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Steadyhand

Why I've boosted my equity holdings to above average

By Tom Bradley

One of the most important things I do in managing money for individual Canadians is to ensure they have appropriate return expectations. Not too high, not too low.

In this regard, it feels as if I'm always at one extreme or the other. In good times, when the stock market is running hot, I'm talking people down and trying to quell the euphoria. In down periods, you guessed it, I find myself talking them up.

Upon reflection, I never seem to spend enough time in the calm, comfortable middle. You might say I'm too contrarian for my own good or am trying to be a psychologist, both of which may be true, but what's really driving my teeter-totter behaviour is the math.

History would suggest that stocks will generate a return of 8% a year. There are two sources for this return. Dividends, which are reasonably stable, contribute 2% to 3%, while corporate profit growth, which is more variable (including some negative periods), chips in 5% to 6%.

Unfortunately, there is a third less-productive variable in the return calculation – how much investors are willing to pay for profits. Price-to-earnings multiples (P/Es), and other valuation measures, are prone to unrealistic highs and overpessimistic lows, which causes stock prices to be much more cyclical than the economy that underpins them. These swings in valuation net out to zero over the long haul, but create havoc along the way.

So, while the long-term potential for investing in stocks changes very little, the medium-term math varies a great deal. Consider the two extremes. When the market has optimistic profit projections, high P/Es and modest dividend yields, returns in the subsequent three to five years fall well short of 8%.

Conversely, when worst-case scenarios are coupled with below-average multiples and high dividend yields, the opposite occurs. Excellent returns are to follow.

When I started in the business in the early 1980s, there were blue-chip companies trading at single-digit multiples, due primarily to the fact that interest rates and inflation were in double-digit territory. After 18 years of good markets, and a healthy dollop of tech hype, those same companies were trading at 30 times earnings or more (multiples on more exotic technology and Internet companies were in the stratosphere).

The bubble burst in 2001, however, and since then P/Es have come back to Earth, moving between the low and high teens.

As I write this, I'm going through yet another transition. I've been a cautionary curmudgeon over the past year, but am now Mr. Positive again, increasing the stock weighting in our Founders Fund to an above-average level (65% of assets). While earnings are likely to grow more slowly in the near term, dividend yields and valuations are attractive again (particularly when compared to fixed-income securities). Over the next five years, 7% to 9% annualized returns are a reasonable expectation – 3% dividend yield, 4% to 6% profit growth and P/Es bouncing around current levels.

The reason I find myself talking people up again is not because 7% to 9% is off the scale, but rather that investor sentiment is so negative. Instead of doing the math and adjusting return expectations up as the market declines, investors are writing stocks off.

Warren Buffett is famous for saying, "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." Well, today the fear is palpable.

While there are many investors and advisers who quote the Oracle of Omaha, there are few who act on his advice. That's because being greedy is hard. It requires digging for positives under the doom and gloom. It means critically assessing companies' long-term prospects and putting a value on them.

And then comes the really hard part – buying more stocks when you've lost money (on paper), are emotionally beat up and have no idea when the market is going to bottom. Mike Tyson, who is slightly less revered for his financial wisdom, captured the challenge well when he said, "Everyone has a plan till they get punched in the face."

As investors, our job is to get off the mat and make decisions that have the best chance of producing attractive returns in the future. That means freshening up the numbers, putting on the noise-cancelling headphones and taking some inspiration from Mr. Buffett.

Tom Bradley is the President of Steadyhand. A version of this article was published on February 10, 2016, as a Special to the Globe and Mail.