QV UPDATE

Weekly Commentary | June 7, 2019

Steve Kim, CFA

Rational Decisions in Uncertain Times

The low economic growth and low interest rates of this cycle have made rational investing increasingly challenging. One logical response by companies operating in this state of elusive growth and cheap debt has been to combine with peers to cut costs and grow earnings. In the latest speculated combination of Fiat Chrysler and Renault, the companies are seeking to (1) create the world's third largest vehicle producer, (2) achieve scale and (3) save billions in the process. While these corporate actions can ultimately create shareholder value, in our experience, they are often easier said than done. It can take years for the business case to materialize. So, while markets will often cheer, we are skeptical of mega combinations and acutely aware of both the risks and opportunities of this approach to manufacturing earnings growth.

Other issues, such as ongoing international trade disputes and the Brexit situation, are also impacting the investing environment. Intensifying trade tensions amongst global super-powers significantly increases short-term uncertainty around input costs and market access for some companies. These issues may also stymie innovation and productivity as companies defer long-term capital allocation and strategic decisions. Rapid technological changes, shifting consumer behaviour patterns and geopolitical clashes have also impacted investment outlooks and visibility of productive growth.

In another example of the curious investing climate, consider that savers in some countries, those seeking flexibility and stability, are being penalized by negative interest rates. While you may think pigs would fly before individuals or businesses would happily pay taxes early, many companies in Switzerland, for example, are doing just that to avoid holding onto (and paying for) cash in a negative interest rate environment.

Due to these dynamic and unpredictable markets, it's important to emphasize adequate diversification. A blend of cash, stocks and bonds that represent a healthy combination of geographic and economic sector exposures is especially crucial for preserving and growing capital. Investors should be happier with a balanced combination of diversified portfolio components interacting together, as this has been proven to result in better risk-adjusted returns over time.

Diversification is particularly relevant in Canada, as a few sectors comprise such a high percentage of both the TSX Composite and Canadian small cap benchmarks. Energy, financials and materials represent over 60% and 53% of the TSX and small cap index, respectively. Interestingly, it is within these dominating sectors that we are seeing value relative to history and the broader market. As value-oriented investors, the risk of being overly concentrated in these areas is a key consideration in portfolio allocation.

QV has not been unscathed in terms of allocating too early or experiencing greater volatility in these economically sensitive sectors. To combat the risk of being wrong, and overly exposed to a single factor, our investment teams are focused on ensuring portfolio decisions promote sound diversification and portfolio enhancement. All portfolios maintain a maximum exposure of 25% to any one sector.

Diversification must go beyond broad sector allocation and is also considered at the individual company level. In the Canadian small cap strategy, for example, although exposure to financials is close to 25%, it is made up of a broad mix of service providers including lenders, insurers and lease companies. Another important consideration is the operating exposure of each business. For example, small cap holding Canadian Western Bank has grown its Central & Eastern Canadian exposure from 10% of its loan book in 2009 to approximately 30% today. Economic diversification within the small cap strategy is further bolstered by select companies with dominant market positions internationally. For example, the geographic exposure of the portfolio is enhanced by Element Fleet Management Corp., which generates less than 10% of its revenues from Canada, and offers equipment leasing to a predominantly investment grade client base across 30 industries in the US.

In the current uncertain climate, where it can be logical to happily pay taxes early, risk management through balanced exposures and portfolio enhancement continues to guide QV's investing decisions.