THE CASE FOR KEEPING THE FAITH IN VALUE

Ask a Canadian to name our country's greatest conflicts and the list will likely include some of our most famous events: The War of 1812, the NAFTA fight between Brian Mulroney and John Turner, or Tim Horton's versus every other coffee company. "Value versus Growth" would probably not make the list, even though, for investors, that debate is like two heavyweights going toe-to-toe with gloves off.

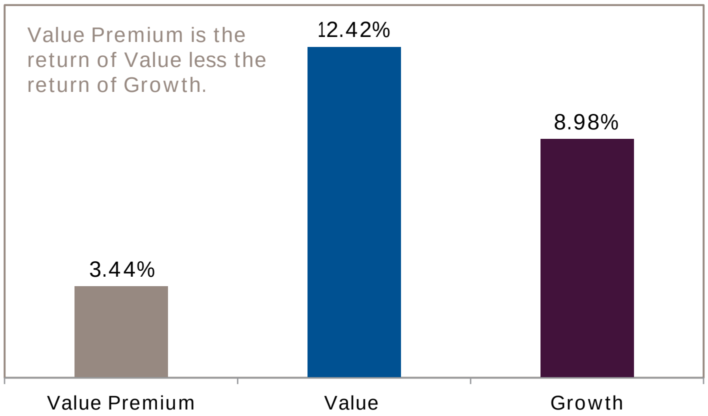
The Historical Importance of Value versus Growth

The battle between the two most prominent investment styles has been going on for decades. In 1934 Benjamin Graham made the case for Value Investing in his book Security Analysis, where he described methods for discovering low-priced stocks. By finding stocks that traded at low prices, his methodology hoped for higher returns by anticipating that those businesses would either improve or the market would eventually recognize the pricing inconsistency and bid the stock price up.

In contrast, we can review the strategies of successful Growth investors such as Thomas Rowe Price Jr. and Philip Fisher. The primary objective of a Growth investor is to buy businesses that are showing strong recent performance and to profit from these ever-expanding enterprises. In this strategy, paying a higher price for the stock is warranted as it is expected that through accelerated business growth and increased profits the stock will eventually be well worth the price paid.

The Value versus Growth debate hit its stride in the 1990s with the research of Nobel Prize winner Eugene Fama and his research partner Kenneth French. Their 1992 paper 'The Cross-Section of Expected Stock Returns' laid the foundation for delineating the factors from which investment returns are achieved. In particular, they showed evidence and provided a rationale for why low-priced "Value" stocks had provided higher returns than higher-priced Growth stocks (see **Chart 1**).

CHART 1:
U.S. Value Returns and Growth Returns in USD 1928-2015



Source: See page 5

Since that Fama-French paper, much has been written from the U.S. perspective about the value of Value Investing. In particular, recent Value versus Growth analysis in the United States has focused on the surprising underperformance of Value over the past few years. As a result of the focus on U.S. data, Canadian investors are left with questions pertinent to the Canadian perspective:

1) Has the Value premium in Canada recently disappeared, as it appears to have done in the United States?

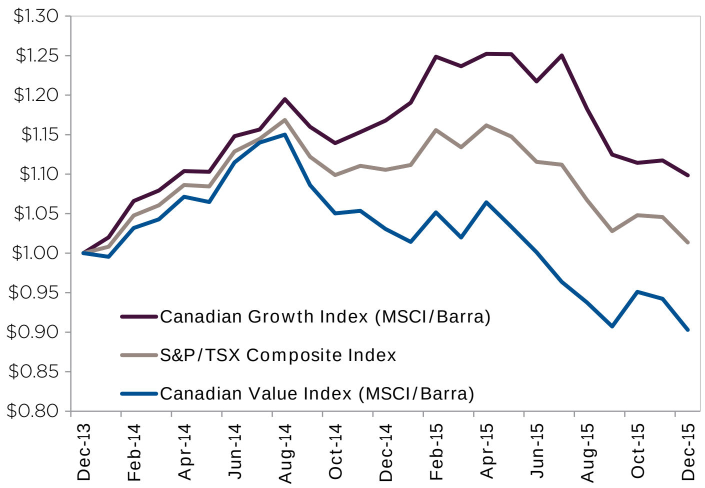
2) How do these recent returns compare to Value's long-term performance in Canada?

3) Can we use this information to invest better in the future?

Value's Disappearing Act

Since June of 2014 and the downturn in commodities, many investors have found themselves disappointed with the performance from allocations to Canadian stocks. In 2014 the TSX Composite returned 10.55% followed by a -8.32% return in 2015, resulting in an annualized return of 0.68% for the two years combined. In comparison, we can see that investors that held U.S. stocks had a far superior annualized return of 21.38% measured using the Russell 3000 Index, thanks in part to the falling Canadian dollar over this period.

