QV UPDATE
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QV Investors Inc.

Knowing the Knowable

"We have two classes of forecasters: Those who don't know – and those who don't know they don't know."

John Kenneth Galbraith, Economist

Yesterday ushered in a new year in the Chinese lunar calendar. According to my limited research, the year of the goat promises a time of calmness and prosperity. This is a welcome relief after the tumultuous year of the horse we had just experienced. Perhaps this forecast will play out. While it is tempting to make broad economic predictions to determine where we should allocate capital, we try our best to keep to what we know when making investment decisions.

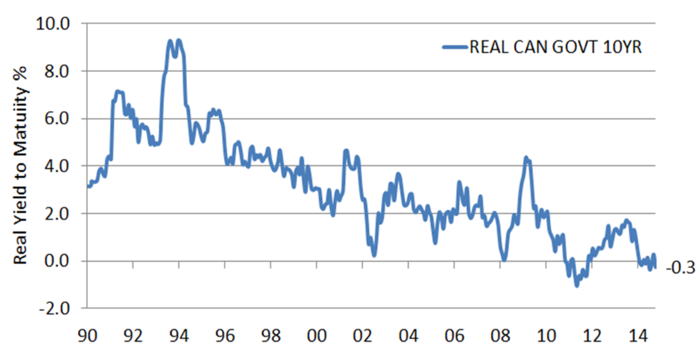
We believe that it is impossible to predict the future. As humans, our inquisitive nature leads us to create tools to which we use past experiences to base future predictions. While these tools like statistics and economic theory do have merit, they also have limitations. For example, correlation does not imply causation and published economic data may be incorrect or require revision. We acknowledge that we cannot accurately make macroeconomic forecasts on a consistent basis, and we believe we do not need to.

As bottom up investors we prefer to focus on the knowable. These are the characteristics that make a great business. These are the valuations that provide a margin of safety. We can understand these variables and have better control of their risks in our portfolios. We believe mitigating risk instead of making bold economic predictions should help us achieve our objective.

With fixed income investing, it is tempting to make macroeconomic forecasts when trying to ascertain the direction of interest rates. Economists and strategists get this wrong all the time. We admit we did not foresee the rapid decline in bond yields over the past year. Our bond portfolios have benefitted from this decline in yields, but to a lesser extent than the benchmark due to our defensive bias. But is now the time to raise the offensive stance in our bond portfolios? We don't believe so and here's why.

We know that the Canadian bond market, as represented by the FTSE TMX Canada Universe Bond Index, currently has the highest duration in thirty years at 7.6, as of the end of January. Duration is a measure that estimates bond price sensitivity to interest rate movements. With the Index showing the highest price sensitivity in three decades, we grow increasingly cautious. Furthermore, as yields have declined, new bond issues are launched with lower coupon rates attached. As a result, these bonds have limited ability to offset price declines should interest rates rise. Another sign to heed caution.

With German and Japanese 10yr bonds trading at yields of under 0.4%, couldn't Canadian government bond yields decline from their current 1.4% yield? Yes they could, but we believe investors are taking on greater risk for lower reward. After adjusting for inflation, the real Canadian 10yr bond yield (nominal yield minus inflation) is back in negative territory. This is an insufficient return for taking on higher interest rate risk. Our analysis showed real Canadian 10yr yields have traded in a range between 2% to 3% in a normalized rate environment. Even if today's low growth environment equates to real yields trading between 1% to 2%, the current level suggests real yields still have room to rise.



Source: Bloomberg and QV Investors

Investing is a long term endeavour. We know that we are currently not being compensated for the risks inherent in longer term bonds. So we will remain patient for better yields. Keeping to what we know and controlling risk where we can will help us preserve and grow our clients' wealth over time.