Fall 2016

The Trump rally is on!

Financial markets love Trump's plans for a big tax cut, infrastructure spending and lower regulations. After a very short lived initial plunge of more than eight hundred points equity markets rebounded sharply and have kept rising ever since election night. As is often the case; markets will surprise us!

During the campaign there was much debate over the impact that the election and each candidate would have on the markets. Indeed that was a question that we were often asked over the course of the past year. Historically, politicians have had little impact on the long term trajectory of markets and businesses. Economic history proves this out; political scandals and scoundrels have been in abundance since the beginning of our electoral system. Yet long term economic growth has persisted and well managed companies have continued to prosper; good businesses outlast politicians of every stripe.

The potential results of the election had no bearing on our investment thinking. In the long term, the price paid for an investment ultimately determines it return. Political drama and outcomes simply provides an opportunity to buy on the concerns or sell into the optimism.

The recent "Trump rally" has pushed valuations to very risky levels. The current value of the Total Market Index is approximately $2.3 trillion, or approximately 124% of GDP. As the chart below indicates, the Total Market Cap/GDP Ratio is the highest it has been since the tech bubble of 2000. Warren Buffet has stated that the percentage of Total Market Cap relative to the US GDP is "probably the best single measure of where valuations stand at any given moment".

Assuming a return to historical averages, the U.S. stock market is likely to provide a *total return of approximately zero* over the next several years. Just as likely, at some point, equity prices are likely to suffer a correction. Other traditional measures such as the Schiller Price/Earnings Ratio, historical Price/Earnings and Price/Book ratios as well as long term dividend yields also support this view. The facts are so obvious that we don't understand how any other conclusion is possible.

It is our view, that the primary focus of an investment manager should be first to protect capital and then to grow it. Chasing returns and yield at any price is a recipe for future capital losses that are unlikely to be recovered within most individual's realistic time horizons. VALUATION MATTERS! Any serious long term investment counsellor should be acutely aware of this overarching fact. They should be discussing *realistic potential long term returns and risk* with existing and prospective clients in the context of today's market reality; particularly those using a conventional fully invested approach. Unfortunately very few do; either because they ignore historical facts or because they believe that only "optimism sells".

Total Market Capitalization/GDP Ratio

No wonder active managers are under attack. Charles Ellis and Burton Malkiel have just written a book entitled, *The Index Revolution: Why Investors Should Join It Now*. The arguments against active management are becoming louder and more persistent. Credible organizations are joining the chorus. For example, a recent study by Standard & Poor's, showed that nearly 99% of active managers in American equities underperformed the S&P 500 index over ten years while in Europe, 86% lagged behind their benchmark over the same period. Greenwich Associates published a report on the Future of Active Management which stated that only 9.8% of active managers have outperformed the S&P Composite 1500 over the last 15 years, down from 52.3% in 2003. In fact, any active manager that beats the index is considered to have been lucky as opposed to skilled.

Investors have responded with their wallets. Passive strategies have grown substantially since they were first introduced more than forty years ago. The Investment Company Institute states that index funds now comprise almost 30% of mutual and exchange-traded funds. These funds have more than doubled their share from a decade ago and grown eight fold over the past twenty years.

Most academics and pundits who declare that active managers can't beat the market look at results on a year to year basis. Studies accurately show that no manager can beat the market every single year in a row. This fact is used to justify passive investing and discredit active managers.

We believe that measuring managers on an annual basis is short sighted and inappropriate. Investment strategies often take several years to produce the desired results; particularly value-based strategies. It is to be totally expected and quite common for well executed investment disciplines to underperform for several consecutive years but outperform over an entire investment cycle.

PCM is a prime example of these phenomena. Since our inception we have underperformed the TSX in nine out of the past fifteen calendar years. Yet we have outperformed the index over the full fifteen year time frame. Other value managers have experienced similar results. To expect outperformance every single year is to implicitly suggest that a disciplined long term investment approach be abandoned for a price momentum strategy. That is a strategy that definitely doesn't work over the long term!

Time frame aside, we believe that a very fundamental reason exists for the underperformance of active managers relative to their benchmarks. Quite simply, most "active managers" don't beat the index because they are "closet indexers". They are an index in disguise. Several academic studies as well as our observations over the past thirty years confirm this fact. Most portfolio managers mimic their benchmark by:

Closely following the benchmark's sector weights;
Holding a very large number of securities;
Investing a significant percentage in the benchmark's largest companies.

All of the above strategies individually and in combination result in portfolio characteristics that are statistically very similar to the benchmark. Aggregate portfolio measures such as P/E, P/B Yield, ROE's, Debt/Equity and Market Capitalization are identical to the benchmark's equivalents. It is very difficult to outperform an index over the long term if a portfolio is the benchmark in all but name. When fees and trading costs are factored into the analysis it becomes virtually impossible for a "closet indexing" strategy to beat the market.

Those who have added value over a long time frame have followed an approach that is exactly the opposite of the above. These successful managers have employed the following key elements in their approach:

- A consistent and disciplined approach that has been applied without compromise;
- A focus on the long-term;
- Low turnover;
- A highly concentrated portfolio;
- A portfolio that is very different than the benchmark both in composition and sector weights;
- A willingness to underperform for not insignificant periods of time in order to outperform over the long term.

Of all the points listed above, the most difficult and most important, is the last item. It takes very strong emotional fortitude to withstand the criticism, the business pressures and often the loss of clients during the periods of underperformance.

Through personal experience I know that support is critical through these times of "looking wrong." This support is rare. But I am blessed to have the unwavering support of you, our clients, the entire team at PCM, my family and an incredible group of friends.

Thank you to all of you!

Vito Maida