Defense, Discipline & Diversity

The month of May might be the time to 'sell and go away' but it is also the time of year for many Calgary based firms to hold their annual general meetings. We took this chance to attend the annual meetings of a number of current QV investments. The opportunity to hear directly from management on the state of their respective market conditions, strategy and outlook is of real value. These factors are important inputs to our bottom-up investment approach.

A refreshing theme across a number of the meetings was a willingness to face the business challenges ahead, and to be adequately prepared for a range of outcomes. One comment that stands out was a frank self-assessment from a management team that prides itself on being defensive, admitting it simply was not defensive enough for this environment. Although the firm had a relatively defensive financial position, balanced business model, and had reduced spending from historic levels, the steps taken were insufficient. This candid admission highlights two considerations for managing portfolios through the cycle.

The first is that whatever the worst case scenario based on recent history might imply, be prepared for the fact that no cycle is ever exactly the same. This fact holds important value on two levels. As analysts, we need to be aware that our assumptions are best estimates that could differ materially from actual outcomes. As investors, we need to psychologically prepare ourselves for owning businesses that the market could hold widely different views on, especially in stressed periods. The second is that maintaining structural guidelines to ensure a balanced and diverse portfolio can partially mitigate against the risk of 'being wrong' in the assessment of a company and its outlook. At QV, we limit exposure to one individual security at 6% of the portfolio and have a maximum of 25% exposure to one sector. When things go sideways or worse, these policies mute the downside of the total portfolio to single factors. The guidelines provide balance to our focussed approach of owning 25-40 securities in portfolios, while also ensuring each mandate concentrates on the strongest business opportunities in each space.

Our dialogues with diverse industry leaders across Canada provide a broad perspective of the economy and its machinations. A recent update from the Melcor Developments team provided more nuance to what is happening in the real estate market in Western Canada. Furthermore, the discussions re-affirmed our belief that Melcor is focussed on generating long-term value.

It can be tempting to assume that the entire real estate market in Western Canada (excluding Vancouver) should be in the doldrums but this would be an unfair generalization. A key takeaway was that the backdrop of record low interest rates has fuelled many different asset class valuations, with varying impact on classes of real estate. The low rates also provide cash flow relief and an equally important time buffer to borrowers from a debt servicing perspective. We remain cautious of the latter for all corporate borrowers, as these factors might not otherwise be available at more normal interest rate levels. Low borrowing costs both support demand for real estate assets, as readily available investment dollars seek a 'home', while also muting potential supply of product as asset owners have flexibility to wait for better periods. As a result, real estate transactions have not been robust as might be anticipated.

Rising office vacancy and the economy are headwinds, but from a fundamental perspective Melcor is positioned to survive. The firm's focus on well situated, modestly priced starter home land plots, income from retail assets with anchor tenants such as grocers, banks, and smaller footprint office locations have helped insulate the business as it benefits from base levels of economic activity. Melcor is not without macro-economic exposure though, as stable retail asset valuations yielding in the 6.0% cap rate range may only look favourable while ten year Canadian bond yields are at 1.5%. Despite the downturn, QV continues to own Melcor as its long-term focus, diverse asset base, and emphasis on financial flexibility is proving itself. Similar to within portfolio management, Melcor is never going to be able to predict cycles or downturns, but its disciplined philosophy is supporting the company's 15 year record of growing book value at 16%.