QV UPDATE
Weekly Commentary | May 25, 2018
Ian Cooke, CFA

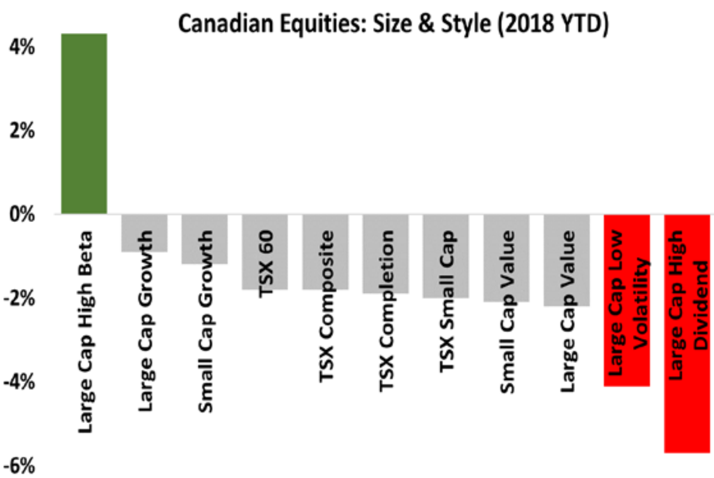
QV Investors Inc.

Fashionable Investing

I'm never the best dressed in the room, it's too much work. Besides, the bang for the buck I get out of Kirkland branded blue dress shirts from Costco is just too hard for a value investor to resist. 100% cotton, single-needle tailoring, wrinkle-free and treated with stain management. The shirt fits well and costs less than a box of diapers. What's not to like?

It's easy to get caught up in what is fashionable in equity markets. The siren song of what has been working in the stock market is backed by short-term monetary incentive, making it difficult to go against the grain. Many market pundits feel the need to have momentum at their backs. This was recently reiterated in a meeting I had with a friend and well-regarded sell-side analyst. He was loath to upgrade a particular stock due to the lack of immediate investor interest. He felt shares in the business offered tremendous value but had limited near term catalysts. As a result, he remains on the sidelines. This approach can be self-reinforcing: limited interest equates to limited attention, and limited attention equates to limited interest. For the patient and astute, this spells opportunity.

Quality and value have been out of favour in the recent past. Growth stocks, many with limited earnings and a healthy amount of speculation, have been stock market darlings. As shown below, high beta stocks have outperformed year to date in Canada, while low volatility and dividend payors have lagged significantly.



Source: Scotiabank GBM Portfolio Strategy, Bloomberg & QV Investors

Recent market trends have not been friendly to QV's approach to investing. Take for example our large cap Canadian investments in the utility space: ATCO, Canadian Utilities and Fortis. All are producing abundant cash flow, investing heavily in per share growth and have deployed capital effectively over time. They have also consistently grown their dividends while maintaining conservative payout ratios. All three stocks have declined 10-25% from last year's share price highs. The stocks now offer dividend yields in the 4-5% range, well above 10-year median levels, while trading at the lower end of their respective price-to-book multiple ranges. Canadian Utilities now offers a yield in excess of 5%, a level we haven't seen in the past 15 years.

Concerns related to rising rates are valid for all assets, but the utilities have been hit particularly hard. There is a short-term lag in a utility's ability to pass on higher rates, but we estimate the financial headwinds to be a mere fraction of the recent value lost from deteriorating stock prices. As a result, we believe that much of the weakness in this space is simply a reflection of what's not fashionable to invest in today.

What one does when their investment approach isn't working is quite telling. Does one panic or methodically pounce? Not changing an investment approach to pursue what has been working recently in the market should not be confused with complacency. We never invest blindly and question all of our capital deployment with vigor. Some of our most significant investment successes over time have been related to investing in quality businesses that, at least for a moment, have fallen out of fashion.

Believe it or not, silk shirts and stocks have something in common. Both can be in vogue today and passé tomorrow. We do not spend a great deal of energy trying to anticipate tomorrow's style. Rather, we are focused on the underlying fabric of our investments. As long as we are invested in businesses that are enduring in nature and purchased at reasonable prices, we are willing to be unfashionable.