QV UPDATE

Weekly Commentary | September 15, 2017

Ian Cooke, CFA

QV Investors Inc.

Risk Evolves

Last week, Equifax, one of the world's largest consumer credit agencies, announced cybercriminals had hacked their systems and obtained data related to 143 million individuals. The hackers gained access to driver's licenses and social security numbers - ripe information for identity theft. The company's handling of the breach was fraught with missteps that magnified the gravity of the situation. The shares of Equifax responded, falling approximately 30% since the announcement. We don't own Equifax in any of the QV strategies, but highlight it as an example of that ever-evolving acquaintance investors try to avoid: risk. The problem is, risk is not entirely avoidable. Some risks are easier to identify than others. Investors attempt to quantify risks associated with balance sheets and valuation. Profit margin and ratio analysis are also frequently used to help measure the financial wherewithal of a business or industry.

Qualitative risks that don't immediately show up in the numbers are much more difficult to properly assess. Harder yet, many perils today are new, brought on by an ever-evolving society. Cybercrime didn't exist a few decades ago. Now, cybersecurity and cyber insurance businesses are growing rapidly. The International Data Corporation estimates close to $75 billion was spent on cybersecurity in 2016, and is expected to grow to $100 billion by 2020. Despite increased prevention, four of the five largest known data breaches have occurred in the past year and a half. The Equifax illustration embodies the reality that as new risks emerge, individuals, companies and investors are often ill prepared.

Earlier this week, I attended a speech delivered by Louis Vachon, CEO of National Bank of Canada. As one of Canada's six largest banks, they have dedicated substantial resources towards cybersecurity. He emphasised no entity or plan is bullet proof. He went on to suggest that having the right culture in place, prepared to respond constructively during times of crisis, is critically important. We couldn't agree more. From an investor perspective, determining who is walking the talk and who is not requires judgement. We take into account alignment of interests and past performance to help form an educated decision. In addition, we always have to reflect upon what risks we believe are priced into the valuation of a business. Real risks that few investors have accounted for are much more damaging to an investor than those that are largely reflected in the value of the shares.

Good Businesses Evolve Too

During a meeting with QV earlier this week, executives from a large commercial real estate company described their retailer tenants as businesses facing constant change. The pace of change has accelerated rapidly in the digital era. As it becomes more evident that consumers are embracing online purchases, this is increasingly reflected in the price investors are willing to pay for traditional merchants. Risks are real for those retailers that are ill equipped to adapt to online buying habits and/or don't have the culture in place to embrace this change. Those with too many stores, high debt levels or weak consumer satisfaction are in for a rocky future.

We also believe retailers that continue to find ways to please their customers in a differentiated yet profitable manner will do well. Retailer stocks have been weak over the past six months as clouds have darkened over the entire merchandising space. These general concerns have created specific opportunities. We believe small cap strategy holding Aritzia is a good example. Aritzia is a women's fashion retailer that designs and offers exclusive brands that can only be bought through their stores and website. Aritzia introduced an e-commerce offering in 2013, which grew to 12% of revenue in 2016. Importantly, in store revenues also continue to produce record results. Increased industry malaise is allowing Aritzia to add more "centre ice" locations under attractive lease terms. Thirty-three years ago, when Brian Hill (also Aritzia's largest share owner) opened the company's first store, he was committed to providing an aspirational shopping experience with exceptional customer service. This commitment remains, but how they are executing will continue to evolve.