QV UPDATE

Weekly Commentary | November 22, 2019

Clement Chiang, CFA

Emphasis on Durability

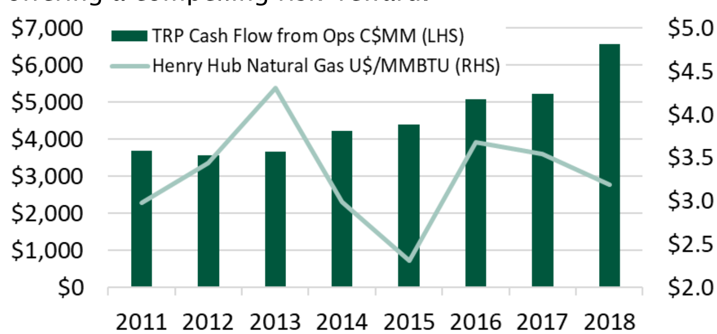
The end of October 2019 marked the 124th month (measured from July 2009) of this economic expansion. And as December quickly approaches, we are likely to see this expansion grow to 125. Regardless, this current expansion is the longest on record dating back to 1854, according to the National Bureau of Economic Research.

Considering we have not experienced a recession for over ten years, one may naturally question if we are likely to expect one soon. The simple answer is maybe, but maybe not. The art of market timing is extremely difficult. We recognize there are a number of signals that suggest we are nearer to the later stages of the market cycle. One of which is the record amount of U.S. nonfinancial corporate debt-to-GDP (gross domestic product). The 46.6% as of June 2019 has surpassed the prior pre-recessionary peak of 45.3%, and we suspect it may continue growing given today's low interest rate environment. Low interest rates for over a decade have matched investors (who have been forced to accept lower returning investments) with borrowers that are taking advantage of some of the most attractive interest rates in recorded history. While we are cautious as to the elevated leverage in the financial system, we also have a duty to invest our clients' capital while managing the associated risks as best we can. For fundamental bottom-up investors like us, this begins at the security selection level.

Within our fixed income strategies, we place a strong emphasis on the franchise strength and flexibility of the corporate bonds we purchase – that is, the businesses we lend to. We accept the fact that markets move in cycles, so we look for corporate issuers that have the quality characteristics to help them operate through difficult times. Not only does this help ensure the receipt of interest income and principal over time, but it also provides the conviction to buy when others are despondently selling.

In our experience, companies with irreplaceable assets typically have strong business franchises. Assets that are difficult to replicate tend to result in pricing power over customers. The ability to dictate prices without experiencing a material decline in demand is a very attractive business quality. Furthermore, unwavering demand is a good indicator that profitability should remain stable throughout the cycle. That earnings stability is the crucial piece that helps investors sleep at night. Businesses that generate durable and persistent cash flows demonstrate resiliency. And it is this earnings quality that is just as, if not more, important to evaluate than aggregating debt levels when assessing credit health. Financial flexibility is also key to ensuring staying power. Even if cash flows are stable, companies still find themselves with strained balance sheets at times. Having adequate flexibility (be it capital expenditure reductions, dividend cutbacks, or non-core asset sales) is essential for providing the necessary relief to return to normalcy. These are some of the key qualities we look for when lending to corporations.

For example, our Canadian bond strategies own bonds issued by TC Energy (TSX:TRP), formerly TransCanada Corp. TRP is the owner and operator of critical energy pipeline infrastructure that spans across North America. Its asset base has proven to be rather difficult to replicate in recent years. About 95% of earnings are underpinned by regulated and long-term contracts, ensuring a steady cash flow stream. The chart below shows TRP's cash flow durability during what has been a volatile natural gas market. Lastly, management has sold $6.3B of mature assets year-to-date to help right-size the balance sheet and return the business to a self-funding model. We purchased TRP bonds when its corporate premiums were offering a compelling risk-reward.



Source: QV Investors, Capital IQ, Bloomberg

Timing the inevitable downturn in this lengthy economic expansion is a difficult task. But emphasizing businesses with durable qualities and sticking to them over time can earn the risk-adjusted returns we seek.