CHART 2: Growth of $1.00 from 2014 – 2015



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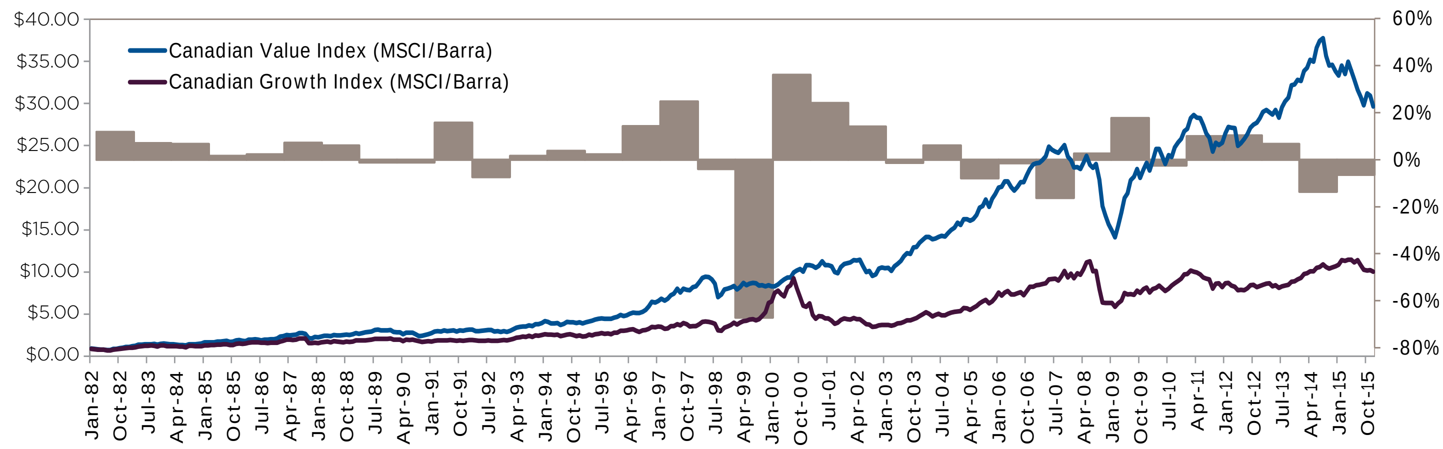
While this highlights the relative poor performance of Canadian stocks, holding a higher concentration of Value stocks in Canada over the last two years would have reduced returns even further. As we can see in **Chart 2**, while Growth and Value tracked closely through the beginning of 2014, the last half of the year shows a virtual collapse in the relative returns of Value stocks. In fact from January 2014 to December 2015, Canadian Growth stocks outperformed Value by a total of 19.56% or by 9.78% when calculating an annualized return.

The Persistence and Prevalence of the Value Premium

Based on this short timeframe, investors could speculate that it is not a good time to be a Value investor. History teaches us that a Value strategy will underperform from time-to-time. Successful investment methodologies, though, should be founded on strategies that are persistent and prevalent over the long term. In modern investing, to the patient go the spoils.

While robust stock market data in Canada does not go back as far as in the U.S., when we look at the past 34 years in Canada we can see that in 11 of these years, companies that qualified as Growth had higher performance than companies that had Value characteristics. However, despite lower returns during these individual years, Value stocks in Canada have provided dramatically higher returns over the full 34 year period (see **Chart 3**).

CHART 3: Growth of $1.00 from 1982 – 2015 versus the Annual Canadian Value Premium



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If we use history as our guide, the outperformance of Value stocks appears to become more likely the longer that one stays faithful to this structured approach. As an example, while Value stocks have underperformed in some calendar years since 1982, there have been very few 10-year periods when Value has not outperformed Growth (see **Chart 4**). This could be the result of significant returns that occur after a period of short-term underperformance by Value.

When Growth has outperformed Value, the resulting reversal tends to be dramatic. The Dotcom boom of the late 1990s was the heyday of Growth stocks. Between the period of January 1998 to December 1999, Growth stocks outperformed Value stocks by a whopping 73.57% in total return over those two years. However, in the economic change that took place following that boom, Value stocks made up significant ground as many tech Growth companies were unable to maintain their lofty valuations. If we extend our measurement period to include the following two years, we see that from January 1st, 1998 to December 31st, 2001 Value stocks actually outperformed with a total return of 8.21% (1.7% annualized) higher than that of Growth stocks in Canada (see **Table 1**).

Lessons for the Future

History indicates that Value persists despite the added focus that investment factors have received since the Fama-French research in 1992. So far in 2016 the turnaround of commodity prices starting in February has contributed to Canadian Value returns of 13.54% in the first six months, which is 7.36% higher than Growth stocks over this same period. Is this the beginning of a reversal similar to the Dotcom example?

