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Colum McKinley, Vice President of Canadian Equities for CIBC Asset Management.

AFTER YEARS OF WEATHERING THE STORM, VALUE STOCK OPTIMISM IS PAYING OFF

Jonathan Ratner

The struggles value investors have faced in recent years are no secret, and 2015 was no exception. It marked the second most significant divergence between growth and value stocks in the past two decades, with growth once again outperforming by a wide margin.

But the value crowd should take solace in the fact that when value stocks recover – and they've started to do so this year – the resulting outperformance can be pretty impressive. Following the tech bubble of the late 1990s, the MSCI Canada Value Index rose nearly 25 per cent in 2000, while the MSCI Canada Growth Index fell more than that same amount.

Colum McKinley, who oversees $8.5 billion in mutual funds and managed products at CIBC Asset Management, wasn't trying to make a market timing call when he turned more optimistic on value stocks in the latter part of 2015. But the portfolio manager of the CIBC Monthly Income Fund and the CIBC Equity Value Fund, among others, simply saw that many stocks sold off too much.

"The market was too pessimistic in their views of the underlying businesses," McKinley said. "We're now seeing a lift in multiples, as valuations go back to more normalized levels."

He noted that the probability of financial default reflected in market prices was excessive, particularly in the materials and energy sectors. Companies with no liquidity problems say their bonds trade down to 40 or 50 cents on the dollar.

The recovery in commodity prices has taken some of that pressure off, and both these bonds and share prices have rallied.

That's helped push the Value Index up 12 per cent year-to-date as of May 30. Meanwhile, the Growth Index had risen just

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two per cent, and the benchmark S&P/TSX Composite Index saw a gain of about eight per cent.

"We all know markets tend to overshoot on the downside and upside, and I think we clearly overshot when growth did so much better than value," McKinley said. "We're starting to see some reversion, and I think it's in the early stages of that process because these cycles tend to last a number of years."

One of the biggest dislocations that occurred in the market was the sharp decline in energy stocks.

McKinley saw an opportunity, and his portfolio's have been overweight the sector since the fall.

Pointing to the very aggressive curtailment of capital expenditures, and the expectations that production numbers have only started to roll over, McKinley is focusing on high-quality energy companies.

He highlighted Canadian Natural Resources Ltd. (CNQ/TSX) as an example given its quality assets, strong management team, and attractive valuation since it trades at a discount to other major producers.

'We want to make sure we buy long lead-life, low decline-rate assets at attractive valuations, with good balance sheets, in order to survive the short-term and very intense volatility we're seeing in the price of oil," McKinley said.

The selloff in oil prices also hurt other market sectors outside of energy, including real estate companies with exposure to Alberta.

Dream Office REIT (D.UN/TSX) is held across McKinley's funds and he took advantage of the stock's volatility to add to his exposure during the downturn.

"We think it has been overly penalized," the portfolio manager said. "The stock has traded as if all of its office portfolio is in Alberta, when in reality, less than a quarter is exposed to that environment."

The company is now focused on debt reduction and share buybacks, and by selling non-core assets in Ontario, for example, McKinley noted that Dream can receive premiums to its net asset value, then buy back shares trading at a substantial discount to NAV.

"That arbitrage is all going to accrue to shareholders over time," he said.

Another core holding McKinley has bought more shares of as volatility dragged the stock lower is Magna International Inc. (MG/TSX).

"Right now, I think a lot of investors are worried about the cyclical rollover that occurs when auto sales eventually see pressure, which hasn't happened it," he said. "Looking through that given the long-term earnings power of this company, makes Magna a great investment today."

In addition to trading at single-digit forward P/Es, McKinley highlighted the improvements management has made in terms of capital allocation decisions.

He noted that Magna is using its balance sheet more prudently, adding slightly more leverage, but using that to consistently grow the dividend, make appropriate acquisitions that add long-term value, and buy back shares.

McKinley also owns Granite REIT (GRT/TSX) in his funds, which happens to have Magna as its largest tenant.

Buying more shares on the pullback that followed the announcement of its strategic revenue, he noted that Granite also has an opportunity to buy back its own shares at a deep discount.

The portfolio manager also pointed out that its lease negotiations with Magna represent an upcoming positive catalyst for the stock, and it also offers investors a more than six per cent dividend yield.

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