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QV Investors Inc.

Illiquidity

Liquidity in trading terms refers to the ability of an asset to be bought or sold without affecting its price. To put this in perspective, a million dollar house in a remote location is likely less liquid than a million dollars' worth of pigs beside a meat packing plant. If the house had to be sold tomorrow it would probably sell at a steep discount in order to entice someone from a limited pool of potential purchasers to buy it. In contrast, something close to fair market value could be expected for the pigs, given almost everybody loves bacon!

In a few instances, we own significant percentages of the companies we hold, and in some cases those businesses trade relatively small amounts on any given day. If we were forced to liquidate certain positions in a short period of time, we might have to do so at a hefty discount in order to find sufficient buyers. Liquidity risk is something in which we remain acutely aware.

Liquidity risk increases directly with the size of the fund. We have soft capped all of our Canadian equity strategies in an effort to provide flexibility in both initiating and liquidating positions efficiently. Our Canadian small cap strategies were soft capped at $1.2 billion and our Canadian large cap strategies were soft capped at $8 billion. These initial limits were chosen as they still allowed us to accumulate positions in businesses without being seriously hampered by liquidity constraints.

An attractive perk of our "buy and hold" mentality is that it inherently reduces liquidity risk. We exhaustively research companies before investing in them, seeking stable businesses worthy of long-term relationships. We do not endeavour to make quick profits from short term "trades" in risky stocks with heightened probabilities of forced sales. In the last five years, we have only turned over the QV Canadian Equity Fund 27% per year on average. This implies our average investment in a business lasts more than three and a half years. We have happily been invested in a handful of businesses since the late '90's, shortly after the inception of our firm.

While executing trades, combatting illiquidity is of the utmost importance. We are occasionally asked how long it might take to liquidate a particular equity investment. We can get a rough idea of how many days it will take by assuming that one can trade about 15%-20% of a typical day's volume without severely affecting its price, then dividing that number into how many shares we are required to sell. What is often overlooked, however, is block trading. There are many definitions of a "block" of stock, but we define it as a trade of at least 10,000 shares of a business in a single transaction versus typical transaction sizes of 100 to 200 shares. Some blocks exceed a million shares! Block trading minimizes market impact as it allows us to execute large trades at a single price, instead of working a trade over multiple days, subjecting the stock to pricing pressure. On occasion, pockets of liquidity are revealed when large blocks of illiquid businesses trade, which can exceed 50 times a typical day's trading volume. Trading these blocks drastically improves our liquidity!

There are a few ways to access block trading. Negotiated blocks require working with third party sell-side traders who act as intermediaries to facilitate trades. We have great relationships with some of the best institutional sell-side traders in the country and trade blocks with them on a daily basis. We also utilize technology that allows us to anonymously trade blocks directly with other institutions, without involving any intermediaries. The double benefit of trading in this manner is that there is practically zero potential for information about our trading strategy to be leaked to other market participants and we pay less commission. We are having more success accessing liquidity this way each year. It is rare that a block of stock trades in Canada that we do not have the opportunity to participate in.

Dealing with liquidity risk is something that we take very seriously. We acknowledge that it is a threat and have firm-wide policies in place to counteract it. Some of our best investments have been in illiquid businesses. Often a business is illiquid due to large insider ownership by management or founding families. We love investing alongside management that has a lot at stake. It would be a shame to miss great investment opportunities due to a fear of illiquidity. We would rather buy a quality illiquid business than a highly liquid pig!