QV UPDATE

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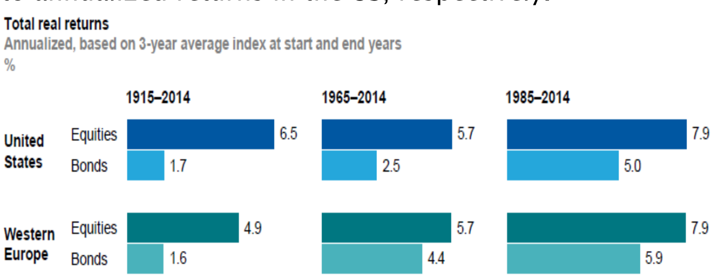
"Lower for longer, not lower forever"

The title is taken from a speech delivered by Bank of Canada Governor, Stephen Poloz, on Tuesday. The intent seems twofold: 1) to ease concerns of future savers hoping for higher interest rates, and; 2) to encourage companies to invest today while funding costs are low. The second point is integral to delivering on the first. Higher corporate investment "can ease the downward pressure on global rates" by raising the economy's potential output. This is an objective of monetary policy, which in theory is quite inspiring (when it works).

What's less inspiring is the concept of having to adjust to lower rates of return for longer, which was another takeaway from Mr. Poloz's presentation. The past 30 years have experienced the strongest returns from stocks and bonds in developed markets when compared to the 50 and 100 year averages (chart below). Among the drivers of growth were the baby boomers entering their prime work years, corporate tax rates falling, and efficiencies gained through technology. Returns over this 30-year period were enhanced by falling bond yields and rising price-to-earnings (P/E) ratios, which consulting firm McKinsey calculates have contributed 1.8% and 2.5% to annualized returns in the US, respectively.



Source: McKinsey Global Institute

With interest rates at historic lows, valuation multiples near historic highs, and a culmination of many of the key growth drivers mentioned above, we understand why investors may need to temper return expectations. Yet, equity markets continue to be a better investment alternative to cash that yields near zero.

Consider the perspective of a corporation looking to deploy capital today. With future demand uncertain, capacity ample and utilization rates below pre-2008 levels, few organic growth investments make much sense. One of the issues stated by Mr. Poloz is that "hurdle rates for new investments do not seem to have adjusted to the new reality." That is, rates of expected return need to come down just as the cost of borrowing has. We might argue, though, that lowering the bar could lead to sub-optimal decisions to create shareholder value.

For example, a hypothetical business deciding whether to invest at a 4% rate of return (a "pretty good return" for today, from the Governor's comments) or repurchase its own stock at 20.0x P/E (current-year multiple of the S&P/TSX) will likely opt for the latter. The resulting earnings per share (EPS) is nearly identical in each case, but the impact from a share repurchase is immediate and low risk when compared to making an investment in an uncertain environment.

In another example, we are five years into the lows of the nutrient cycle and producers have responded by curtailing operations. On their own, fertilizer companies have been challenged to find high return projects amid an industry awash with capacity. Recently, PotashCorp and Agrium, both held in the QV Canadian Equity Strategy, announced their intention to merge. Together, they will create the world's largest public fertilizer company and expect up to $500 million in annual savings through production efficiencies, cost reductions, and scale benefits. Furthermore, few jobs are anticipated to be lost in the process, near term. Time has returned a creative and potentially lucrative solution to the current lull in the agricultural space. This merger of equals combines best-in-class wholesale and retail assets, optimally redistributes capital to the best projects, and could create a lot of value without a big price tag.

Capital allocation is a careful balancing act. Needless to say, it takes time to get it right. Mr. Poloz is in an unenviable position to try and motivate corporate spending in a weak climate that follows decades of strong returns. While he justly identifies the need to adapt to the times, we feel companies can achieve this without having to sacrifice much on their hurdle rates. With all good investment decisions, patience is required; and as with all cycles, it certainly is not lower forever.