Kim Shannon: Lessons on value investing from a true contrarian

Kim Shannon is a contrarian in more ways than one. She switched from anthropology/biology student to the finance field and started working in the investment industry at a time when women were in the minority. She also takes a contrarian approach to investing at her firm, Sionna Investment Managers in Toronto, which she founded in 2002. Shannon spoke with the editors of the Ben Graham Centre's Newsletter about why she adopted the value investing philosophy, how she applies it at Sionna, and why it works in the Canadian market.

BG: You pursued a Bachelor of Science degree in Zoology and Anthropology from the University of Toronto then switched to a BA in Economics and Commerce a few years later. Why did you switch to business?

KS: I realized that, in order to carry on in anthropology, I'd need to do a lot of higher education. I didn't come from a wealthy family, so I knew I wouldn't get to be a genteel academic woman. I had a reality check after seeing some job postings that a PhD back then would get a grand sum of $14,000 a year. So I revised my thinking. I had done a lot of volunteer work and I loved doing it. Like you, as a volunteering student, I was on the student council at the University of Toronto, I started a women's newspaper magazine on campus, and I was a member of a women's fraternity. I also started a peer counseling program at the University of Toronto's Victoria College, matching fourth year students with first year students. The program was still being used the last time I spoke to students there. At some point, I realized I just can't afford the lifestyle of following the anthropology route, and I wondered what to do next. I love to organize things so I asked around how I can find a job where I can organize things. Someone told me it's business! I was in shock back then because I thought business was something nerdy and weird. I thought it was about working with calculators, not working with people. After entering the program, I realized it was the right field for me. I ended up in business totally by accident. But I haven't looked back since.

BG: How did you eventually adopt the value investing philosophy?

KS: My very first job after graduating was working in the accounting department at a trucking fleet insurance company where I was rolling treasury bills. To understand investing better, I took a course at the School of Continuing Studies at the University of Toronto. It was basically the Canadian Securities Course taught with a lecturer. The course had many guest lecturers and they all talked about how they accidentally fell into the investment world, because back then people didn't really go into investing. Keep in mind I started working in 1983, and we had just gone through a really bad sideways market. Equities were not as attractive as at the beginning of the bull market runs. At that time, people had concerns choosing investing as a career field, but they found out that they were challenged, enjoying meeting people, were making good money, and having fun every day. After several weeks of the course, I began to ask, "What is this investing thing?" Then I heard about the Chartered Financial Analyst (CFA) program and I signed up. After 18 months in the program, I applied to get a job working in a real investing department. I got a job at Royal & Sun Alliance, and it just so happened that I worked under John Di Tomasso (now with the Di Tomasso Group investment management firm in British Columbia). He was a well-regarded value manager, and he taught me value investing. I remember at the beginning I thought he was a nutbar, because he literally said, "Stocks revert to their means." As a science major, I asked for evidence and he simply said, "Because they do." So I didn't believe him, but, because I was working under him, I had to help him look through annual reports and research reports. After two years, I watched all these stocks float back up to their intrinsic value, and that's when I started to become a believer and got started in value investing.

BG: What is your research and due diligence process like when looking at investment opportunities?

KS: We start off quantitatively and then get into the fundamentals. We purchase from databanks, download the information, crunch through a model, and the model is really an up-and-ready ranking machine. It tells me what's truly cheap in the marketplace. You then marry that with deep fundamental analysis. We use a very structured questionnaire to take the emotions out of investing. It's very prescriptive so I can take a new analyst and say, "Here are 20 questions and all the sub-questions, I want a PhD thesis from you on this company." They may not know what they are doing in the very first report they write, but there should be enough in there that the rest of us can then make an investment decision even if the analyst was wrong on the conclusion. You go from what is the competitive advantage of the business, to the quality of the management, to the corporate governance, to the financial risk, all the way to the valuation relative to its peers, what the downsides and upsides are, and what will move the stock, etc. These qualitative analyses help us decide whether this stock that looks cheap really is cheap, and deserves to be in the portfolio. We work in a team and break up the market into industry groups where individuals cover sectors. Now there are 10 major GICS (Global Industry Classification Standards) sectors covered by portfolio managers, and the analysts generally cover sub-sectors. New analysts will start with individual stocks, and after they build up some experience and affinity, we will assign them a sub-sector. For example, within the oil and gas sector, we may give them a natural gas pipeline, or something more specific. It's usually easier to start off with small-cap stocks since they are easier to analyze.

BG: What do you think is different about value investing today compared to when you first started out?

KS: Value investing doesn't change. You go out there and find mispriced cheap stocks, and you slowly wait for them to revert back to their means. That core has never really changed. There are little things around the edges, and they ebb and they flow. Earlier in my career, the highest price to book value (P/BV) you would ever see, right until the 1980s, is around 1.75x. About 90 per cent of the time, the stocks traded between book value and 1.75x. I would attribute the degradation of accounting policies to the increase in P/BV multiples that we are seeing in stocks today. So there are small adjustments, and you do have to be flexible around the edges, but it could revert back to that old number again, and you just have to be cognitive of that. By and large, the real guts and core of value investing really haven't changed at all, in my opinion.

BG: Sionna invests largely in Canadian companies. Can you explain to us how an investor might approach the Canadian market differently from the more familiar/popularized U.S. market?

