The VIEW *from* BURGUNDY

JANUARY 1994

THE MARKET VALUATIONS

EVERY ONCE IN A BLUE MOON, securities markets go to extremes and currently we appear to have such a situation. Small investors are flocking to stocks, taxi drivers are talking about stocks, Initial Public Offerings are coming to market hourly; and exotic funds and emerging markets are all the rage. Equity mutual funds in Canada increased their assets by 65% in the past year. The "new highs list" in the newspaper outnumbers the "new lows list" by a ratio of 10 to 1 on many days.

In this article, we will review the historical valuation statistics of equity markets in both Canada and the U.S. Our conclusion is that stock markets are at abnormally high levels by traditional measures. This does not necessarily mean stock markets are at a risk of imminent decline; prior markets have defied gravity, sometimes for several years (e.g., Japan in the late 1980s). And as a close friend used to say in university, "If you leave the party too early, you'll miss a lot of the fun!"

Clients, friends and regular readers will know that Burgundy's investment philosophy is to focus on value by seeking out individual securities that are selling for less than they are worth. Our primary orientation is towards equities and we are long-term oriented, and this is where we direct most of our research effort: putting companies under an analytical microscope, tearing apart their financial statements and assessing their management. We spend relatively little time trying to forecast interest rates, the economy or the securities market as a whole. In our mind, these macro factors are basically not predictable and trying to predict them is kind of like weather forecasting. We share the view of Peter Lynch who said in a speech given in Toronto last fall, "If you spent 15 minutes in 1993 worrying about the economy, you spent 12 minutes too much."†

But the current market activity and valuation is so unusual that we have recently spent a fair amount of time researching and pulling together key statistics on the valuation of the market as a whole, both as a background for our readers' consideration and also to help guide our own investment judgments.

Our work begins with an estimate of the "intrinsic value" of the overall market. In a nutshell, what a stock (or, in this instance, an index) is worth depends on what it can earn. To arrive at this value, we begin with the shareholders' equity, or book value of the index. Then we look at the kinds of returns that have been generated over an extended period on that book value (i.e., return on equity). This will give us a general idea of what would be a "normal" earnings level for the index (serious judgment now enters the process, for the future won't necessarily reflect the past). The final exercise is to put an appropriate multiplier on these normalized earnings – for this we use the reciprocal of prevailing long-term interest rates. Conclusion: the TSE Index, at today's 4400 level, is well above its intrinsic worth of approximately 3200-3400. Our estimate of the U.S. market shows that its degree of overvaluation is even more pronounced (estimated value is in the range of 2600-2800).

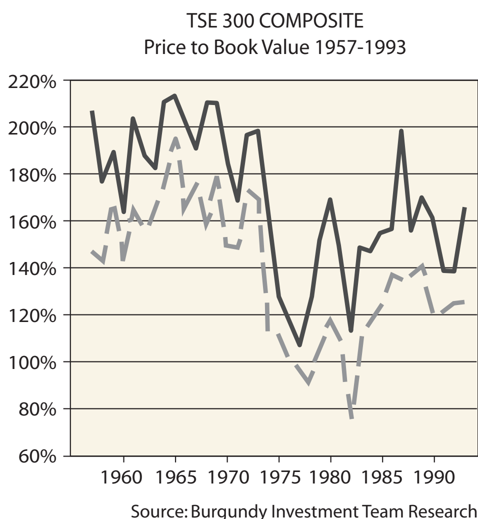
Whenever the market has reached this degree of overvaluation in the past, investors received disappointing returns in the ensuing years. The average annual return from the TSE stocks over the long term is about 10% per year; but obviously, those who buy near market highs will experience much lower long-term returns, and astute investors who buy during

