

Steadyhand

Why I'm Buying Stocks Again

By Tom Bradley



Over the past year, people have not wanted to hear my cautious take on bonds and stocks. I've been called a Debby Downer and party pooper and, as the head of a growing investment management firm, have definitely been a marketing albatross.

In the spring, one of my partners asked me, "What would it take for you to lighten up a bit?" I was too grouchy to answer at the time, but it got me thinking. What has to change for me to be more optimistic, and by how much?

Better stock valuations

In the investment community and media, the great debate throughout this year has been whether stocks were overvalued. My work would suggest P/E multiples were on the expensive side going into the summer, and this was confirmed by our fund managers' complaints about not finding many cheap stocks.

As the leaves start to drop with the temperatures, have we made any progress on this front? My answer is yes, stock prices are down from their peaks and price-earnings ratios have moved closer to their long-term averages. In recent weeks, we've been using weak days to buy stocks in all our funds, including the Founders Fund, which I manage.

Sustainable bond yields

The bond market is referred to as the senior market. As an old stock analyst, I've always been reluctant to accept that title, but the truth of the matter is that interest rates provide the foundation for all capital markets.

A big part of my grouchiness relates to the unsustainable interest rates we have today. Central bankers are micro-managing short-term rates and bond investors are being forced to accept inadequate returns for the risks they're taking. Real interest rates (after inflation) are hovering around zero.

Unfortunately, this situation got worse over the summer due to concerns about slower economic growth. Rates are lower and the pre-eminence of the central bankers was reaffirmed again last week when we waited breathlessly for the Fed to decide on whether to start normalizing interest rates. Needless to say, this part of the investment foundation is still shaky.

Wider credit spreads

With our faux interest rates, it's been a great time to be a borrower. Nowhere has this been more evident than in the corporate bond market. Companies of all types and quality have had open access to financing at yields they could only have dreamed of a few years ago. But it follows then that it's not been so great for lenders. The extra yield received for taking more risk in owning a corporate bond, referred to as the spread over government bond yields, has been at cyclical lows.

But there's good news on this front. The summer's uncertainty has increased spreads and made investment-grade and lower-quality bonds more attractive. For example, the yield on the U.S. high yield index is now more palatable at 7.3 per cent, up from just 5.2 per cent a year ago.

Reasonable expectations

Art Phillips, co-founder of Phillips, Hager & North, taught me to use investor sentiment as a contrarian indicator. The more bearish people were, the more buy tickets Mr. Phillips put on the trading desk, and vice-versa.

I wouldn't have described the mood of investors as unabashedly bullish in the spring, but there was definitely complacency around the risks in the market, and an emerging consensus called TINA – There Is No Alternative (to owning stocks) – indicated a lack of skepticism.

As we get ready for winter, the sentiment backdrop is much healthier. The choppy and mostly down markets of the past two months have eliminated the blind optimism toward stocks. And importantly, growth expectations for the world economy are more realistic. Investors are recognizing the impact of the world's debt burden, and are no longer counting on China to be the "Eveready" growth engine.

A better environment

I can't say that all of this has yet made me a joy to be around, but I am in a more optimistic mood. As always, we have no idea where the markets are going in the short to medium term, but the backdrop is better, values have improved and expected returns are higher.

Tom Bradley is the President of Steadyhand. A version of this article was published on Sept. 23, 2015, as a Special to the Globe and Mail.

