QV UPDATE
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QV Investors Inc.

Positioning For Uncertain Winds

Markets have been choppy so far in 2018, especially compared to the smooth sailing that characterized most of the last year. The recent increase in volatility has coincided with US 10-year bond yields beginning to test the highs of 2013, as the US 10-year bond rate hit 2.95% earlier this week. It's unclear how much of the recent spike in volatility is simply a normalization from below-average levels and how much is due to uncertainty surrounding inflation and the future level of interest rates. In either case, it is evidence that the market has likely been underestimating risk.

Long-term interest rates often set the hurdle for required investment returns. Lower rates tend to drive up valuations across asset classes and reduce future expected returns. At a certain point, rising interest rates can drive down asset valuations. This effect can be particularly pronounced in certain sectors. We can consider these impacts on two levels: 1) the operational effects on individual businesses, and 2) the impact on sentiment and/or valuation.

The most interest-sensitive segments of the market and QV portfolios tend to be higher yielding sectors, such as utilities. Some of QV's investments within the utilities space are off between 5-10% so far this year. When we review our companies' operational exposure to rising rates, we believe it is manageable. Over time, rising interest rates should allow for increases in the utilities' regulated returns. While valuations in the utilities sector are exposed to the threat of higher interest rates today, the above-GDP growth profiles of our utility businesses should provide increasing earnings to offset various degrees of valuation compression and provide reasonable risk-adjusted returns.

The varying effects of interest rates on different sectors highlights the importance of portfolio diversification. While utilities can be adversely impacted by rising rates, other sectors, including financials, potentially stand to benefit. Globally, financial institutions such as banks have experienced reduced profitability due to abnormally low rates - the interest rates charged to borrowers have been less resilient than required payments to depositors. During periods of rising rates, banks should experience a reversal of some of these prior challenges and generate additional profitability for minimal incremental cost. While initially positive, we are also mindful that if rates rise too high and too quickly, this would have a negative impact on the overall economy and impact bank results and sentiment.

The rapid spike in market volatility, often cited as a gauge of investor 'fear' levels, highlights how quickly expectations and resulting assessments of risk can change. Inflation levels, geo-political turmoil, technological advancements and cross-border trade disputes are just a few of the many exogenous factors that can impact the global economy and market 'fear' levels.

We believe a balanced approach to portfolio construction is a very effective tool to mitigate fundamental economic risks, shifts in market sentiment, and company specific risks. As discussed, a factor like interest rates can have differing impacts on the operational results and valuations of different industries. Adequate sector diversification - although, at times, detrimental to short-term returns - continues to be a key component in the construction and positioning of our client portfolios.

Equity returns are driven by three factors: changes in earnings, changes in valuation multiples, and dividends. Our aim is to have a thoughtful view on how each of these drivers could evolve over the investment horizon. This approach helps explain our current positioning in the utilities space relative to other defensive, higher yielding sectors. Certain utilities currently offer much better per share earnings growth compared to other defensive sectors.

A positive implication of rising interest rates and greater volatility going forward may be increased discipline in the market. Complacency may begin to fade as investors put greater emphasis on risk management and consideration of alternatives, thus contributing to market health. Greater volatility could also increase the likelihood of finding investment opportunities that offer both multiple and earnings-driven growth.