Where to Dig for Bargains in the S&P/TSX Composite

Description

Take Stock *is the Motley Fool Canada's* ***free*** *investing newsletter and is distributed weekly. This edition was sent to our followers last week. To have future editions delivered directly to you, simply* ***click here now****.*

Dear Fellow Fools,

The passing of another April Fool's Day means different things to different folks. To many in the button-downed financial world, it mostly represents the completion of the year's first quarter.

In this edition of Take Stock we're going to take a look back at the quarter that was, and have a look at what the rest of the year might hold while pointing toward several areas of the market that may be well-positioned to bear fruit in the months and years to come.

The quarter that was

Thus far in 2015, the Canadian market has offered us a bit of a roller-coaster ride. There have been ups and downs, and just like all roller coasters, we're essentially right back where we were when the year began.

The S&P/TSX Composite closed the quarter a whopping 1.8% higher than where it finished off in 2014. This compares to the 0.4% move higher that the S&P 500 has made thus far in 2015.

Leading the Canadian market (and U.S. for that matter) higher in the first quarter was the Healthcare sector. In Canada, the bulk of the heavy lifting from this sector was done by one stock, **Valeant Pharmaceuticals** (TSX:VRX), the near-$90 billion behemoth that continues to add to its stable of pharmaceutical-related products.

Holding our market back in the quarter were the Financials and Energy sectors, which posted returns of -1.1% and -2.0%, respectively. Given that these are the two biggest sectors in the S&P/TSX Composite, it's a bit surprising that the Canadian market actually finished the quarter in positive territory. The combination of Valeant's size and return was enough to overcome the drag that these two sectors created.

Energy's performance is rather self-explanatory. The performance of the Financials sector, however, was more covert and impacted by a rather lacklustre quarter from the Canadian banks. The Big 5 put together an average return of -5.4%, and not one of the five posted a positive return. Interest rates, a weak Canadian economy, and growth challenges can all be cited as potential reasons for the weak quarter out of bank stocks.

The road ahead

So the question now becomes, where do we go from here?

As long-term investors, we believe the answer is always clear – higher!

However, the path to higher ground is likely to be full of pot holes and unexpected twists.

And according to a number of sources, the path directly in front of us may be riddled with these kinds of obstacles.

A recent report out of Morningstar warned to "proceed with caution" as the firm sees little margin of safety and few opportunities in current stock prices.

Interest rates are a primary concern for the U.S.-based firm as it's becoming the consensus view that at some point in 2015, the Federal Reserve is likely to move its Fed funds rate higher. This, of course, is the opposite direction to the one the Canadian monetary authorities have taken, but should a rising rate environment in the U.S. evolve, it's likely to provide a significant headwind for all North American markets.

While rising interest rates may take some of the shine off the U.S. economy, the Canadian economy has yet to experience the full ramifications of the recent slump in the energy sector. Should energy prices stay at current levels through 2015, and beyond, there's another shoe (or four) to drop on this front, a scenario that's rather uncomfortable to contemplate, particularly when it comes to our western provinces.

These aren't the only big picture issues that we face, but compounding them is the fact that our markets remain within very close proximity to their all-time highs. Fools, we're not dealing with cheap markets here, and this generally means that the potholes and twists will be more exaggerated than if we were at more moderate levels of valuation.

As cited in a recent report from Russell Investments, the Canadian market currently trades at a trailing price-to-earnings (P/E) multiple of 25 and forward P/E of 18, both above their long-term averages of 20 and 14, respectively.

A similar dynamic exists for the markets south of the border.

Sounds rather dire, doesn't it?

Read on, Fool….

What to do

In order to deal with the obstacles that lay before us, we can return to that Morningstar report mentioned above for some advice.

In it, the author indicates that "**investors in common stocks must have a long time horizon and the patience and discipline to ride out volatility.**"

In this day and age of high-frequency trading, technical analysis, and stock evangelists everywhere we turn, if only there was an operation that lived and died by these principles …

Of course, I'm here to tell you: there is!

The recipe for success mentioned in the Morningstar report is exactly how the Fool has invested since its inception 22 years ago. And this recipe has certainly not been lost on our *Stock Advisor Canada* members-only advisory service – a service that I lead.

Each month we provide members with one Canadian and one U.S. stock recommendation that we think they can buy today and hold, ideally forever.

As we're seemingly headed for some turbulence, to help our members get to the other side, the team has been hunting for ideas in some of the less "frothy" sectors of Canadian markets — that is, the ones that appear to currently be offering up some value relative to the rest of the market.

The table below provides an indication of where this value might lie right now. It ranks the various sectors by their current average price-to-book (P/B) ratios (lower = cheaper).

Sector	**Average P/B**
Materials	1.54
Energy	1.69
Financials	1.91
Utilities	2.66
Industrials	2.90
Consumer Staples	3.06
Telecomm Services	3.36
Consumer Discretionary	3.45
Info Tech	5.89
Healthcare	17.32
Average	*4.38*

Source: Capital IQ

Not surprisingly, given their performance of late, the Materials and Energy sectors are showing up as the cheapest, by this measure anyway, in the Canadian market.

The thing is, because we're business-first investors, and these sectors are loaded with bad businesses, picking the eventual winners from these groups is tricky.

With that said, we've not been scared by the carnage that's occurred, and though we've avoided the producing companies, our list of recommendations is well represented by several companies from both sectors (for example, check out this link to a BNN clip featuring our own analyst Taylor Muckerman discussing energy stocks).

In our minds, the recommendations we've made from these beaten-up sectors are some of the best resource-oriented companies that exist, anywhere.

This "best-of-the-best" theme runs deep within *Stock Advisor Canada*, to the point that you might even call it our underlying philosophy. As long as we continually recommend great companies, over time, odds are that they will provide our members with great (and, we hope, oftentimes better than great) returns.

And though we can't provide you with the names of any of our current recommendations (outside of the one's mentioned in the BNN clip), we have made it especially easy for you to join your fellow Fools within *Stock Advisor Canada* and let us help you navigate the potentially rough waters ahead.

Sign up, log in, and you'll quickly find that our market-beating list of recommendations is just the beginning of what *Stock Advisor Canada* has to offer. There's a pile of valuable material we've made available, all with the intention of making you (and the rest of the world) a better investor.

And you'll be backed by our money-back guarantee: full refund if you decide the service isn't for you in the first 30 days after signing on, prorated thereafter.

After logging in, you're welcome to download every word we've ever written, keep it for yourself, forever, and leave the service all in the same breath. Of course you'll miss out on any subsequent recommendations and the ongoing commentary and guidance that we provide, but you're still going to walk away with a heck of a treasure trove.

In our mind, this is an offer you can't refuse, and especially given the stormy waters that many see on the horizon, now might be the best time to have our professional team of analysts (who, by the way, you're welcome to contact anytime once you're a member) working for you.

Join the thousands of Fools that have already signed on and find out what the fuss is all about!

Simply **click here** to get started today!

Foolishly yours,

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