QV UPDATE
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Running of the Bulls

In a Friday letter dated exactly one year ago, QV debated whether positive images of stock market bulls (like the one below) are bad omens for stocks as market corrections typically accompany these cheery illustrations. Our September 2013 letter pictured the Wall Street Bull celebrating its 4th consecutive year in an up market. Fast forward one year later and the bull has not stopped his revelry. In fact Mr. Bull has since bought a yacht and got some shiny dental work.

Source: Scott Pollack for Barron's

In the accompanying Barron's article, ten Wall Street investment strategists were interviewed and all ten called for a continued stock market rally. None were bearish. They admitted to some growing market risks, but all predicted that it's steady as she goes from here. Perhaps these strategists are suffering from what Howard Marks of Oaktree Capital Management describes as FOMO risk (fear of missing out). In his recent memo, Marks describes FOMO as the excessive fear of missing out on upside, forcing investors to do things they shouldn't do. In this market, many investors today are taking on greater risk for potentially less reward. The latest Investors Intelligence advisory survey reported that the percentage of bearish investment advisors has reached a low of 13.3%. This is the lowest level reached since 1987 and suggests excessive market optimism.

We don't disregard these warning signs. It may be foolish to throw caution to the wind when such indicators point to long run extremes. However, it may be equally foolish to let fear take over and sell everything. Our process of investing in the most attractive risk/reward opportunities at any given time remains unchanged. Instead of trying to time the market, our fundamental research efforts pinpoint the opportunities and risks inside and outside our portfolios.

For example, our process led us to recently purchase Citigroup (NYSE:C) for our global equity portfolio. Even five years after the financial crisis, poor sentiment still overshadows this global bank which is reflected in its low price-to-tangible book valuation of 0.9x. We see this as an interesting opportunity as we believe the worst is behind the business. CEO Michael Corbat has done a good job repairing operations since his appointment in 2012. The bank has since returned to loan growth and improved operational efficiencies. It has a clear pathway to drive return on tangible equity to 10%. It also grew tangible book value at 8.7% each year over the last five years despite a poor operating environment. This helped Citigroup build up a large capital reserve, which it may return to shareholders if it passes the Fed's comprehensive capital adequacy requirement (CCAR) tests next year. Our analysis showed its risk/reward proposition was attractive enough for investment.

Within fixed income, we see value in existing Canadian bank deposit notes. These are senior unsecured corporate debentures that rank on the same hierarchy as bank deposit liabilities. Last month the Department of Finance published its bail-in regime proposal that would see the conversion of senior bonds to common shares if a big six bank reaches the point of non-viability. Although this conversion risk may be minimal given the resilient credit of Canadian banks, it is still a risk nonetheless. Current deposit notes will be grandfathered and are not subject to this risk. With 5 to 7 year deposit notes yielding 2.5-2.7% (versus similar Canadian governments yielding 1.7-1.9%), we see these securities as good value in their given term to maturity. Their lower interest rate risk, strong credit support and higher liquidity provide defensive characteristics and stable income to our bond portfolios in this uncertain rate environment.

As Mr. Bull may not be aware, the seas are not always as pristine as they seem. Our process keeps us mindful of the growing risks within the market.

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