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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET STRATEGY

To maximize your risk-adjusted returns, don't mix investments and emotions. With a quality portfolio, you'll be able to ...

SLEEP WELL

Craig Jerusalim

When it comes to investing, particularly in today's heightened state of volatility, the average investor is often more influenced by their emotions than their brain. To prove this theory, I'm going to paint two true scenarios that have occurred in the past 24 months.

SCENARIO #1: BEARISH HEADLINES

The front page of a financial newspaper screams out, "MARKET TANKS 600 POINTS THIS WEEK!" Investment pundits proclaim we've entered a "corrective phase" in the markets; crude oil prices have dropped 20 per cent over the month; the Greek government debt crisis is fuelling concerns of a greater euro zone crisis; the Ebola virus epidemic is sweeping across Western Africa; and contentious issues in Syria, Iran, Russia and Ferguson, Missouri are all reaching boiling points.

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SCENARIO #2: BULLISH HEADLINES

The following month, the same front page says, "MARKETS RIPPING HIGHER." Consumer confidence is soaring; the S&P/TSX Composite Index has recently experienced a "Golden Cross[1]"; merger and acquisition activity is frothy—including a $70 billion bid for BG Group from Royal Dutch Shell plc; and equity issuance, including initial public offering activity, is heating up.

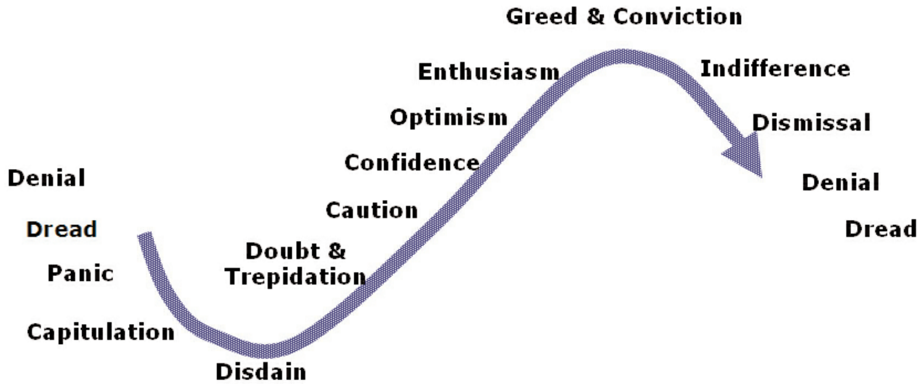
The interesting outcome is that, following each scenario, stock markets moved in the opposite direction to the headlines' sentiments. After bearish Scenario #1, the S&P/TSX returned a positive 15 per cent, only to give back almost all that positive return in the months following bullish Scenario #2. One obvious take-away could stem from one of Warren Buffett's famous quotes, "Be fearful when others are greedy and greedy when others are fearful."?

Investments and Emotions Don't Mix

I would argue that practicing Mr. Buffett's credo is a challenge. Everyone wants to believe they have investment discipline and control over their emotions. They believe they can act contrary to sentiment. Instead, I advocate a much simpler approach that avoids the need to identify pivotal market inflection points. My approach is to avoid market timing altogether. As an alternative, invest in high-quality companies most likely to survive virtually any market trough, but also positioned to thrive during the normal course of market growth.

The World's Worst Market Timer

Here's another (fictitious) example of why market timing is not worth the economic or emotional risk. I have a friend (whom



I'll call Steve), who is literally the world's worst market timer. He has invested $1,000 in the S&P/TSX every year for the past 25 years. However, he only invests when the outlook is rosy, confidence and commentary is most bullish, and, inherently, the market has reached its all-time high for the year.

His one saving grace is that he never sells. He keeps his money in the market, allowing it to work for him even when "others are fearful." One would imagine that Steve's performance would significantly lag the returns of the market. However, because Steve is not making the amateur mistake of both buying at the top AND selling at the bottom, his performance is only slightly worse than the market overall. Steve's 25-year compounded annual return is approximately five per cent, versus the market return of just over six per cent.

Maximizing Risk-adjusted Returns

Now, the goal is not only to meet market returns, but to exceed those returns on a consistent basis over time. Investing in a well-diversified portfolio of high-quality companies allows investors to sleep well at night, while still participating in market growth. It is a strategy that looks to maximize risk-adjusted returns. Since the term "quality" is not ubiquitous within the investment community, it is important to explicitly define what is meant by a high-quality company. Most common definitions of quality refer to companies that demonstrate earnings stability and consistency. However, my more robust definition of quality includes earnings stability, but also incorporates four additional traits: high margins, low leverage, strong management teams, and growth at a reasonable price ("GARP").

