QV UPDATE
Weekly Commentary | November 14, 2014
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QV Investors Inc.

This week commemorated the 18th anniversary of our firm. We thank all of our clients for their continued support and confidence in QV.

Change is the Only Constant

The BoC's Governor, Stephen Poloz, recently reminded Canadians that the markets and economy are dynamic and adaptive systems. Early in the quarter, Mr. Poloz outlined why Canadian manufacturing and exports haven't benefitted the economy as one would expect in a falling Loonie environment. In past years of Loonie strength, less competitive Canadian manufacturing permanently shut down, leaving less capacity to take advantage of the next cycle. Evidence of adaptive systems in an investing context is seen when great assets, such as utilities, become mediocre return vehicles when too many investors bid up prices in search of stability.

When contemplating investments or the economy, investors need to recognize that markets and co-relationships are rarely static. There are few instances where "all-else equal" assumptions hold true in reality. As investors, we appreciate when company managers respect this fact and are prepared for ever changing prospects.

During a recent earnings call, a CEO stated in relation to competitive positioning, "You never, never underestimate competition and never get complacent". This is a simple yet powerful insight that speaks to our philosophy on management's stewardship of shareholder capital. Especially, as the pitfalls of complacency are plentiful. From an industry perspective, the newspaper business was once considered a cash cow, with stable recurring revenues from subscribers and advertisers. But faster than expected secular shifts in reader patterns have forced the newspaper industry to re-invent itself. There are also examples of strong technology companies that have deteriorated in business franchise because they failed to evolve. As peers outpaced these companies along the technology curve, shareholders were left with a permanent loss of capital.

Offsetting this constant need to think about evolving is the tendency of many managers to over act. Although corporate activity can generate value, the rear-view mirror is littered with ill-advised business initiatives that can destroy shareholder value. Unfortunately, management's ability to steer their business forward versus in circles, usually becomes most evident after the fact. This is why QV believes management and financial record are pivotal factors in our security selection process.

The record of the team at QV holding, Pason Systems, demonstrates qualities we look for. An oilfield service provider, Pason develops technology to provide oil and gas producers with information to improve decision making and efficiency. Jim Hill and later CEO Marcel Kessler have continued to build upon their strong franchise. Despite being in a dominant position at 90% market share in Canada in 2003, Pason's focus on innovation and improvement has paid large returns. In the subsequent decade the company grew Canadian market share to 95% and overall revenue at 16% per annum. Driving this growth, Pason replicated their Canadian success into the much larger US market, improving from 33% to 57% market share. Supplemented by smart acquisitions, the growth has more importantly been profitable. Pason's earnings per share have grown over 10% per year from $0.34 in 2003 to $1.09 in the last twelve months. The company also continues to deploy record amounts of capital. Of further comfort is the team's stated prioritization for growth. To defend the core business and improve market share, followed by the development of new products and geographies.

Weakness in energy prices has not left Pason unscathed in terms of its stock performance. Lower energy prices will be a headwind. However, Pason's historic aversion to debt and net cash position lowers the likelihood of an impaired franchise coming out of this cycle. As Pason's management continues to improve their business, QV's own search to improve the portfolios never ends. Our monthly risk management process highlights the valuation levels, growth and balance sheet risks of each portfolio and is a dynamic driver for improvement and strengthening within the portfolios.