QV UPDATE

Weekly Commentary | August 12, 2016

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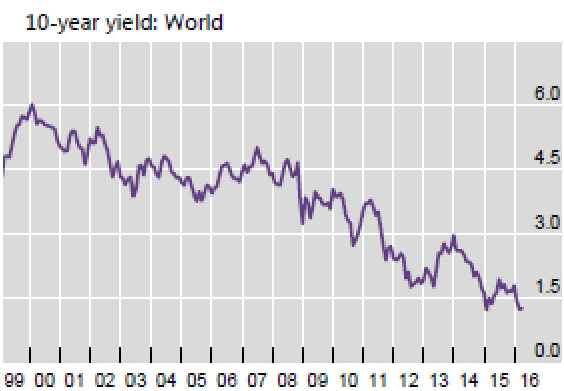
The Case for Patience

Canada has been gripped by the endeavours of our athletes as they show tremendous will and determination to achieve the ultimate prize. These athletes understand that daily decisions to practice and sacrifice led to their long-term victory. Part of the science behind success is supported by a Stanford study on marshmallows. The study placed a small treat in front of a child, with the promise of a second treat if they could refrain from eating it for 20 minutes. Later studies found that children who exercised self-control to delay gratification correlated with better life outcomes in the ensuing decades.

The principal of exercising discipline today for a greater future reward is both a good life and investing principle. Self-control to maintain an investment philosophy, which might not be working in today's market, is crucial. Irrespective of investment philosophy, grasping at the investment marshmallow of the day, month or year can be disastrous to compounding capital. Similar to toddlers able to wait for the extra treat, investing by thinking long-term is going to yield more bountiful rewards.



Source: Bank for International Settlements - Aug 2016

However, today's anticipated rewards in both bonds and stocks seem much skinnier than in the past. Global ten year bonds offered investors yields of 6% in 2000, but today they offer only 1.5%. Additionally, elevated valuation levels in equities and slow economic growth could imply more muted equities returns. Those willing to wait patiently are getting a substantially smaller 'marshmallow' than in the past. Due to the downsized future payoff for waiting, it could be tempting to abandon a long-term focus and discipline for today's 'prizes'. Recognizing we are in unprecedented territory, certain considerations to guide capital allocation could be helpful.

This too shall pass. It is easy to feel today's market conditions will persist in perpetuity. However, definitions of 'rational' are dynamic. Rewinding a decade, yesterday's investors would likely claim sub-zero interest rates are a crazy and ill-conceived notion. Flip forward and ask today's investors whether 3-5% ten year bond yields are likely again, and you might get a similar look. Being open minded to the possibility that the investment opportunity set could change in the next 3-5 years should play an important role in decision making.

Apportion the risks. With a lower return expectation across asset classes, we believe a key strategy is to reduce risk, not increase it to generate incremental returns. Our monthly risk audit tells us that the QV Canadian Small Cap Strategy's balance sheet is in as good shape as it has been in over the past 15 years. We believe reducing absolute risk by focussing on well-capitalized companies, especially in commodity linked industries, is prudent. Other areas to potentially reduce absolute risk are on the liquidity and income fronts. Ensuring you are comfortable owning your assets in a market downturn, mitigates the risk of untimely stampedes. There has been a glut of dollars chasing dividend yield, but seeking a sustainable and growing modest yield, which can help preserve capital and future funding, is another risk mitigation strategy.

Be more selective. There are still pockets of opportunity in bonds and stocks. However, when comparing opportunities, we are wary of 'relativism' seeping into our thought process. It would be obtuse to ignore the impact record low hurdle rates have on investments completely. However, with trillions of sovereign or 'risk-free' debt globally offering a negative yield and gold looking like a relative yield play, the potential dangers of 'relativism' should be respected.

Although, the 'marshmallow' to wait for in today's market appears smaller than ever, we believe the emphasis on patience and long-term focus becomes more important, not less. As the compensation for accepting risk is at record lows, it is time to think harder about managing risk rather than chasing return.