KS: I think relative value works really well in Canada, which is an idiosyncratic market. All markets are idiosyncratic. I find a lot of people assume that an ideal market would have all 10 GICS sectors, and the market would be equally weighted in all of them, and that would be the perfect market. That's far from the truth. The Ricardian Law of Comparative Advantage from several hundred years ago says that if you are good at something, you should make more of it and sell it internationally. It also says you should stop making what you are bad at making and import it. Your economy and the rest of the world will be better off as a result. So, fortunately, almost all markets are idiosyncratic, even the U.S. market, which is the broadest and deepest market in the world. Most of the time, the top three sectors represent some 60 per cent of the market. Some markets are way worse than Canada. I think Japan's top three sectors account for 80 per cent of the market. So I think not investing in the Canadian market because of its idiosyncrasy is a fallacious perspective because by definition all markets in the long run get the same returns. If a market is subpar and nobody would invest in it, and vice versa, then the markets rebalance. From time to time it could change, but, on average, a market would return 10-12 per cent in the very long run.

BG: Sionna is different from other value investing firms and has a big focus on relative value investing. Can you talk about relative value investing in the context of the Canadian market?

KS: The style box matrix was developed in the U.S., which had the most choice; so you could play true growth or deep value in the U.S., in large cap and small cap, with the large cap always having a smaller number of names than small cap. I think in Canada in particular, because of the concentration and resource focus of the market, deep value is hard to play in Canada because you would be heavy or underweight in cyclicals from time to time, and have very divergent returns from the market. Clients would really wonder if the managers know what they are doing. It's the same with growth investing. A decent-sized portfolio needs at least 15 stocks for diversification. Are there 15 true growth stocks in Canada? Rarely, if ever. Most people who do growth investing in Canada tend to do momentum investing, or some version of it. So to me, the best way to play value in Canada is relative value, which means being in all industry groups at all times and finding the cheapest stocks of the sector. But don't make a big sector bet, which is what a deep value manager would do, and you'll get a more consistent return. I think it's very pragmatic for the Canadian marketplace, especially for a large-cap focused fund. This is what I'm best known for.

BG: What metrics do you use to evaluate management?

KS: Are the managers vivid spirits? Do they inspire other people? Have they demonstrated skills in capital allocation? Do they pay themselves fairly? We have found that CEOs that pay themselves egregiously have a high correlation with aggressive accounting practices. The book *Good to Great* [by Jim Collins] did a great job of highlighting that larger-than-life CEOs build vulnerable firms because they build the firm around their personality and they can't be replaced. When they retire, the firms struggle for a period of time to find a new normal. Firms are much better off having a lower key quality CEO. That way the culture and the capability of the firm continues. You see that in certain companies. RBC Royal Bank and BMO Bank of Montreal, for instance, have really strong corporate cultures. When they shift from CEO to CEO, you really do not see the culture changing dramatically.

BG: During periods of intense bull markets, how do you find value?

KS: When the overall market gets crazy, then all stocks are crazy and then you can't find much of anything that's relevant value. You can't find anything that's decent quality and trading at a low Price-Earnings Ratio (P/E) multiple. You can't find returns of 30 per cent or greater and the ones that you do are just bad quality or have a lot of attributes you don't want to own. We'll shift down from a 30-per cent expected return to a 20-per cent expected return and see if we can widen our opportunities. We'll also do more switching. Running a portfolio is a bit like running a wine cellar. You go out and buy the wine and they all mature at different times. You have to watch your wine cellar because you don't want to have vinegar in there. What matures has to come out of the cellar. When your stock is fully valued, you have to get your profit. And when the overall market gets expensive, you want to take some of those bottles and sell them, yet you want to have a future supply to drink that tastes good. So if you take something out, you have to replace it. Sometimes you can't find a replacement. When we can't find a 30-per cent return stock in the same segment or sector, but we can find a 20-per cent expected return stock and it has a cheaper P/E multiple, and a better dividend, and better characteristics, and we like the company, we will take our risky name out of the portfolio and replace it with this name. Although it's not giving me exactly what I'd like, I get a better future.

Generally, the overall markets will eventually have a schism. Different stocks collapse over others. The ones that collapse the most tend to be the high-flyers with the big fat valuations. The nervous growth stock owners start tossing their stocks out at bargain prices. That can create fantastic opportunities for value managers. In those environments, even if you're totally invested, if there's stock you wanted to buy that's suddenly cheap enough, you do it. You can take your names and just sell a little bit and buy some of these others. You can play with the fact that you don't have absolute values overall within a whole portfolio construction, but you're trying to get attributes that will benefit clients going forward in the future.

BG: How do you identify value traps?

KS: We try and avoid management teams we don't trust. I want to have stocks so when everything gets into trouble, I have a leg to stand on as to why I own them. If I didn't like the management or I didn't like the business, it's hard for me to justify why I bought it in the first place. The biggest challenge for me in terms of value traps is fraud. As much as we develop some techniques to try and identify fraud in advance, I'm not sure we can always do that. There will always be some business managers who will look for cracks between the lines of legality and will be innovative to find novel new ways to play tricky games. It's pretty hard to know them all. By sticking with managements that we feel comfortable with and that we feel have integrity, and certainly if we see that there's a minimum of aggressive accounting going on, that gives us some comfort. Often the frauds have aggressive accounting embedded in them.

BG: What is the most important thing you've learned in life and investing in the last 30 years?

KS: You learn from all your mistakes and you will have mistakes. The key to surviving in investment management is learning to live with your mistakes. You have to learn to accept that, if you get more things right than wrong, you can win the game of investing. Don't spend too much time focusing on what didn't work. For me and my team it's about being collegial and working together at all times and supporting each other through the rough times.