QV UPDATE

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Voting Time

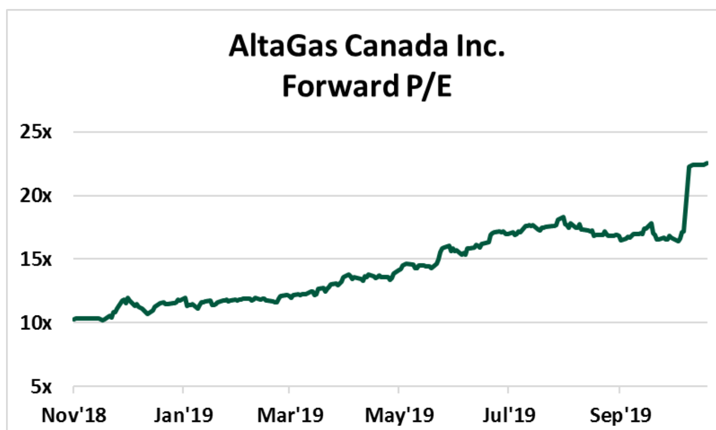
With the federal election behind us, it's timely to reflect on how quickly preferences and perceptions can change. A famous quote by legendary investor Ben Graham characterizes the market as a voting machine in the short run – that is, simply a measure of popular opinion. Only in the long run does the market become a "weighing machine" reflective of actual business fundamentals. Unlike a typical 4-year federal election cycle, a sector or security's time in the sun or shade can be much shorter. Consider the recent volatile swings in Canadian market returns. Year to date through September, the TSX Composite Index is up over 19%, after declining nearly 9% over the previous calendar year. At the security level, the following quote by Roman poet Horace seems apt: "Many shall be restored that are now fallen, and many shall fall that are now in honor."

Investors need to avoid falling prey to the short-run voting tendencies of the market, and instead benefit from them by focusing on the business fundamentals that can compound in a risk-adjusted manner. The following two examples demonstrate the need for careful independent assessment in markets where "voting results" can turn very quickly.

Consider the volatile path of office-sharing company WeWork, which recently failed to complete its initial public offering (IPO). In January of this year, Japanese holding company Softbank, led by well-known tech investor Masayoshi Son, made an equity investment in WeWork that valued the company at approximately $47 billion USD. In September, the failed IPO valuation pegged WeWork's value at $15-20 billion, amid concerns around management integrity and operating losses. Softbank recently injected further equity into the business, at a valuation of roughly $8 billion, representing an ~80% decline in value over 10 months. This outcome is a reminder of how even the seemingly brightest and most intelligent business people can assess businesses incorrectly and fall.

In another example of rapidly shifting valuations due to popular sentiment, consider QV's holding in small cap utility company AltaGas Canada Inc. (ACI). The company was spun-out last year as part of a deleveraging process by parent company AltaGas Inc. At the time, sentiment on ACI was pessimistic – in addition to the small size of the new company and perceived association with its challenged parent company, defensive and utility stock valuations were being pressured by concerns of rising interest rates. As a result, ACI began trading at $14.50 per share and an estimated price to earnings (P/E) ratio of less than 10.5x, representing a discount of approximately 30% relative to large cap peers. We saw an opportunity. Despite the negative sentiment, 80% of the business was generating regulated cash flows growing at above-GDP rates, with the remaining 20% in high quality renewable power generation.

Last week, two Canadian-based pension funds made an offer for the entire ACI business at a share price of $33.50, or a P/E ratio of over 20x. In this case, the "weighing machine" worked quicker than one might usually expect. Our assessment of the value that an informed, objective and long-term investor would pay for this business was validated sooner than expected.



Source: Capital IQ

Cognizant of the risks of investing based on the extremities of public votes, it is our goal to ensure we have independent assessments of businesses, are resolute when we have conviction and take appropriate action when our assessments prove incorrect.