QV UPDATE
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QV Investors Inc.

Escape Valves

"In purely practical terms, when the stock market is at or near a peak, there are likely to be very few, if any, bargains to be had…there is, therefore, a naturally induced bias towards selling and building cash during such periods…this is not to suggest that it makes the selling judgement straightforward or easy for the investor – in fact it probably [works] towards selling too early and often towards buying too early as well. What it does do, however, is to considerably reduce the likely volatility of the portfolio and bolster the margin of safety, reinforcing the potency of the dictum that the secret of making money over the long term is not to lose it."

This excerpt from "There's Always Something To Do: The Peter Cundill Investment Approach" is increasingly relevant as stock market valuations drift through the upper end of fair value. In the most recent quarterly letter by Grantham, Mayo, van Otterloo (GMO) LLC, Jeremy Grantham also reminds "the prudent investor should definitely recognize overvaluation, factor in regression to the mean, and calculate the longer-term returns that result from this process." Managers with a value tilt are likely trimming equity positions and raising cash, if they have not already been doing so. While QV's process differs from those of the managers above, we are similar in the belief that global markets are overheating. That being said, with China cutting its interest rates today, following in the stimulus efforts of the European Central Bank and the Bank of Japan, asset valuations are poised to potentially move higher.

The cash levels across the QV equity mandates are currently above their historic averages. This is consistent with our market observations and our attention to the rising valuations within QV's own portfolios. Holding more cash could lead to a temporary drag on portfolio returns. However, it gives us the same flexibility we like to see in the strong balance sheet businesses that we own. As investment managers, we can deploy cash quickly as opportunities become available. It is akin to the 'escape valve' we feel every good company should have. Examples of the advantages of escape valves are the immense real estate portfolios spun out by Canadian Tire Corp. and Loblaw Co. in 2013. Whether out of necessity or market timing, these companies took an opportunity to raise cash. The excess cash allowed them to improve their balance sheets, raise dividends, and, in the case of Loblaw, fund the purchase of another valuable asset in Shoppers Drug Mart. The crux of this example is that good managers with strong assets will generally find ways to effectively deploy capital.

Despite the higher cash level, the QV Canadian Equity portfolio continues to hold meaningful weights in what we believe are some of Canada's best businesses. Bargains are simply harder to come by. But mid-single to low double digit returns over the next three to five years are still achievable using reasonable valuation parameters.

Earlier this week we had the opportunity to meet with TELUS Corporation's CEO, Joe Natale, and CFO, John Gossling. TELUS is one of Canada's incumbent telecom service providers, and a long time holding of the QV Canadian Equity strategy. The company maintains the lowest leverage ratio amongst its peers, the lowest rate of customer turnover, and has returned almost 13% of its $26 billion market capitalization to shareholders since the beginning of 2013. TELUS has achieved all of this by taking a conservative approach to managing its capital. While its competitors were paying for media assets, TELUS spent consistently each year to deliver the highest quality customer service – an area where its competitors are playing catch up. Furthermore, the company has been building its Health division, which develops solutions to share information and execute transactions among hospitals, insurance companies, and pharmacists. This segment is only five percent of TELUS' total revenues, but has the potential to become a meaningful escape valve over time.

Like other high quality, defensive businesses, TELUS is trading at all-time high valuation levels. Managing valuation risk may lead to the difficult decision of trimming our weight in TELUS. But there are worse situations than to add to our cash position; for instance, the inability to buy more businesses like TELUS when their valuations become extremely attractive.