QV UPDATE

Weekly Commentary | December 16, 2016

Mathew Hermary, CFA

The Price You Pay

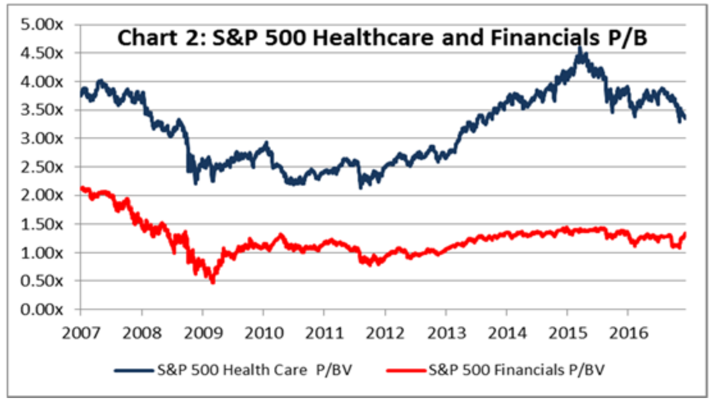
In 2012, good quality healthcare stocks were cheap. The S&P 500 healthcare index traded at an average price-to-earnings ratio (P/E) of only 12.7x and the QV Global Equity Strategy was able to add wonderful businesses like McKesson Corp., Varian Medical Systems and Aetna Inc. to our existing holdings in the sector at very attractive valuations. Healthcare soon became the largest weight in the strategy (Chart 1, blue line).

Source: S&P Capital IQ, QV Investors

In an environment of low growth and low interest rates however, investors quickly began to ascribe higher multiples to healthcare companies' stable earnings power and strong growth potential. By late 2013, sector-wide valuations began to reach multi-year highs (Chart 2, blue line) and we were forced to reduce our healthcare holdings much sooner than we would have preferred in order to mitigate what we viewed to be outsized risk.

In a similar timeframe, we heavily increased our ownership in strong franchises in the financial sector. Our purchases included Wells Fargo, Berkshire Hathaway and Aflac as valuations remained very low in this space due to the overhang of low interest rates and steady but unexciting growth (Chart 2, red line). Financials subsequently became the largest weight in the strategy (Chart 1, red line).

In the short term, selling our healthcare businesses and buying financials proved to be painful. Our focus on downside protection can, at times, cause us to sell companies only to watch their stock prices perform well long after we've exited them. To their peaks in mid-2015, two of our previous healthcare sales, McKesson and Novo Nordisk, rose 45% and 86% from our last sale prices as the entire sector reached decade high valuations (Chart 2, blue line). While our financials had adequate results in this time period, they dimmed compared to the high flying returns of healthcare stocks and our relative performance suffered.



Source: S&P Capital IQ, QV Investors

Since the summer of 2015 however, QV's initially painful decision to favor cheap financials over expensive healthcare companies began to help to preserve clients' capital in a meaningful way. In response to ongoing scrutiny over potentially unscrupulous pricing policies by a number of pharmaceutical and bio-technology companies, the sentiment supporting healthcare stocks' high valuations has all but dissipated. For example, McKesson's stock has fallen 45% from its highs and is now 15% below our final sales price while Novo Nordisk has fallen 41% from its high and is only 10% above our final sales price. Both have underperformed the S&P 500 by 42% and 35% respectively since we exited these businesses.

More recently, our financials' valuations have moved up from very low levels in conjunction with the post-election rise in bond yields and equity markets. As of November 30th, the global strategy has returned 8.3% year-to-date gross of fees versus the MSCI World Index's 2.4% return, with approximately half of the outperformance arising from our positioning in healthcare.

While not all of our sales work out this well, we remain steadfast that despite potential short term discomfort, when investors own good businesses and control downside risks, the upside often takes care of itself. Today, our financials still remain reasonably valued in the global strategy. But with areas such as U.S. pharmaceuticals having fallen as much as 37% since July 2015, we see new potential opportunities in an area that looked quite risky only 18 months ago.

QV would like to wish you and your family all the best over the holiday season! Our QV Update will resume on Friday January 6th, 2017.