

VALUE PROPOSITION

In its May 1999 issue, *BENEFITS CANADA* presented a study of investment styles that revealed the value style dominated the Canadian equity market to the extent that growth managers had to be superb stock pickers to compensate for their style's systematic underperformance. The article concluded with the observation that there were glaring inefficiencies in the Canadian equity market that could be exploited. It was predicted that plan sponsors would add more value stocks to their portfolios overall, and that by investing sufficiently in this style they would lose less value in down markets.

Three years later, the markets have undergone some major changes. Yet, all of the above observations still ring true—perhaps even more so today than then.

In Canada, value—as measured by the Barra value index—has outperformed growth as well as the Toronto Stock Exchange (TSX) 300 total returns index in both the short and long term, extending back 20 years (see “Pure style indexes,” page 38).

The picture is somewhat different in the U.S., though. Due to its larger size, that market is able to accommodate multiple major styles. Both the value and the growth style alternatively outperform one another for two- to three-year stretches. In contrast, Canadian investors will not pay more for a stock than they believe it is worth for any length of time. This is why value outperforms growth in Canada.

GROWTH RALLY

From the last quarter of 1998 to the first quarter of 2000, Canada witnessed a growth rally driven by a

In both the long and short term, the value style has outperformed growth as well as Canada's major equity index. Pension funds should ensure their money managers adopt a disciplined and quantitative approach to value investing.

By Sam Wiseman

handful of high-technology stocks. Following 16 months of superior performance, growth investments peaked on both Canadian and U.S. indexes in February 2000. That quarter also marked the greatest difference on record between value investments and the equity market in both Canada and the U.S. (see “All-cap characteristics,” page 38). This occurred just as a wave of Canadian money managers was planting itself firmly in the growth camp and confidently declaring that value was obsolete.

Today, half of the capitalization of the TSX 300 is categorized as growth, including Nortel Networks. The stock remains a risky play today, according to the Barra model—a tool used by investors to quantify the risk of a particular stock or portfolio. No manager would want to be seen as buying overvalued stocks, but with average price-to-earnings ratios of 50 times, this is exactly what occurred at the height of the market in 1999-2000.

FOLLOWING THE CROWD

During the tech mania of late 1998 to early 2000, value managers were under pressure from the burgeoning weight of Nortel in the TSX 300, as well as the prevailing belief among plan sponsors that the weighting of high-tech stocks in their portfolios had to be much higher than their investment style would normally indicate.

Pure style indexes

The value style of investing has traditionally outperformed the growth style, as evidenced here by the three-, five- and 10-year returns of the Barra indexes.

| Index | 2001 | 1999-2001 (3 yr) | 1997-2001 (5 yr) | 1992-2001 (10 yr) |
|---------------------------|--------|------------------|------------------|-------------------|
| Barra Canada Value index | 5.1% | 12.4% | 12.5% | 13.8% |
| Barra Canada Growth index | -21.4% | 1.9% | 2.4% | 7.5% |

Source: Barra

As a result, many value managers followed the crowd to growth stocks. In doing so, they lost their way and were not objectively evaluating the strengths and weaknesses of their equity investments. If any Canadian firm had remained a steadfast value investor over the past 10 years, it would have been a top-performing manager in the country, beating the TSX 300 by 2.8% a year.

Pure value investments are less volatile than the TSX 300. They have a lower beta and a long-term correlation of only 40%, compared to 85% or more for the typical Canadian equity manager. Over 2000 and 2001, the correlation between value and the TSE 300 dropped to only 19% as the style continued to outperform the index by a large margin.

VALUE TRAPS

The Barra value index is based on one definition of value, which is a combination of price-to-book earnings and dividend yields. Although these are important value characteristics, their exclusivity leads to several inefficiencies in the index. However, exploiting these inefficiencies in a disciplined manner can add to returns.

