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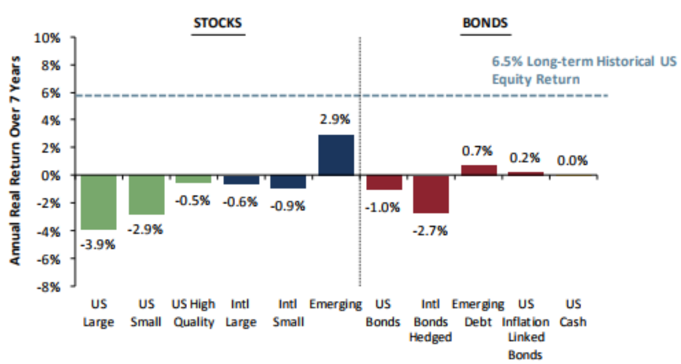
Clouds of Smoke

Forest fires in British Columbia have continued to burn, and in Calgary we have seen an ebb and flow of smoke for many weeks. Park authorities have attempted to deal with unseasonably dry and warm weather by enacting fire bans throughout Alberta and British Columbia to limit potential risks. Natural Resources Canada has simplified the threat level of a potential fire into simple colour codes – green for low threat, yellow for moderate, orange for high and red for an extreme risk. In terms of risk in equity and credit markets, we believe we are approaching the orange level in certain areas.

In a recent memo from GMO (a large U.S. based asset manager), Matt Kadnar and James Montier highlight some of the risks they are seeing in markets around the world. In the graph below, they provide an overview of real asset class return expectations looking out 7 years. Of note, they are not expecting positive real rates of return for any asset classes other than for emerging market equities and debt. We must remind ourselves that they are forecasts nonetheless and the data below can be challenging to predict. However, we do agree that return prospects are amongst the lowest they have been in recent years. Investors are simply taking more risk today than they have in the past and many things need to go right for investors to earn a reasonable return for the increased risk.



Source: GMO LLC

The authors also highlight the lack of value in the market through the results of a Benjamin Graham deep value stock screen. The results of the screen were relatively uninspiring for value investors as there were no results to be found in the U.S. recently, compared to ~4% of the market back in 2009. In Japan, we saw the biggest drop in stocks meeting this criteria falling from ~20% in 2009 to about 4% today. Easily identifiable bargains simply don't seem to exist today, perhaps another hallmark of where we are in the cycle.

In credit markets, we are also seeing signs of investor complacency and risk taking. A prime example of this was when Argentina recently issued $2.75 billion in bonds with a 100-year maturity. The interest rate on the bonds was only 7.125% for a country that has defaulted numerous times in history, with the most recent being in 2014. The yield may look relatively attractive when compared to other sovereign yields, but we believe it is unattractive given its troubled financial record. It is either that the previous investors have forgotten about their losses or that they have been replaced by people who haven't quite studied the full credit history of the country.

On an issuer specific basis, last week electric car manufacturer Tesla announced a $1.5 billion bond issuance with an 8-year maturity. The deal had elevated demand and was upsized to an $1.8 billion offering. The interest rate on the bonds was ~5.3%, a discount to similarly rated bonds which trade in the range of ~5.7%. We find it quite surprising that investors would accept such low relative returns for a business which has not generated GAAP profits, or any returns on capital invested in its history. It does beg the question, why are bond investors excited about this issue? Elon Musk has certainly driven unprecedented change and growth in many of the industries he has been involved with in the past few years, but this doesn't change the paltry risk-reward prospects of this issue.

We feel investors are getting involved in smoky areas and the potential to get burnt is increasing. Within our global equity strategy, we believe there are a number of well-positioned companies that offer attractive return potential with relatively limited risk. Aflac is a good example of what we look for in a business. Aflac is a leading provider of medical and life insurance in Japan and the United States. The company's sales have grown by 6.6% per annum over the past 10 years while earnings per share have grown by 8.1% over the same time frame. We believe the company's strong competitive position has translated into healthy returns on equity and strong book value per share growth. Aflac has also built a strong track record of growing its dividend – today yielding 2.1%. We believe management remains well aligned with shareholders given their large equity holding while the company's valuation remains relatively undemanding with a price to earnings multiple of ~12x vs the S&P 500 at ~18x. After all, paying for less than what you may receive in the future is paramount for long term investment success.

Across our investment mandates, we are continuing to focus on high grading balance sheet strength and quality metrics where possible. At QV, our focus is on capital preservation and prudent risk management while not ignoring the smoke signals that seem far too common in today's market.