QV UPDATE
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QV Investors Inc.

Consistently Different

The Globe and Mail recently published an article entitled, "Revealing the closet indexers among Canada's mutual funds." The author reveals that many actively managed mutual funds sold in Canada fail to sufficiently distinguish themselves from their benchmarks. It is claimed that investors in these funds risk paying excessive fees for index-like returns.

The article reminds readers of a quantitative measure called "active share" that can help identify closet indexers masquerading as active managers. Coincidentally, active share has also become a more frequent discussion point in our client meetings.

The concept of active share was first proposed by Drs. Martijn Cremers and Antti Petajisto in their March 2009 paper. Active share measures how different a fund is from its benchmark. An index fund has an active share of 0%. An investment strategy absent of any benchmark securities has an active share of 100%. In between these two extremes lies the continuum of active management. An active share value between 0-20% suggests pure indexing, a value between 20-60% suggests closet indexing, whereas a value above 60% indicates active management.

Annualized gross returns and active shares of our equity pooled funds as of September 30, 2015 are as follows:

	Cdn. Large*	Cdn. Small	Global
Inception	12/31/98	12/31/96	12/31/06
Return	11.9%	12.6%	7.7%
Benchmark^	6.8%	3.1%	5.1%
Active Share	**68.4%**	**88.8%**	**91.6%**

** Carve-out of QV Canadian Balanced Fund*

^ S&P TSX Comp. TR, BMO Small Cap Blended (Unwtd) TR, MSCI World TR ($C)

Active share is generally lower for Canadian large cap funds due to the highly concentrated S&P/TSX benchmark in which the top 10 companies account for almost 40% of the index. Contrast this with the MSCI World index in which the top 10 names account for only 10% of the index.

The evidence suggests that funds with high active shares outperform those with low values. But it would be risky to select a fund purely on a single statistic. After all, being different also presents the possibility of being wrong.

We therefore suggest a healthy dose of skepticism towards active share. A manager with a consistently high active share could be one worth exploring in greater detail. At QV, active share is an outcome - rather than a deliberate target - of our bottom-up investment process.

Our investment philosophy is to create portfolios of businesses that generate above average returns with below average risk. We consistently apply seven tests for quality and value to every business we examine. When we find a business we like, its weight is determined by the conviction of our research and how adding the company improves portfolio risk and profitability. As defensive investors we are often doing the opposite of other market participants: selling what is becoming over-valued and buying what is on sale. We hold 25-40 stocks in our equity strategies as opposed to hundreds in the various equity benchmarks.

Our process of systematically identifying quality and value is only repeatable to the extent we can continue to trade our best ideas. After all, we can't beat the market if we are the market. Our Canadian large and small cap equity funds are under a "soft cap", meaning we will accommodate additional funds from existing clients, but will not accept new large institutional accounts. By limiting the assets we manage we will continue to make decisions based on the conviction of our research, not the composition of benchmarks.

The active share in our funds will fluctuate over time due to our investment activity and because of changes to the benchmarks. For example, the active share of our QV Canadian Equity Fund has declined from the mid-70s earlier this year due to us favouring three of Canada's big banks.

Going forward you can expect our active share to remain high because we consistently apply the same investment process, generating long term returns that are different, and better, than the benchmark.