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ON THE HUNT FOR VALUE

What kind of year can investors expect in 2018? Our experts are bullish on equities, and still see solid prospects in both the Canadian and U.S. markets. For a real bargain, though, it might be time to look overseas

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1495 Words
Friday, September 29, 2017
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You can't blame investors for being worried with an outlook like this: The U.S. Federal Reserve is tightening monetary policy, and forecasters expect interest rates to rise next year. American stocks have been on a steady upswing, and priceto-earnings multiples have surged to unsteady new highs. Canadian stocks are stumbling along at roughly the same level they were at three years ago, while the U.S. feuds with major trading partners and a rogue regime forges ahead with a frightening nuclear program.

Sound familiar? That actually describes the fall of 2013. It appears to be risky enough to make any prudent investor bail out of the market completely. But if you hadn't--if you had instead bought into two popular exchange-traded funds that track large-cap U.S. and Canadian stocks--you would now be up more than 40% on the U.S. fund (which hedges currency exposure) and nearly 20% on the Canadian one.

That said, the potential perils today are more daunting than they were in late 2013. The U.S. stock market rally is now very long in the tooth, and valuations are even higher. The Standard & Poor's 500 Index is trading at an average of 21 times current earnings per share, compared with about 17 four years ago. The Federal Reserve started raising its benchmark rate last December, and just about every aspect of U.S. domestic and foreign policy is in turmoil under President Donald Trump. In Canada, the energy sector continues to struggle under depressed oil prices that can't crack $50 (U.S.) a barrel, and bank stocks--the other dominant force in the market--appear to be losing steam.

For individual investors, "when the cycle gets in its late stages, it's time to take a little risk off the table," says Eric Lascelles, chief economist of RBC Global Asset Management in Toronto.

Still, he and other experts don't think that individuals with properly balanced portfolios need to make drastic changes.

Yes, North American stocks are expensive, particularly in the soaring tech sector. But there's no

need to shift huge amounts to bonds or overseas stocks. "We still see very good value in North American markets," says Lascelles.

It just takes some hunting to find it.

First, it's important to keep interest rate hikes in perspective. The Federal Reserve wants to raise its benchmark to about 2% in 2018 and 3% in 2019. The Bank of Canada has lagged behind, but it might soon catch up. But those new higher central bank rates will still be considerably less than 5%, which means bond yields likely won't rise enough to make them much more attractive than stocks.

Like many institutional investors, Stephen Lingard, a senior vice-president and portfolio manager who oversees about $9.5 billion at Franklin Templeton Multi-Asset Solutions in Toronto, has been overweight stocks in recent years.

The firm now holds about 63% stocks and 34% bonds in portfolios with a longterm 60-40 target split. By the end of 2018, he may reduce the stock weighting, but not by a lot--possibly to 60% or slightly less.

Most of us shouldn't follow his lead--Lingard says that many individual investors still don't have enough invested in stocks. Many were burned by the financial crisis and kept a large proportion of their money in bonds.

"Retail investors, unfortunately, tend not to have the best timing," he says.

"We still believe equities are best."

Forecasting economic growth is harder than predicting interest rates.

Canada has been on a tear in 2017, with our gross domestic product (GDP) expanding at annualized rates of 3.7% and 4.5% in the first two quarters. But much of that surge is due to factors that won't repeat--the stirrings of a rebound in the oil patch, a jump in exports due to a low Canadian dollar, and unexpectedly strong consumer spending.

The Bank of Canada is forecasting 2% growth for next year. But that may be hard to sustain if the whitehot housing markets in Vancouver and Toronto really have started to cool. Soaring home values have allowed households to take on record amounts of debt over the past decade. But in a recent research note, Lascelles said that a 25% drop in Canadian house prices could subtract a whopping 4% from real GDP over the next few years, and even a "middling scenario" in which prices stop rising at a ferocious rate would subtract 1% or 2%.

In the United States, the Federal Reserve is also forecasting GDP growth of about 2% next year. But U.S. stocks are more expensive than Canadian ones--with a price-to-earnings ratio of 21 for the S&P 500 compared to 19 for the S&P/TSX Composite Index. Even so, many experts say U.S. stocks offer better prospects, particularly in certain sectors.

Take energy. Since oil prices plummeted by half in late 2014 and 2015, West Texas Intermediate crude has traded much of the time between $40 and $50 a barrel (all currency in U.S. dollars), which, it turns out, is an unfortunate range for those of us north of the border. Below $50, much

of the heavy oil from Canada's oil sands is unprofitable, but a lot of the shale oil and other unconventional deposits in the United States are profitable even at $40. "This is not good for Canadian producers," says Martin Pelletier, a portfolio manager with TriVest Wealth Counsel in Calgary.

Even Canada's astonishingly resilient Big Six banks now pale in some ways compared with their international competitors. "If you like banks globally, you can pick up U.S. banks and European banks at half the price-to-book value of Canadian banks," says Lingard.

The U.S. market also offers far more sector diversity than Canada. Together, financials, energy and raw materials make up two-thirds of the S&P/TSX Composite, but less than a quarter of the S&P 500. The biggest sector by far in the United States is tech, which accounts for more than 23% of the S&P 500.

Is the tech sector riskier and more prone to euphoria and panic than the rest of the market? Yes, but arguably much less so than it was during the tech bubble and bust in the 1990s and early 2000s. In those days, value investors warned individuals to steer clear of tech in general, and initial public offerings (IPOs) in particular.

But Josef Schuster, founder and CEO of Chicago-based IPOX Schuster LLC, says that things really are different this time around. Scrutiny of the sector by market regulators and investment analysts is stronger, and it helps if investors adopt a systematic approach.

He founded his firm in 2004, based on a PhD thesis he wrote at the London School of Economics. It has created 11 indexes to track U.S. and international IPOs. The basic strategy is to buy a basket of IPOs, hold each one for about four years, limit the weight of any one stock to 10%, then sell out, carefully.

Since 2005, Schuster's IPOX-100 index of U.S. IPOs has posted more than double the gain of the S&P 500. But he admits you need some tolerance for risk. "Out of 100 stocks, you might have two big winners like Facebook, 20 that trade with the S&P 500 and the rest fall short," he says.

The other glaring risk in the United States, of course, is the Trump factor.

But the oddly reassuring thing is that investors appear to be skeptical that Trump can get any of the extreme planks in his economic and trade agendas through Congress. Meanwhile, many business fundamentals still look strong.

"Rightly or wrongly, the market is discounting a lot of his bluster," says Franklin Templeton's Lingard.

If North American markets seem too risky or expensive, European and Asian markets look like relative bargains.

Germany's DAX 30 index is valued at about 17 times earnings, and Hong Kong's Hang Seng Composite Index is at 14. In a recently published research note, Matt Kadnar and James Montier, members of the asset allocation committee at the influential Boston-based global asset manager GMO, wrote, "Basically, on only a couple of occasions in the late 1990s and during the

European crisis of several years ago have, [European, Asian and Far Eastern] stocks been as cheap as they are relative to U.S. equities."

Regardless of what year it is, experts argue that so-called "home bias" remains a big drag on the portfolios of too many individual Canadian investors. A lot of them still have most of their holdings in Canadian assets, says Lingard. "We would counsel much less than that," he says. "Maybe 30% total on the equity side." In the hunt for value, it never hurts to broaden your horizons.

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