While we would like to see the historical pattern of Value reversals hold true, investors would be well-advised to

CHART 4: Rolling 10 Year Returns of Canadian Value

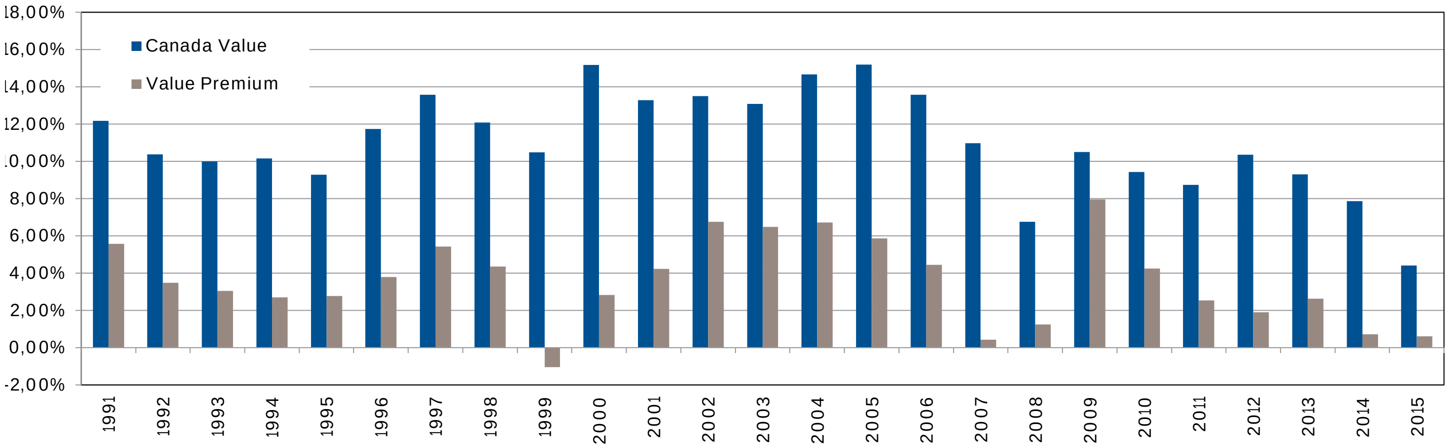

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TABLE 1: The Great Reversal: Canadian Value versus Canadian Growth 1998-2001

	Canada Value Total Return (%)	Canada Value Annualized Return (%)	Canada Growth Total Return (%)	Canada Growth Annualized Return (%)
Jan 1, 1998 - Dec 31, 1999	2.99	1.49	76.56	32.88
Jan 1, 2000 - Dec 31, 2001	29.65	13.86	(29.02)	(15.75)
Jan 1, 1998 - Dec 31, 2001	33.53	7.50	25.32	5.80

Source: See page 5

keep overconfidence bias in check and not succumb to the false hopes of market timing. This is especially true for conservative, diversified investors since not all global markets are seeing the same type of reversal. A portfolio diversified by geography and currency was integral to reduce the pain from the downturn in Canadian commodity and Value stocks in 2014 and 2015. Now that Canadian stocks and the Canadian dollar have experienced a reversal, investors should not lose sight of their long-term, diversified strategy.

Conclusion

While averages may give us a window into performance over time, from year-to-year, markets almost never provide the exact average. Stock market returns are, by their nature, "lumpy". While the Value premium has been absent from capital market returns in recent years, we have not lost our faith. We still believe that investors should have a better investment experience if they are patient and focus on a structured approach that draws on the strength of persistent and pervasive factors like diversification and the Value premium. Hopefully, the positive situation for Value stocks in Canada in the first half of 2016 will bode well for Value stocks going forward at both home and abroad.

Sources

CHART 1:
- Fama/French US Value Index Provided by Fama/French from CRSP securities data. Includes the lower 30% in price-to-book of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973).
- Fama/French US Growth Index Provided by Fama/French from CRSP securities data. Includes the higher 30% in price-to-book of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973). Returns in USD.
- Value Premium is defined as the Value Index minus the Growth Index

CHART 2, 3, AND 4, AND TABLE 1:
- Canadian Growth Index provided by MSCI/Barra 01, 1982- 06, 2016. June 1998 - present: MSCI Canada IMI Growth Index (gross div.) Total Returns Gross Dividends in CAD. Source: MSCI. January 1982 - May 1998: Barra Canada Growth Index Total Returns in CAD. Source: Barra Canada Country Code NC Currency: CAD.
- Canadian Value Index provided by MSCI/Barra 01, 1982- 06, 2016. June 1998 - present: MSCI Canada IMI Value Index (gross div.) Total Returns Gross Dividends in CAD. Source: MSCI. January 1982 - May 1998: Barra Canada Value Index Total Returns in CAD. Source: Barra Canada. Country Code NC. Currency: CAD.
- Value Premium defined by the returns of the Canadian Value Index minus the returns of the Canadian Growth Index

CHART 2 ADDITIONAL REFERENCES:
- S&P/TSX Composite Index 02, 1956- 06, 2016. February 1956 - present: S&P/TSX Composite Index Total Return in CAD. Country Code NC. Source: S&P/TSX from Morningstar Direct. Currency: CAD. S&P/TSX data provided by S&P/TSX.

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