QV UPDATE

Weekly Commentary | October 28, 2016

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The Spooky Season

Like so many others, as a child, Halloween was one of my favourite times of year. I would use an old pillowcase as a candy bag. It was durable and large - the perfect tool for my moonlight adventures. I still enjoy Halloween but it comes with a bit more unease these days. Did I buy enough candy? Will I have to tell some weeknight trick or treaters that they are knocking on my door too late? When it comes to markets, I am also worrying a bit more these days. Here are a few of the scarier things that have been on my mind this week.

1) The old-fashioned retail model is under fierce attack, as the internet continues to eat traditional merchants for lunch. E-commerce poster child Amazon reported quarterly results yesterday, including revenue growth of almost 30% year-over-year. With annual sales of approximately US$128 billion, 70% of the world's countries have annual GDP figures less than Amazon's trailing 12-month revenue. We need to make sure we are not complacently investing in businesses that are vulnerable to head on competition from this disruptive juggernaut.

2) Optimism in the North American energy industry is growing. Over time, we have found Murray Mullen, CEO of Mullen Trucking, to be balanced and thoughtful when it comes to his assessment of oil and gas markets. Below are a few of his comments from Mullen's recent quarterly call:

"So today, for the first time in a very, very long time, I am beginning to see signs of what I hope will be a period of sustainable recovery…"

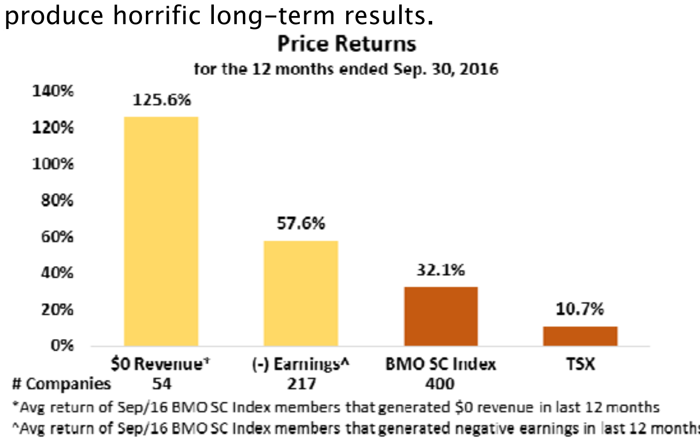
"I'm not taking more business at the same pricing…We're not moving equipment off the fence to go to work unless pricing comes up. Period."

Some energy-related stocks are beginning to reflect this renewed optimism. A number of the stocks we own exposed to the energy industry have rallied from lows reached earlier in the year. All this sounds great, but as investors we need to be careful. There is now less downside support if a meaningful recovery does not gain traction.

3) The Canadian Federation of Independent Business recently released the organization's October Business Barometer. It showed Canadian small business optimism eased off this month and intentions to spend on capital improvements over the next three months have reached a new cycle low. Survey respondents increasingly cite insufficient domestic demand as the largest growth limitation. We need to make sure our investments do not depend on overly rosy Canadian economic forecasts.

4) German long bond yields are back above zero. Low yields have helped inflate asset values; even a slight creep up in yields without a commensurate increase in global growth will act as a headwind for asset price appreciation. We must be fearful of the risks associated with expensive assets that have been propped up by low interest rates for a long time.

5) Animal spirits have grown at a time when the global economy is fragile. M&A activity has been rampant and broad-based. This week alone, we have seen close to $200 billion worth of transactions. We have also experienced a year full of lower quality stock outperformance. Canadian small cap stocks with no revenue and/or negative earnings have been outperforming by a considerable margin. We must not lower our quality standards to chase returns. That would produce horrific long-term results.



Source: BMO Capital Markets, Bloomberg, QV Investors

Halloween or not, there is always something that can spook investors. As we aim to avoid financial monsters lurking around the corner, our focus remains centered around risk management and an investment process anchored by quality and value.