It is important to address the composition of the index. The Barra value index contains what are known as value traps. These are stocks that appear attractive to the Graham and Dodd approach (characterized by bottom-up stock picking) but are priced lower than the industry average. That is for good reason—they are inefficiently managed and never outperform in the long term.

A disciplined, active management process applied to the value universe would outperform the Barra index. Going forward, firms adopting this approach can expect to rank among the top Canadian money managers.

Enabling a manager to successfully add significant risk-adjusted value means allowing the individual or firm to focus on more than just value-index stocks. Some industries may not be included in the value index or in typical value screenings, resulting in missed value stock opportunities.

But active value management is not as simple as, say, screening for low price-to-earnings ratio stocks. That

All-cap characteristics

All-cap is a sample of large-, mid- and small-cap value stocks used as a proxy for the value style in Canada.

| As of July 2002 | All-cap | TSX 300 |
|-------------------|---------|---------|
| Price-to-book | 1.5x | 1.8x |
| Price-to-earnings | 10x | 12x |
| Dividend yield | 1.91% | 1.46% |

| As of February 2000 | All-cap | TSX 300 |
|---------------------|---------|---------|
| Price-to-book | 1.4x | 2.8x |
| Price-to-earnings | 15x | 17x |
| Dividend yield | 2.38% | 1.13% |

Source: Wise Capital Management Inc.

would result in getting caught in value traps and missing undervalued stocks in several sectors. The value-added process isn't as easy as being a good stock picker either. Sector weightings is an important factor to manage. The financial sector has always comprised about half of the value index.

Over the last few years, including stocks in a portfolio with both strong value and growth characteristics would have resulted in the most efficient return-risk tradeoff. As a bonus, since the fall of 2000 these stocks have been among the strongest performing names on Canadian and U.S. indexes.

COMPREHENSIVE APPROACH

A quantitative approach is needed to comprehensively manage the increasing flow of data available on companies today. A generation ago, about 40 Canadian stocks were liquid and managers could rely on memory for their essential characteristics. Today, there are over 500 liquid stocks, and even a large team of analysts cannot do a thorough, bottom-up job of analyzing this large volume of names.

Screening alone, though performed by many Canadian firms, is not comprehensive. If a manager screens for

The rewards of active management

The fall of Nortel kickstarted active management returns last year. Over the past 10 years, active management has outpaced the TSX 300.

| Index | 10 Years (1992-2001) | 2001 |
|---------------------------------------|----------------------|--------|
| Median TSX 300 mandate manager return | 12% | -4% |
| TSX 300 | 10.4% | -12.6% |
| TSX 300 capped | 11.8% | -8.4% |

Note: Once we adjust for oversized stocks via the TSX 300 capped, active management still outperforms, but only gross of management fees.

Source: COMSTAT Capital Sciences

stocks below a given price-to-earnings valuation, he or she will miss stocks that are undervalued based on other important criteria, such as the price-to-book ratio. In addition, several Canadian managers now have one or two levels of risk control. However, successful U.S. investment firms employ many more measures.

A quantitative approach is also needed to tackle the

subjectivity of portfolio weighting and to address issues such as: What percentage of Bank of Nova Scotia shares, for example, are needed in the portfolio? How subjective should the weighting be? And, how much risk is added by this subjectivity?

Going forward, firms adopting a disciplined, rather than subjective approach can expect to be among the most successful performers. And the tools have been established to enable managers to achieve this goal at lower-than-market risk levels.

The bulk (85%) of a pension fund's equity performance is attributable to an investment manager's style. Over time, it is more important to ensure that equity managers maintain a pure value style than it is to worry about minor changes in asset allocation. This is because, historically, even a small tilt towards value has improved a fund's equity returns.

Pension funds can ensure that their managers are committed to value investing by closely monitoring their holdings' underlying style characteristics. **BC**

Sam Wiseman is the chief investment officer with Wise Capital Management Inc. in Toronto. sjwiseman@wisecapitalmanagement.com.
