ETF insight

**OCTOBER 31, 2014**

**Kim Inglis, BCom, CIM, PFP, FCSI, AIFP**

# Value investing in volatile markets

Lots of value when adjusting for cash hoarding

Without doubt, markets have been volatile this fall. From the September peak to the most recent October low, the S&P/TSX Composite Index dropped approximately 13% and the S&P 500 by 9.8%. These numbers indicate an intermediate correction, an event which typically occurs once every two to three years.

Looking at current market valuations, some pundits argue that price-to-earnings multiples are too high and therefore the markets have nowhere to go but down. They conclude that, since the current valuation of the S&P 500 is trading slightly higher than the historical average of 15.8x forward earnings, there isn't a lot of room for growth.

The flaw in that argument is that it fails to examine things on a cash-adjusted basis. Instead it ignores the estimated $1.6 trillion currently sitting on corporate balance sheets, which is an unprecedented accumulation of cash.

An RBC Wealth Management report says that this cash build-up is making the S&P 500 look more expensive than is actually the case. After adjusting the price-earnings multiple of the market to reflect the cash, the report found that the markets pushed below 9x earnings in the latest cycle. That's an important point. Historically, when markets have been in the low single digit range for multiples, it has marked the beginning of a secular bull market.

Other factors favour the long-term market outlook. Vertex Asset Management notes that oil is the largest tax on the U.S. economy and that lower prices will be a major driver of economic expansion: "With rising wages, falling oil prices and stable interest rates, consumers will have fuller pockets to buy that new house, car, technology, etc. All the while corporate margins are expanding with reduced manufacturing and transport costs."

This bodes well for long-term value investors, and any near team volatility should be viewed as a buying opportunity. Canaccord Genuity North American Portfolio Strategist and Quantitative Analyst Martin Roberge points out that most of the ingredients for a capitulation low have occurred, including an upside blow to the CBOE Volatility Index (VIX), and the trip to market lows happened on very heavy volume.

Investors wishing to take advantage of the market volatility on a risk-adjusted basis may wish to use an exchange-traded fund (ETF) like the First Asset Morningstar Value Index (TSX: FXM). It's a diversified ETF containing 30 Canadian value stocks, with a maximum of five companies from any one sector. The ETF is fairly new, but the index it replicates has been around for quite some time and has outperformed the TSX over the past one-, three-, five- and ten-year periods. Further, it has done so with volatility levels not materially different from the S&P/TSX Composite Index.

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This means the index has outperformed without taking on more risk.

The markets have pulled back quite a bit and at some point they will rebound. A lot of good quality value stocks have been beaten up and "buying the market" with an index fund is a good way to acquire them without taking on single equity risk.

*Kim Inglis, CIM, PFP, FCSI, AIFP is an Investment Advisor & Portfolio Manager. The views in this column are solely those of the author. www.kiminglis.ca*

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