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QV Investors Inc.

Give to Caesar what is Caesar's

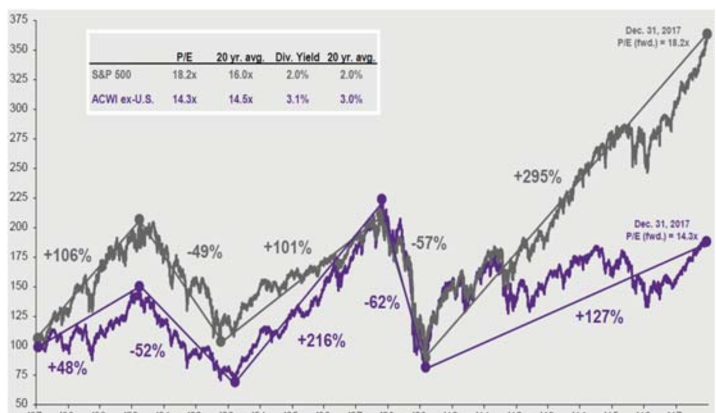
As the old saying goes, few things in life are certain except for death and taxes. Income tax in the US was introduced by President Abraham Lincoln in 1861 to fund the American Civil War. Canada's first income tax acts (both personal and business) were introduced between 1916 and 1917 by Prime Minister Robert Borden to fund the efforts of World War One. The purpose of income taxation has evolved over time, from being a vehicle to fund sovereignty efforts, to funding ordinary government expenditures as a part of what is now broadly referred to as fiscal policy.

Fiscal policy is used to encourage certain types of investment and consumption behaviour, and to shift wealth between socio-economic classes. Its provisions can be temporary emergency measures or more permanent in nature. For example, immediately after the 2008 financial crisis, the US government created tax incentives to encourage businesses to purchase equipment and individuals to purchase their first homes or to get cash for their "clunkers." These, along with monetary policies, were able to provide stimulus and fiscal stability in a turbulent economic environment. On the other hand, structural changes are more philosophical in nature, such as shifting the tax burden between business and individuals, or amongst income classes, which is what took place in Alberta in 2015/2016 and what is currently playing out in the US.

Taxation also has a role to play in considering investment ideas and the composition of portfolios. However, while taxation may be a permanent fixture of government revenues, its structure and levels are anything but. Therefore, making investment decisions solely on one factor, like tax environments, does not support a strong long-term investment thesis. Investment decisions are best determined through taking into account numerous factors, which at QV, includes a franchise's past record and future outlook, management, and capital allocation. Our analysis inherently includes deep dives into a company's competitive position and valuation, which may be materially impacted by the tax jurisdictions in which it operates. How a company addresses taxation can provide insight into management's thought process surrounding capital allocation, and the financial record that may result.

For example, prior to recent tax changes, American Express, a holding in the QV Global Equity Strategy, had an effective tax rate in the range of 33-35%. Because its earnings are largely generated in the US, management anticipates its effective tax rate to move closer to 22%, providing a very attractive boost to shareholder earnings. It is also anticipated that management will use the lower tax burden to reinvest in the business in addition to sharing some of the benefits with employees.

The recent tax changes in the US add stimulus to one of the longest economic recoveries in its history. This comes at the expense of borrowing from the future given that these tax changes will add to deficits and future servicing costs. At the same time, the US Federal Reserve is testing the brakes of the economy by raising interest rates to keep inflation expectations at moderate levels. The apparent disconnect between monetary and fiscal policy adds an additional layer of risk, as two powerful incentive mechanisms are being changed in an uncoordinated manner.



Source: J.P. Morgan Asset Management
ACWI: A benchmark of global stocks outside of the US

Through higher future earnings, these changes are also relieving pressure on elevated valuations. However, valuations in the US remain high relative to other regions, as shown in the chart above. Over the past 12-18 months we have found a number of attractive opportunities outside the US where valuations have remained more attractive. So, while Caesar will receive what is Caesar's, there may be better investment opportunities outside of Rome.