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Paying it forward

In a world where investors have become impatient with lackluster returns from many high-quality companies, we are pleased to highlight some of the wealth that many of these holdings continue to generate for shareholders.

One of the traits we look for in the management teams of our holdings is a track record of prudent capital allocation. This includes reinvesting in the company to generate future growth, all while maintaining a healthy balance sheet. Absent attractive investment opportunities, we like when firms return capital to shareholders, particularly through a regular and growing dividend. As the saying goes - "A bird in hand is worth two in the bush." Getting paid-out actual profits in the form of a dividend provides investors with more flexibility to exercise their discretion in reinvesting that dividend. The power of compounding dividends over time represents a significant portion of an investor's overall long-term rate of return. The majority of QV's equity holdings do pay a regular dividend, and many of them have consistently grown their dividends over time. Yet, our core strategies maintain reasonable dividend payout ratios, allowing the management teams to still focus on growing their businesses.

Another form of returning capital to investors is through share buybacks where a company repurchases shares from the market, reducing the number of shares outstanding. Unlike a dividend, which represents a definite return of profits to shareholders, the upside of share repurchases is not necessarily guaranteed. However, it gives remaining shareholders an increased share of potential future profits. Any future benefit generated from a share repurchase is not taxed until the associated capital gains are realized. A dividend, however, is taxed in the period it was received, unless the stock is held within a tax-deferred or non-taxable account. It should also be noted that capital gains are taxed more favourably than dividends.

We've commented in past updates on our general view of share repurchases. In short, each repurchase program must be assessed on a case-by-case basis.

There has been a definite up-tick in share repurchases as of late, particularly in the US after federal corporate tax rates dropped to 21% from 35% earlier this year. JP Morgan Chase analysts estimate 2018 buybacks could possibly surpass the 2007 peak of $US700 billion. Canada has also seen its fair share of repurchases. According to Scotia Capital, QV Canadian equity holding, TD Bank, has not only made attractive acquisitions to further diversify its asset management business, but it has also led the banking sector in its buybacks.

One of our non-dividend paying QV global equity holdings, Berkshire Hathaway, announced last week its decision to lift its long-time cap on share repurchases. Previously, the company would only consider buying back shares if the share price was trading at less than 120% of its current book value. Going forward, they will have the latitude to buy back shares whenever the stock price is trading below its intrinsic value - that is, the firm's perception of its own true worth. We would agree that, although useful as a baseline measure, book value has become less relevant in determining the value of a company like Berkshire due to the acquisitive nature of the business. With the company's successful track record of buying good companies at bargain prices, the fair values of many of the underlying businesses have grown far beyond their book values. Buying back shares below intrinsic value will be positive for shareholders. With Warren Buffett's reputation as one of the best capital allocators of all time, our preference would be to see the company redeploy capital into new businesses. However, given the rich valuations of this aging bull market, we understand why share repurchases are an attractive alternative at this time. Patient shareholders who have been steadfast supporters of the company, even during long periods of share price weakness, may now receive their share of the wealth that the company has amassed over time - a cash war chest of well over US$100 billion.

We commend management teams for working to enhance shareholder value regardless of the sentiment surrounding its share price. It is our goal to continue to hold such companies at attractive valuations in order to enhance our clients' long-term returns.

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