QV UPDATE

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Preparing for Uncertainty

The volatility brought on by fears of the spreading coronavirus disease has been a wake-up call for the market, which may have been dozing. The wake-up call is an important reminder that, despite sometimes exuberant confidence by the market, the future is always uncertain.

At the end of 2018, the S&P 500 Price/Earnings ratio was ~15x, below the 20-year average valuation level of 16-16.5x. By the end of 2019 it had reached current levels of over 19x. With minimal trailing earnings growth behind it, the market had priced years of future growth into equity markets. Factors such as low unemployment, US wage growth and low borrowing costs were justifications for the healthy outlook on US economic growth (and, by extension, corporate earnings). While this recent wake-up call is not necessarily a harbinger of the end of the bull market, it is likely the result of a market that had become too complacent in the face of very real risks, such as trade wars, military conflicts, exceptionally low bond yields, etc.

As aptly put by others, the market perspective tends to swing between extremes of unsustainable optimism and unjustified pessimism. It would be a stretch to say the market currently has a hopeless view. However, the contraction from 19.5x P/E to 17.1x P/E, on an increasingly suspect forward earnings level, reflects a market that is now substantially more fearful and pessimistic about the future than it was a month before.

Knowing that the future is uncertain, how can we combat short-term uncertainty and avoid getting distracted by the mood swings of the market? Amongst others, two things help to mitigate these challenges. One is a core tenant of the QV investment philosophy, and the second relates to preparing for the risk of being wrong.

#1) Keep a long-term view – On behalf of our clients we buy (NOT RENT) long-term ownership stakes in real businesses. In the midst of corporate earnings releases for 2019, many companies are seeing declines in stock prices and valuations related to expected impacts of the coronavirus disease and other company-specific challenges. In some cases, valuations have become disconnected from reasonable estimations of earnings power over the long term. This divergence is of great interest to value investors. Businesses with sound growth runways trading at attractive levels can represent substantial value. We are particularly interested when these businesses have tangible track records throughout prior geopolitical and economic challenges. For example, we are currently adding to an existing position that trades at a 7% earnings yield after factoring in that ~20% of its market capitalization is in net cash. With a 10-year record of growing revenue per share at 5%/annum and earnings per share at 10%/annum, the business exhibits value relative to both the broader market and meagre global bond yields.

#2) Build in protection – Preparation for the possibility of being wrong can help prevent investors from getting caught up in market emotions. To control for the risk of being wrong on a business, we stress test potential investments to factor in a margin for error. For the company in the example noted above, a key risk is that the past may not be reflective of the future – the 'edge' of the business may have started to erode over time. Rather than growing at ~2x GDP, what if revenue and EPS only grow at 1/3 of the historic rate? We have considered that scenario and feel the risk of permanent capital loss is fairly limited. This business generated 5-6% of its share price in excess cash per share. Furthermore, growing earnings at 3%/annum rather than 5%-10%/annum would still provide owners reasonable returns over time and mitigate permanent capital loss. As a result, we can thoughtfully add to our position using market swings to our advantage.

Investing is inherently an uncertain and psychologically-testing venture, as we have been reminded over these last couple weeks. Our long-term focus and preparation for the risks, by stress testing business cases and being careful not to overpay, provide the confidence needed to navigate uncertain times.