Ryan Watson, MBA, CFA

QV Investors Inc.

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We recently had the opportunity to draw the insights of Murray Mullen, President and CEO of Mullen Group Ltd. – a leading provider of trucking and logistics in Canada. Mullen has a successful track record of generating free cash flow throughout cycles, and Mr. Mullen has experienced many cycles. His comments corroborate much of what we have heard from oil and gas service businesses; that is, supply is outstripping demand. With cheap money continuing to circulate, Mr. Mullen has valid concerns about the on-going impact of undisciplined competition in an industry with generally low barriers to enter. As a result, Mullen is taking a “wait and see” approach by reducing its capital spending. In many ways, Mr. Mullen’s job is much like ours at QV. For instance, acquisition opportunities are assessed in terms of management quality, asset exclusiveness, and the right price to pay. In periods of uncertainty when cash provides the flexibility to invest counter-cyclically (i.e. buying assets when they are cheap), we applaud Mullen’s discipline and patience when deploying capital.

As the banks recently reported, Mr. Mullen’s comment on competitive barriers highlights what wonderful *businesses* the Canadian banks are. In general, Canada’s big banks operate in an oligopoly, have ample access to low-cost funding, and have fairly low risk appetites relative to global peers. With these strengths it may not come as a surprise that the Canadian banks generated record earnings in Q3. The quality of the earnings is debatable as capital markets divisions, due to higher trading volumes and increased deal flow, were a primary growth driver rather than domestic loan growth. However, the strength of the diversified bank business model is demonstrated by its ability to generate earnings growth through various operating segments; even in the face of a tougher regulatory regime, lower consumer loan growth, and persistently low interest rates.

What makes the Canadian bank sector a good *investment* today is its consistency at generating low double-digit return on equity over long periods of time, dividend yields in excess of 3.5%, and better value relative to the S&P/TSX Composite Index (TSX). Understanding that not all banks are created equal, the QV Large Cap mandates hold just three of Canada’s Big Six banks: TD Bank (TD), Bank of Nova Scotia (BNS), and National Bank of Canada (NA). We believe that each of these banks have a record of successful execution and provide QV with varying geographic exposure inside and outside of Canada. TD, BNS, and NA are part of our top-ten holdings.

That being said, the bank sector is quickly becoming the best of a worsening bunch. It continues to look attractive relative to the TSX and to similar dividend yielding businesses, such as pipelines and infrastructure. The TSX trades at 17.0x forward earnings, which is above its ten-year median of 15.0x. The banks trade at 12.4x, which is above its multiple of 10.0x from a year ago and slightly higher than its ten-year median of 11.8x. Over the past ten years the banks traded as high as 14.0x in 2006 and 2007. The external environment that set the stage for the prior high multiple is quite different from today’s tighter standards. As such, we need to be careful of assuming a similar valuation level in the future if the sector is unable to extract the same level of past growth. Furthermore, we need to actively monitor the quality of bank assets. With mortgage delinquencies back at 20-year lows and bank provisioning for losses on a similar trend, the appetite to take more risk and sacrifice credit quality is looming.

One of the primary reasons we invest in TD is for its management depth. Just like we respect the market insights of Murray Mullen, we also pay close attention to the outlook of veteran bank executive Ed Clark, President and CEO of TD. In TD’s Q3 outlook he stated the following: “As I look ahead, I am struck by how much uncertainty we still face…In this environment, it's important to be patient and stay faithful to our long-term strategy of growing our businesses in line with our risk appetite. One of the most enduring lessons of my career has been that good management teams leading sound business models adapt.” While opportunities to invest are still out there, the market has driven up valuations across sectors to the point where the most attractive ones could just be the least worst. It is always necessary to formulate your own conclusions. But when some of Canada’s great business leaders are opting to be patient, maybe there is some rationality behind it.