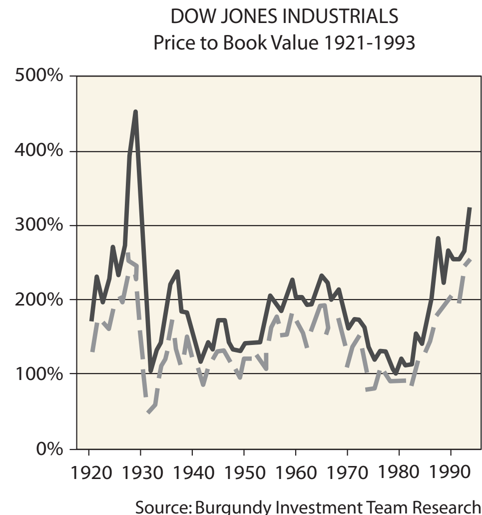
market dips will get better than a 10% compound rate of return.

What is abundantly clear from a review of stock prices is that they fluctuate significantly during their upward march. And it is during these periods of extreme prices that opportunity knocks particularly loudly. Taking advantage of buying opportunities requires discipline and conviction, for at those times such action is difficult, with popular sentiment running heavily against stocks and all-around negative economic news. Conversely, in the euphoria of a bull market, one requires exactly the same discipline in reverse.

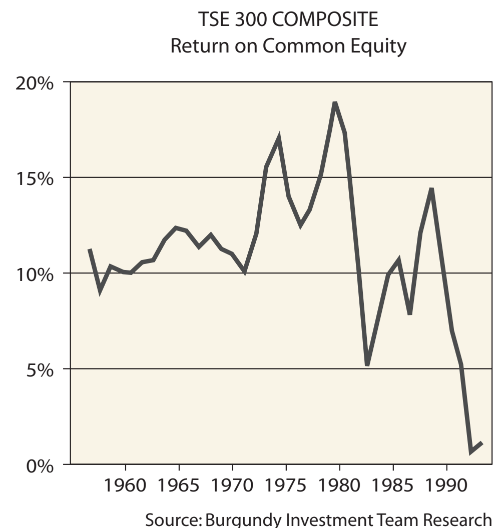
Today, what is required is the courage to sell when the majority of investors are clamoring for stock and when economic news is positive. A wise man once said, "It isn't how much you make, but how much you keep!" Raising cash is not necessarily a wimpy act; we feel that it will provide buying power when true bargains are plentiful once again.

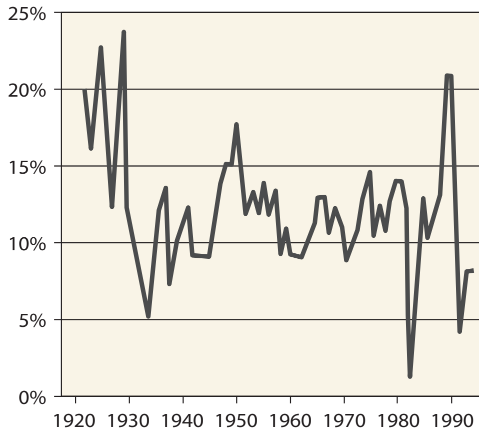
Let us look at how those prices compare to the underlying assets or "book value" of the major Canadian and U.S. stock markets.



