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Finding the Balance

Have you ever descended a staircase at night anticipating the arrival of the floor one step too early? That brief moment of terror must be endured for what feels like ages until you are finally back on firm footing. The best reaction in this scenario is usually no reaction. Sudden and jerky movements rarely improve the situation and can even cause harm. We slowly learn over time that staircases are risky and need to be respected. Laugh if you will, but Google returned 285,000 hits to the search query “Staircase injuries Canada”. The first hit – I can’t make this up – is a warning from the Canadian Mortgage and Housing Corporation, as if they have no other potential falls from lofty places to worry about! But I digress. As we get older the stakes are higher for both stairs and stocks so we naturally become more careful. When we have something worth keeping (health or wealth), we spend less time reacting and more time deliberating.

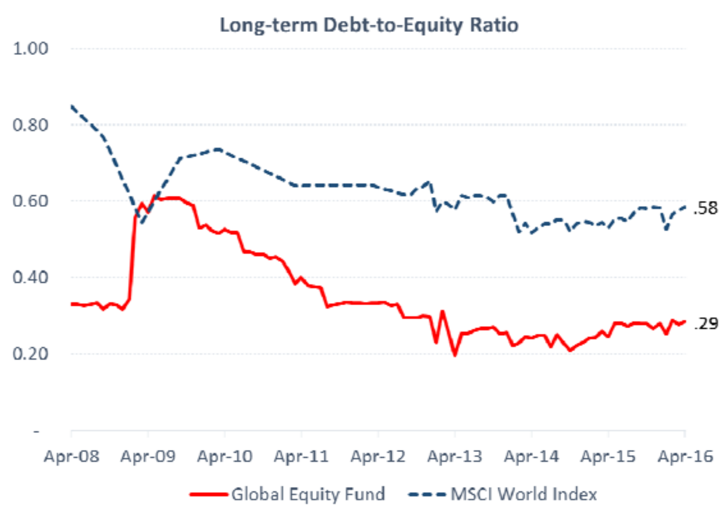
The beginning of 2016 in the financial markets felt a lot like a midnight misstep. But sentiment quickly turned positive and the markets have since rallied impressively, especially in Canada. Since the Canadian stock market low on January 20th, the loonie is up over 12%, the big six banks over 20%, and WTI has roared back by over 80%. Also since January 20th, the QV Canadian Equity Fund has outperformed the QV Global Equity Fund by almost 15%. Indeed, selling Canada during this tumultuous period was not a profitable trade, as is the case for most trades made out of fear. Now that we have regained our footing on the staircase, it is time to deliberate.

The relatively strong Canadian stock market combined with a strengthening loonie means the Canadian content of equity portfolios has risen during 2016. We are using this opportunity to rebalance the exposure in client portfolios that follow a global-balanced approach to investing. We do this by reducing Canadian equities and purchasing global stocks. The overall allocation to equities will be unchanged on account that valuations everywhere are elevated by historical averages. Our decision is guided by our risk management framework which emphasizes capital preservation.

Our reasoning is that the global strategy offers similar return potential to the Canadian, but with less potential risk. One such risk we track is financial leverage. In our global equity portfolio we see exceptional balance sheet strength that should be helpful if business fundamentals or market sentiment deteriorates.

Consider Microsoft, one of the top holdings in the global strategy. Microsoft has debt of $6 per share, but offsetting this is over $100 billion in cash, representing approximately $13 per share. Should the market lose its appetite for corporate credit – a naturally occurring phase of the credit cycle – Microsoft need not worry, as they are self-financing with a profitable business and enough cash to survive a long drought. Highly indebted companies, on the other hand, depend on the availability of external financing just to survive.

The following chart illustrates the long-term debt-to-equity ratio for QV’s global strategy versus its MSCI World benchmark. We can see the significant balance sheet advantage in our global portfolio. If we account for balance sheet cash, net debt is almost zero.



Source: QV Investors & Capital IQ

Whatever the future may hold, the best defense against risk is to hold a diverse basket of high quality businesses. We will continue to make incremental portfolio shifts to reflect our view of a prudent balance between capital appreciation and preservation.