy when the market is fearful. This is a key tenet of our value investment philosophy.

Today we face a compelling investment opportunity. With the average stock in Canada and the U.S. entering bear market territory in early 2016 (down at least 20% from 52-week highs) valuations are attractive. However, we are not blind to the risks in the global economy. It is difficult to have conviction that a reacceleration in global growth will occur, and we do not embed such an outlook in our models for individual companies when making investment decisions. Rather, we are focusing on downside risks. This is leading us to focus on blue chip companies. We define blue chips as companies that are large and dominant within their industries and most importantly, financially strong. Blue chips have strong balance sheets, persistent cash flow generation and dividend yield support. These characteristics enable them to navigate through difficult times and emerge stronger, and with an enhanced competitive position. Importantly, dividend support limits downside risk to share prices. For instance, throughout 2015, long-time portfolio holding Suncor Energy increased its dividend, bought assets cheaply, repurchased shares and invested in its underlying operations during the most severe oil rout in a generation. Last year, Suncor's shares stood out by delivering a flat return, and in so doing significantly outperformed the S&P/TSX Composite Index and other energy companies. In a similar vein, we have been constructive on Proctor & Gamble, which is focusing its efforts on the ten core categories where they have leading market positions and strong brands. Proctor & Gamble is one of the strongest cash generators among large cap companies, with its shares supported by a growing dividend that currently yields 3.3%. In short, we are placing capital into strong companies at good values.

Our style of investing has always gravitated toward large-capitalization, blue chip companies trading at reasonable valuations. This remains our focus as we progress through the early weeks of 2016. Positions where we are concerned about downside risks have been trimmed or sold outright, a process that has been ongoing over the past few months. The capital from these sales is being allocated into blue chip companies with the best combination of valuation support and financial

strength. While timing remains uncertain, we are using the ongoing market volatility to prepare for the inevitable market rotation toward value.

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