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QV Investors Inc.

Christmas Wish List

As the calendar flips to December, our attention shifts to the holiday season that is fast approaching. On the Canadian small cap team, we have given some thought to three items that would be on our Christmas wish list for the QV Canadian Small Cap Strategy. Dear Santa…

Better Value for High Quality Stocks in our Portfolio, Allowing us the Opportunity to Increase Weight

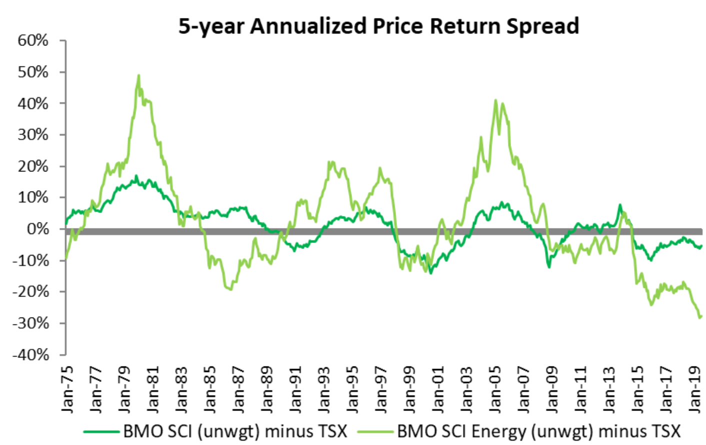
There is a divergence in the market between what is working and what isn't. Stocks with momentum, growth and quality characteristics are receiving greater investor attention and higher valuations, while the typically more value-oriented areas of the market in Canada are seeing compressed valuations. Year to date, momentum stocks have returned over 25%, outperforming value stocks by a factor of nearly 2.4 times. Similarly, quality stocks have advanced 23%, sitting firmly in the bucket of "what is working." In the small cap strategy, we have holdings we'd characterize as "high quality" that we would like to increase. However, we continue to prudently wait for more attractive value, as these companies have generally advanced alongside the rest of the "Quality" bucket. Examples include holdings such as Winpak and Richelieu Hardware. Both have aligned management teams, enduring franchises, sound capital allocation practices, net cash balance sheets and a proven ability to compound book value at an above-average rate over the long term. Today, both businesses are trading at what we would characterize as *reasonable* value. We would cherish an opportunity to be able to add to businesses like these should the margins of safety become more palatable.

An Attractive Entry Point for Prospective Investments

As we actively seek new investment opportunities, we've noticed that attractive incremental businesses for the portfolio are not necessarily attractive investments at today's valuations. Therefore, we create an inventory of prospective investments – companies that have the potential to meet our 7-tests framework at the right price. A scan of our inventory shows that, on average, we would like to see 18% lower share prices before the margins of safety would be attractive enough to add these holdings to the portfolio.

A Shift in Sentiment

In general, Canadian small cap companies are being hampered by negative sentiment, but this is more acutely felt in certain sectors. The current price to book ratio for the BMO Small Cap Index is 1.1x vs. a 20-year average of 1.6x. Looking back to 1975, the energy sector of the BMO Small Cap Index (see light green line in the chart below), has *never* lagged the S&P/TSX Composite Index by this much. The valuation compression in small cap energy has been widespread without regard for individual company attributes. An example within the QV Canadian Small Cap Strategy is Enerflex Ltd. – a geographically diversified oilfield service provider that should grow organically in line with global natural gas growth. In addition to generating record revenue and profitability, Enerflex continues to improve its franchise by growing the proportion of recurring revenues in its business. However, the valuation of the stock is at an all-time low. In fact, Enerflex is pricing in a scenario for 2020 that is materially worse than the trough environment experienced in 2016!



Source: BMO Capital Markets

We hope Santa has made his list and checked it twice. The small cap team is ready to act if he's determined we've been nice!