Clement Chiang, CFA I Joe Jugovic, CFA

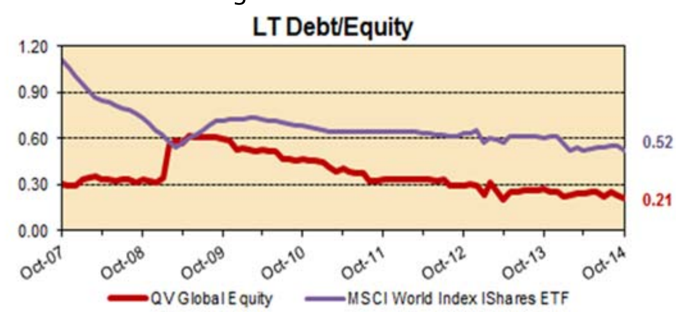
Down Swing

Rarely do the capital markets move in a straight line. Instead, history has shown market valuations to be more cyclical than linear. We believe human emotion is a leading cause of these market oscillations. It is investor psychology at market extremes that determine the amplitude of the pendulum swing from greed to fear and back again. Greed is most rampant when risk levels are usually at a peak, but are typically ignored.

Oil prices have certainly seen a down swing in full effect. Last week, the Organization of Petroleum Exporting Countries (OPEC) agreed to maintain its production output of 30 million barrels per day. The announcement insinuated an oversupplied market and prices swiftly corrected. Today, West Texas Intermediate crude oil sits at $66 per barrel, -32% lower from the December 2013 price of $97/bbl, and -18% lower than the $80/bbl price just a month ago.

Low cost oil producing countries like Saudi Arabia do not require the same capital intensity to produce a barrel of oil as North American competitors. Higher cost producers are feeling profit margin pressure from deteriorating well economics. According to Reuters, new well permits in the U.S., an indicator of new drilling activity over the next two to three months, declined 37% month over month in November. Clearly, lower oil prices have adversely impacted drilling activity. And more importantly, the expected future cash flows that were a function of sustained higher prices are now likely to decline, in the worst case leaving little cushion to cover capital needs.

The Canadian and U.S. high yield bond markets are now more exposed to energy prices than in the recent past. Oil and gas sensitive issuers make up 37% of the Canadian-dollar high yield market. It is lower in the U.S., but still significant at nearly 18% of all outstanding U.S.-dollar high yield bonds. Issuers rated non-investment grade, deemed as having greater default risk than investment grade issuers, have benefitted massively from the low interest rate environment with some relying heavily on debt to fund their operations. High cost production economics thrived at triple digit oil prices, we're still ok at over $80/bbl, but at current levels these debt laden producers are struggling to cover interest expenses. This week, two Canadian oil producers, Southern Pacific Resource Corp. (TSX:STP) and Connacher Oil & Gas Ltd. (TSX:CLL) both announced a review of their capital structures and will also be assessing liquidity options to maintain viability. Connacher 5yr bonds now trade at 40 cents on the dollar, implying a significant loss in market credibility and looming bankruptcy. It is concerning that the high yield market is so sensitive to oil prices. Clearly, the saving grace for many producers in this environment will be a strong balance sheet. That being said, when sentiment falls in this sector few company's share prices are unaffected. We too have seen a number of our names sell off during this correction.



Source: QV Investors/Capital IQ

The above chart shows the debt to equity measure of our global equity portfolio versus the MSCI World Index. It shows we hold a portfolio of businesses that employ less leverage than the benchmark and that we have kept this advantage over time (this would also be true of our Canadian portfolios). Balance sheet strength is one of the key attributes we look for during our investment process. We look for management teams that have demonstrated sensible financing over different market cycles. This is assessed by comparing debt levels to cash flow and equity value, and evaluating the trends of these measures. We emphasize businesses with an ability to fund capital needs through internal cash generation and have ample interest coverage even under stressed scenarios. The market is ever changing and rough patches come without warning. We believe our attention to balance sheet strength helps protect the portfolio from unforeseeable future down swings.