QV UPDATE
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Gut Check

"Gut Check" according to the Collins English Dictionary is defined as "a pause to assess the state, progress, or condition of something such as an enterprise or institution." It typically does not involve a physical challenge, but rather is mental. Market declines such as the one witnessed in October and over the last number of weeks in Canada are defining moments for investors – a gut check. They can be a test to determine if the investor has the right asset mix. It is easier for an investor to convince themselves that they can accept steep declines in the market when the market is ascending as opposed to retreating.

In a 2011 paper written by James Montier, he explores what he calls the seven immutable laws of investing. One of his laws states that "Risk is a permanent loss of capital, never a number." Some of the Canadian banks refer to risk in terms of a value at risk, which is calculated by using probabilities. As an example, a bank's trading department might say there is a 5% chance the bank's investment portfolio might lose more than $5 million in one day. We believe the issue of risk involves more than just a probability formula. We are concerned with the potential downside in a portfolio and the many inputs that go into that calculation. What we are trying to figure out is simply how much money might we lose. For us, this loss of capital can be broken down into two components; fundamental risk and valuation risk. Fundamental risk refers to a problem with the underlying business that may lead to lower earnings and cash flow. This is something we continually monitor by reviewing each company's quarterly releases and speaking with management.

Valuation risk refers to the price paid for the investment. If too high of a price is paid on the initial investment or the valuation has moved up substantially, there may be limited ability for the price to expand. Prior to the October downturn, we began selling businesses within our portfolios that we felt had increased valuation risk. These included Genworth MI Canada in the balanced and large cap mandates, Surge Energy in the small cap mandates and Intel and Microsoft in the global mandates. We do not wait for a market decline to evaluate the risk we are taking in our portfolios. We constantly ensure we have a good idea of the downside potential and try to position our portfolios to preserve capital.

Oil

This week the price of oil dropped to a five year low of under $60 USD. The difficulty when investing in commodity exposed companies is trying to determine where the commodity price will settle. We did not predict the current oil price, but we were careful in ensuring the companies we owned were well financed in the event of weaker markets. To us, well financed means that at lower commodity prices the company will still be able to maintain a flexible budget, stable dividend and supportive balance sheet.

Let's use Suncor Energy as an example. Even at $55 oil, the cash flow can sustain the dividend, maintain production, and although the growth would slow the balance sheet would still be strong. The importance of a well-financed balance sheet is highlighted by Suncor's CEO on a recent conference. "We have been clinical in our execution of capital discipline for the last 3 years. The primary purpose of that was to get us into a position where our balance sheet was strong so that when the market has downturns, we wouldn't be stopping and starting capital projects…Every time you slow it down, it costs money. Every time you remobilize, it costs money."

Unlike Suncor, a variety of companies slashed capital budgets and dividends this week. As an example, one company in business for over 20 years lowered its dividend by over 55% and cut its capital expenditures by over 20%. However, if these drastic measures were not taken the debt level would move up substantially as the dividend payout and capital spend was 158% of the cash flow. This company's stock price is down over 60% in the past three months while the more conservatively managed Suncor is down 25%. We are confident Suncor will make it through a downturn with its capital structure. We are less sure about many of the other companies out there.