QV UPDATE
Weekly Commentary | June 15, 2018
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Investors Inc.

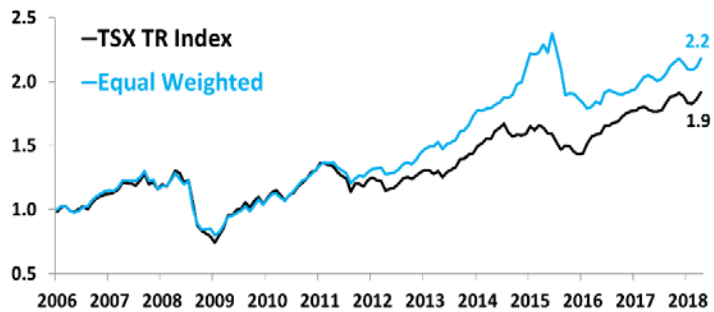
Spreading Eggs Among Baskets

Within all of our equity strategies, QV has always limited single sector exposure to a maximum of 25%. This self-imposed sector constraint ensures an adequate level of industry diversification across our concentrated portfolios. Compared to most global indices, the TSX is an extremely narrow market. On average, diversified global indices have much less than 25% exposure to any one sector. In Canada, however, the top 3 of 11 sectors – financials, energy and materials – represent nearly 65% of the benchmark. Our portfolio constraints and allocation decisions mean we tend to be structurally underweight the most dominant sectors in the Canadian market. As of May 31st, for example, businesses within the financials sector represented 24% of the QV Canadian Equity Strategy, compared to the benchmark's exposure of nearly 34%.

Canadian banks have been a strong driver of index performance, with the bank sub-index up more than 13% over the 12 months ending May 31st. TD, RBC and BMO are 3 of the top 5 single contributors to the TSX over the year. As a group, banks account for approximately 23% of the index, and 14% of the portfolio. This underweight has been a significant driver of 1 year underperformance. Although sector allocation has detracted from relative results in the short-term, better diversification has contributed to stronger returns over the long run.

The banks have outperformed the broader index for more than 7 consecutive calendar years. With such strong, consistent performance from such a narrow area of the market, one might ask whether our sector constraints have limited our ability to achieve attractive returns. However, over this 7 year period, the QV Canadian Equity Strategy has outperformed the TSX by a substantial margin, despite being significantly underweight the financials sector and, in particular, banks. In fact, the consumers and industrials sectors – in which the portfolio has traditionally maintained overweight exposure – have actually advanced more than financials in the period since 2011. Because we do not feel constrained by the opportunity set of non-financials in Canada, we don't feel we need to stray from our commitment to diversification that has worked through the years.

Sector diversification can help to minimize risk and preserve capital. Its positive effects can be seen when we compare the performance of the TSX (weighted by market cap) to an index that assumes equal weight across all 11 sectors, shown below.



Source: Bloomberg

The current stretch of consecutive calendar year outperformance by the banks is unprecedented. Notwithstanding very consistent performance over time, history has shown that these Canadian powerhouses are not immune to periods of underperformance. Banking has cyclical elements, with profitability highly dependent on the credit cycle and the health of the Canadian consumer. We're not calling an imminent reversal, but with credit losses and unemployment at record lows, and bank net margins at record highs, it's clear we are not in the early stages of the credit cycle. Despite a recent improvement, household debt as a percentage of income is close to record highs, leaving the average Canadian highly exposed to rising interest rates over time. In theory, higher rates are a positive force for bank profitability, but only to the extent that customers remain solvent in the face of increased debt service costs and tighter credit.

The Canadian banks run attractive, highly profitable business models. It's these qualities that justify their sizable position in the strategy today. Nevertheless, we have a process that shows we do not have to overexpose ourselves to any one sector in order to generate healthy long-term excess returns. A diversified approach will sometimes lag in the short-term, but the results have been proven over time.