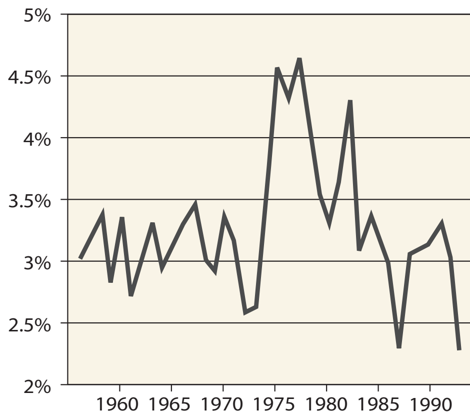


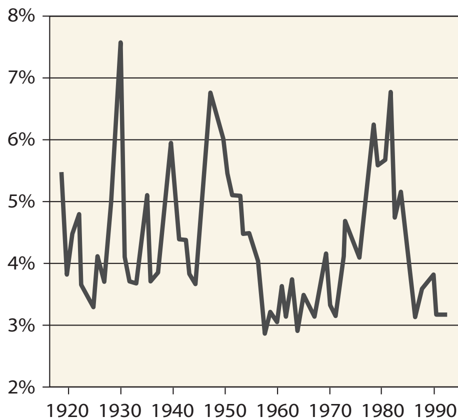
The Toronto market today appears abnormally high in relation to its recent history, although in the 1960s and 1970s, stocks traded in this range of book value ratios. During the 1960s and 1970s, however, Canadian listed companies were far more profitable than today; they provided better after-tax returns than bonds and so they were in great demand. With bonds yielding 5-6% throughout the 1960s, returns on equity of 10-15% looked pretty attractive. Thus, the price-to-book ratios tended toward hefty premiums. A picture of just how badly profitability (ROE) of the TSE companies has declined is evidenced in the chart below. This pattern of declining profitability is not evident in the Dow Jones Industrial Index.





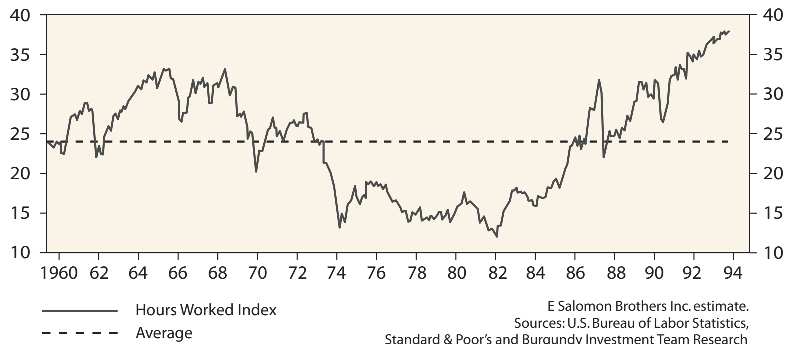
Now let's take a look at dividend yields through the years.





It isn't very encouraging. Today the TSE Composite Index yields around 2.2%, which is the lowest on the record. (The Dow is at 2.6% – also at a record low.) While other comparative statistics suffer various criticisms due to changing accounting practices, write-offs, and so on, the cash dividend yield is factual and has proven to be a reliable indicator in the past. Today's low yields are discomforting.

One final interesting way to look at the valuation of the market is provided in the chart below, which shows the number of hours of work at the average wage rate needed to buy one S&P unit. At 38 hours, it is the highest on record.



We have no idea what the market is going to do. We feel that we can say with certainty that North American equity markets have almost never sold so high relative to earnings, dividends, book value or labour earnings. Possibly the economy could have such a great boom that the current pricing will eventually be justified. Or, maybe money flows from back deposits and CDs will just keep driving stock prices up, notwithstanding the valuation levels of stocks.

What we can say is the current level of pricing is causing us to go about our business of managing your money in a very cautious way. At Burgundy, at the moment, we have more than a normal amount of cash; we have long bonds, and the bonds we hold are of a short duration (some of which are inflation-indexed).

We are especially fussy about our equity positions – and we only own stocks in companies that we have confidence in and that are below their intrinsic value. Where appropriate, we have partly insured against a market decline using S&P Index "put options."

We feel that our portfolios are positioned to benefit from rising stock prices, yet we have sound downside protection. We should hasten to add that our caution has not led to weak investment results. We are pleased to learn that our Canadian Equity Fund – which increased in value by 57% for the 12 months ended November 30, 1993 – placed Burgundy at the top of the 49 pooled Canadian equity funds measured by the latest Towers Perrin Survey.

The performance of our Funds in a rising market is fine, so far. Yet we are mindful of our primary duty – to protect our clients' capital. We take that responsibility seriously and we are doing something about it. When our clients rest easy, so do we.

Endnotes

†. Lynch, speech, 1993.

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