QV UPDATE

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Vanessa Rohl, BComm I Wendy Booker-Urban, BA

QV Investors Inc.

All that Jazz...

Everybody loves a good story. In fact, one of my all time favourite stories is none other than the one portrayed in the musical *Chicago*. For those not familiar...poor, sweet and innocent Roxie Hart under the influence of liquor and jazz, and in an act of self defense, shot and killed her ex-lover as he came towards her with a gun. Well that's the story her defense lawyer would like you to believe.

James Montier, in his *Little Book of Behavioral Investing*, highlights the danger of the "siren song of stories." This is the tendency for people to discount evidence and fundamentals in favour of a good story. Even if the facts were to stand up and slap one in the face, a person's heart strings are more easily pulled by the glamour of a story. Luckily for Miss Hart, this is exactly what earned her acquittal.

Unfortunately, the investing world is not immune to storytelling. It is ever present in the headlines and especially afflicts initial public offerings (IPOs). The hype that builds around an IPO can be excessive, driving investors to significantly overpay. This scenario leaves very little margin of safety if the company's operating results fall short of over inflated expectations.

One IPO we cannot help but read about is the Chinese e-commerce goliath, Alibaba (NYSE:BABA), which came to the US market this past Friday. Now there's a great story of a man who started an e-commerce company out of his apartment, turning it into what is now the largest IPO in history. Alibaba's shares spiked 38% on its first day of trading and have since slid by about 5% at time of writing. It is currently trading at 36.0x forward price-to-earnings. Whether its shares continue to fall is unknown, but for the sake of the investors that bought into this overvalued business, I hope that is not the case.

Not all stories are created equal. A story can be justified if the fundamentals speak for themselves. Something we try very hard not to do is a concept Montier describes as "capitalizing on hope," which is essentially overpaying for the hope of growth. In the case of IPOs, instead of buying into hope, we prefer to wait until the hype disappears to ascertain a more realistic picture of the company's future prospects and to obtain a better margin of safety.

One of our practices used to avoid the glamour of a company's story is the way in which we make portfolio decisions through our Investment Committee (IC). The IC serves as a forum to keep portfolio managers and analysts accountable to our discipline where decisions must meet consensus. If a storybook company comes across the IC table, there are ten members looking to poke holes in the investment thesis to ensure it meets our fundamental tests. We then purchase the business only after the thesis has been fully vetted.

In many cases our best companies don't have much of a story in the traditional sense. Some might even call them boring. Boring is good. Take Stella-Jones (TSX:SJ) for example, one of the holdings in the Small Cap Fund, which manufactures pressure treated railway ties and utility poles. Not necessarily the most glamorous business. What is exciting about this business is how well it has contributed to the portfolio with a cumulative price return of 233% over the past three years.

This past quarter, the company posted positive results with strong organic growth of 10.8% year-over-year, excluding effects from currency fluctuations. They have demonstrated smart allocation of capital in making acquisitions, with a solid plan to pay down debt utilising their healthy free cash flow. The company is in a position where they are financially flexible to make further acquisitions if the opportunity presents itself. It has made efforts to improve its competitive position over the past decade. As a result of this success, it is trading at a premium to its long-term average forward price-to-earnings ratio of 12.9x. Given our focus on fundamentals and downside protection, we have reflected the increased valuation risk with a lower weight in the portfolio. We will continue to hold at this weight until we are able to justify buying more of this boring, but solid company because at the end of the day, jazz is best left where it belongs…on Broadway!

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