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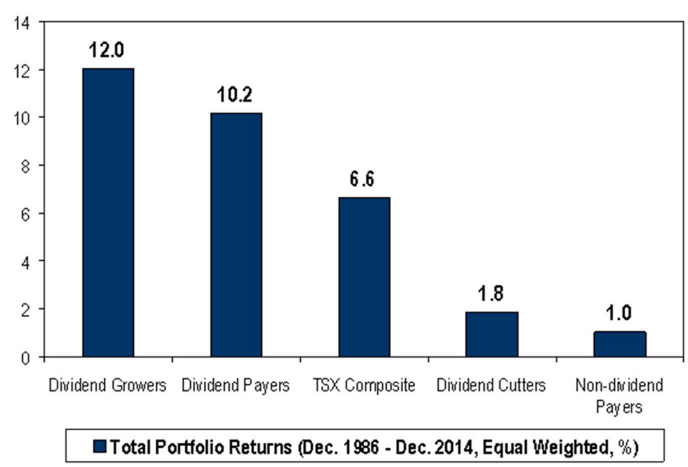
What to do with a Dollar?

I hope that this is a problem that we all have from time to time. You earn some money, pay off your bills and have to decide what to do with the excess cash. Individuals may choose from a range of options such as investing it in the stock market or having a big night out. We would like to think that the former is more rewarding. In the most simple of terms, public companies must choose to either reinvest the excess in their own affairs or pay it out to shareholders. These capital allocation decisions often have significant influence on future value creation.

Typically when companies keep greater portions of earnings, they can reinvest in operations or make acquisitions without depending heavily on external financing. With a little bit of wisdom and luck, both actions result in organic growth. The options to pay down debt or squirrel away cash to bolster future investing power also exist. Absent attractive internal investment opportunities, the company may choose to redistribute the cash back to shareholders in the form of dividends or stock repurchases.

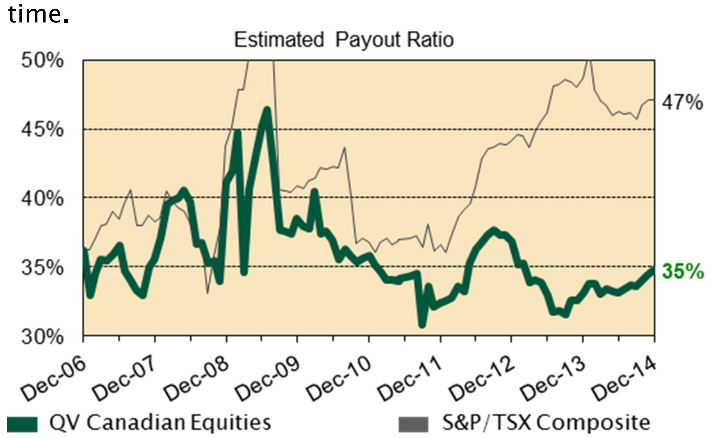
In general we prefer to invest in companies that can afford to pay out some cash while remaining disciplined enough to keep something for themselves. Companies that are able grow all aspects of their business (including dividends) at a steady rate make beautiful investments for the long term. Historically, companies that consecutively increased their dividend payments created more value for their shareholders than their peers.



Source: RBC Capital Markets Quantitative Research

QV holding, Toromont Industries, reported its quarterly financials this morning. It illustrates a great example of capital allocation that appeals to us. Toromont increased its dividend for 26 consecutive years. Since 1996 it earned an average return on equity of over 18% and shareholders enjoyed a total return of over 16% per year. It currently has a manageable dividend yield of just over 2% and pays out 37% of its estimated earnings as dividends.

Maintaining a healthy payout ratio plays an important role in achieving sustainable organic growth. In recent years record low bond yields forced income seeking investors to look for alternative investments resulting, to a degree, in increased investment in high dividend yielding stocks. In 2012, many companies increased their payout ratio in hopes of catching the bid as can be seen in the chart below. Due to increased business and valuation risk we chose not to chase the yield. At current levels of 2.4% in the Canadian Large Cap Strategy vs 2.9% in the TSX Composite, we are sacrificing some dividend yield but believe it will benefit our clients over time.



Source: Capital IQ & QV Investors

Sensible capital allocation, especially in down cycles helps to defend against unpredictable future swings in the market. In the oil and gas industry, for example, expectations are already that Canadian exploration and production budgets will be cut by around 35% in 2015. Companies that are less disciplined in managing their capital over the cycle may be forced to sell their assets at discounted prices. If oil prices stay depressed for a prolonged period of time, we may witness this scenario unfold here in Alberta!