Any company can exhibit **high margins** or **high profitability** in any one quarter or year. However, in order for those margins to be consistently maintained, a company needs to possess a sustainable and defendable competitive advantage. Otherwise, competitors will enter the market and erode any excess returns.

GILDAN: LEADING IN ITS INDUSTRY

For example, take **Gildan Activewear Inc.** (TSX-GIL). Gildan has invested hundreds of millions of dollars over many years to automate its manufacturing process and drive down costs, to become the lowest-cost producer in its industry. Competitors would take years to replicate Gildan's cost structure, and Gildan could put excessive pricing pressure on competitors during the time needed to close that gap, given Gildan's head start. Therefore, Gildan is likely to maintain its cost advantage in the short-to-medium term.

A company that has a strong **balance sheet,** or low financial leverage, is gifted with both flexibility and optionality. All companies, good or bad, encounter rough patches or experience unexpected adverse events. If a company has a relatively low level of debt, chances are the company won't be forced into doing something undesirable at an inopportune time. The company has enough flexibility to avoid issuing equity at a low share price level or having to sell core assets at a market trough.

Low debt levels also provide

prudent companies with optionality when their peers hit rough patches. These high-quality companies can then make strategic and accretive acquisitions at market troughs, positioning themselves to thrive once the market recovers. The energy sector is a good example of this contrast. Companies that had high debt levels when crude prices fell were forced to sell off their best assets to pay down debt. It was the high-quality companies like **Suncor Energy Inc.** (TSX-SU) that were ready and waiting to snap up premier assets at attractive prices.

CONSISTENT AND PREDICTABLE EARNINGS MATTER

The next characteristic that I like to see is **low variability,** or **high predictability,** in earnings. I feel more comfortable owning companies with recurring earnings or large backlogs of business so there isn't a concern about the source of next quarter's revenue. Good examples of these types of companies include utilities like **Fortis Inc.** (TSX-FTS), telecommunication companies like **Telus Corp.** (TSX-T) and **Rogers Communications Inc.** (TSX-RCI.B), and definitely the large Canadian banks. If one of the Canadian banks ever "misses" its quarterly expectations, it is usually by a nickel or dime on a per-share basis. These stocks don't typically swing from large gains to large losses, other than as a result of an infrequent event like the great financial crisis.

The telecommunications companies are another group with very high levels of visibility and low levels of volatility in their earnings. I hate paying my Rogers bill each month, but their cellular and broadband services are essential, so stopping these services is not an option. It's a case of "if you can't beat 'em, you might as well own their stock!"

STRONG LEADERSHIP IS ESSENTIAL

The fourth tenet is seeking companies with strong **management teams,** exemplified by consistent track records of success. I like to see a pattern of under-promising and over-delivering results. Most importantly, management must always follow through with its promises and commitments. Holding management teams responsible for their actions is why I consistently meet with leadership teams face-to-face. I gain insights into the intricacies of their businesses, and also pick up changes in tone and outlook.

A conservative management team, such as **ARC Resources Ltd.** (ARX-TSX), always seems to be able to exceed expectations. It sets targets that it knows it can beat, and leaves buffers for those unexpected circumstances that occur in all industries from time to time.

GARP

Finally, I want to invest in companies that are growing. That is, growth in their top-line revenues, which funnels down into bottom-line earnings, cash flow, and ultimately, free cash flow. Companies with excess free cash can create value for their shareholders by investing in the business, making strategic acquisitions, opportunistically buying back shares and growing the dividend. I want to pay a reasonable price for that growth; otherwise, I won't realize a return on my investment. This style is often referred to as **GARP** or **Growth at a Reasonable Price.**

THE HARD PART: IDENTIFYING INFLECTION POINTS

The easy part of the process is identifying these characteristics. The hard part is scrutinizing the management teams and identifying inflection points when a company loses some of these qualities or, conversely, proves it has emerged as a high-quality company. At CIBC Asset Management, one of our competitive advantages is our in-depth fundamental analysis that strives to uncover mispriced opportunities. Site visits, expert networks, management meetings, and proprietary long-term financial modelling are some of the tools that help us make the best investment decisions within the context of our style discipline.

To recap, market volatility is expected in today's hypersensitive, lightning-speed information era. However, you can hopefully sleep a little easier at night when your portfolio or mutual fund is filled with high-quality companies with defendable competitive advantages, strong balance sheets and seasoned management teams prepared to take advantage of any adverse situation. My two young children at home may sometimes wake me at night, but my investments let me sleep in peace. ▼

[1] *A "Golden Cross" occurs when the 50-day moving average moves above the 200-day moving average.*
[2] *S&P/TSX Composite Index return*