Jason Reed, CFA, FCIA

QV Investors Inc.

Pulling the Goalie

Tiny Thompson holds the record for the best winning percentage by any goalie in the NHL. Thompson's performance between the pipes, however, was not the most remarkable thing about his career. During Game Two of the 1931 Stanley Cup semi-finals between Boston and Montreal, Thompson became the first goalie to be pulled in the history of the NHL. Down 1-0 late in the third period, Bruins coach Art Ross figured the extra attacker would improve his team's odds of winning. What does pulling the goalie have to do with investing? A lot, according to AQR Capital co-founder Cliff Asness, and his colleague and professor, Aaron Brown.

Asness and Brown modelled the optimal time to pull a goalie using data from the 2015-2016 NHL season. According to the authors, coaches should pull the goalie with 6 minutes remaining when losing by one, and with 13 minutes remaining when trailing by two. Pulling the goalie increases the likelihood of winning in the same way increasing volatility makes a call option more valuable. There are no negative points in the standings for losing badly. But by pulling the goalie, a coach doubles the team's chances of scoring, increasing the odds of getting a point or two in the standings. So, it is worth the risk, despite the greater volatility of outcomes. The investing lesson here is: make sure you are managing the right portfolio risk. For many, the most important risk is failing to earn an acceptable rate of return. In general, risk does not equate to volatility, despite it being a popular metric.

Value investors have something in common with a coach who pulls his goalie with 6 minutes to go; they are willing to risk their reputations (career risk) in order to generate attractive returns. Oftentimes, companies trade cheaply because they have recently experienced operational difficulties, or the outlook for the industry isn't particularly attractive. What sets value investors apart is they make their purchases for defensive reasons (to gain a margin of safety), unlike the hockey coach who abandons defense for one more attacker. Value investing is no free lunch, however, because a perceived discounted valuation could turn out to be fair (or worse, expensive) if recently depressed earnings do not eventually recover to the degree expected. Traditional value sectors (financials, commodities, industrials) are economically sensitive and typically require a strengthening economy for their value to be realized.

Growth investors, on the other hand, are those who purchase businesses presently enjoying strong tail winds. The relatively high valuations they pay reflects their optimism. This can work out well, or badly, depending on the degree of optimism baked into share prices. Take Canada Goose (TSX/NYSE: GOOS), for example, a wonderful business that has grown revenue by 40% per year for the past five years. On Wednesday, GOOS reported strong fiscal 2019 results, but also guided "annual revenue growth of at least 20%". Most businesses would kill for double-digit revenue growth, but these revised expectations caused GOOS shares to swan dive by 30%. Ideally, we would always own portfolios of highly profitable and fast-growing businesses at excellent prices. But this isn't possible without a crystal ball to tell you where economic growth and interest rates will be in the future.

Fama and French discovered the value premium - greater returns for value stocks over growth stocks. While this premium has not been realized over the past decade, it is in the traditional value areas of the market that we see the most compelling valuations. The spread between valuations between growth and value stocks is also abnormally high. There is no guarantee that this valuation gap will be closed in the near term. However, to benefit from an eventual realization of the value premium, one must clearly articulate their objectives and definition of risk. Otherwise, it's far too easy to abandon a strategy when it's out of favour. For us, this means continuing to pay attention to the price we pay for businesses.

Pulling the goalie against the Canadiens didn't work for Art Ross, but he created an enduring strategy still in use today. Today, NHL coaches are pulling the goalie earlier than ever. Similarly, value investing can be at times fraught with volatility and stretches of disappointment but should eventually be rewarded with a few extra points in the standings.