QV UPDATE
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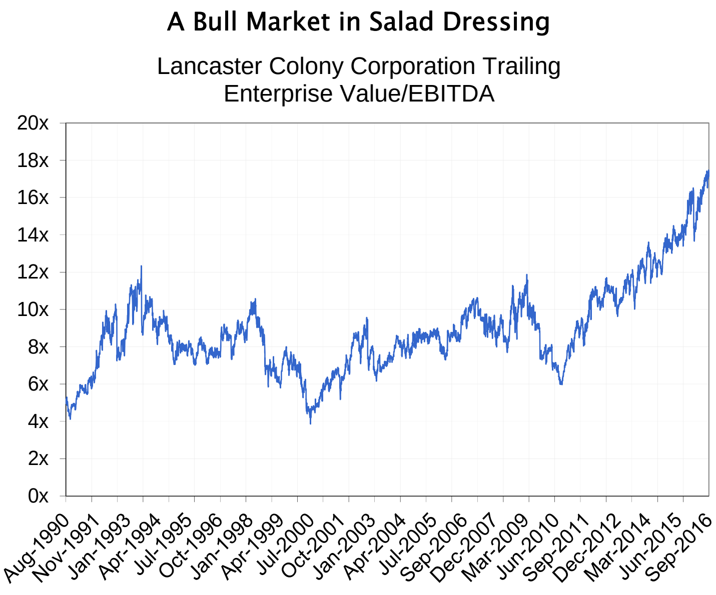
Value in Having Good Options

With stock markets near highs and interest rates near lows, our quest for value is no easy task. Some assets are trading hands at unprecedented valuation levels. Look no further than last month's sale of the finest known mint condition Wayne Gretzky rookie card for US$465,000. The exact same card sold for around US$95,000 in 2011. It originally came from a pack of sports cards that cost twenty cents back in 1979.

We have also witnessed shares of numerous quality companies commanding record high valuations. Lancaster Colony Corporation, a producer of salad dressing and sauces under the Marzetti Simply Dressed brand, is a good example. Lancaster Colony has an enviable financial record, maintaining a return on equity above 10% every year over the past 10 years. Earnings have been unexciting but stable, compounding at around 3.3% per annum.

Steady and unexciting have been in vogue. Shares in this salad dressing maker now garner a record high multiple of approximately 17.0x Enterprise Value/Trailing EBITDA. In less favourable markets like 2009, 2000 and 1990, this stock traded at less than 6.0x.



Source: S&P Capital IQ

Lancaster Colony isn't alone. We have opined in this letter for some time that enduring businesses are increasingly trading at record valuation levels. Despite augmented valuation risk, replacing a mint condition company for a low quality alternative can be a damaging decision. The inferior franchise may appear cheap today but will quickly become expensive if it is ill equipped to handle a more challenging future.

We do not believe it is a coincidence that some of our best portfolio successes have come from ownership in wonderful corporations that on the surface appear expensive but have under-appreciated opportunities to compound earnings for shareowners. A good example occurred last week when small cap strategy holding Ritchie Bros. Auctioneers announced the acquisition of its competitor Iron Planet. With net cash on its balance sheet, Ritchie Bros. was able to fund the proposed transaction entirely with debt. This will augment potential accretion for shareholders while pro forma debt levels stay at a reasonable level. Shares in Ritchie Bros. benefited as investors revised their earnings per share expectations upward.

Although we cannot predict when a management team will execute a valuable strategic option, we can identify the well positioned and best prepared. Businesses with underleveraged balance sheets and strong cash generating capabilities tend to be in a preeminent position. Teams that have exemplary records for capital deployment are our odds-on favourites for future success.

After a strategic capital outlay has been implemented by one of our companies, our work does not stop. We have to recalibrate our assessment of options going forward and evaluate newly formed risks. We also have to monitor results relative to plan and balance these changing dynamics against market expectations. Unlike the memorabilia collector hanging onto the past, our job is to ensure that the businesses we own still have their best playing days ahead of them.