Mathew Hermary, CFA

Standing Room Only

In early March I attended the 36th annual Raymond James investor conference in Orlando, Florida. It is an event which QV has attended for many years because it showcases over 350 companies throughout multiple industries over three short days. This year I was not only able to attend 24 company presentations but also to meet with eight teams from current and prospective investments.

Apart from the energy sector, it was clear from this year's presentations that the business environment is the healthiest it's been since the Financial Crisis. Organic growth has been robust and management teams expect it to remain so. Additionally, cost savings, balance sheet discipline, return on capital and restraint on excessive M&A were all prominent corporate focal points. From an investor's perspective this is all reassuring.

Unfortunately however, this optimistic backdrop is no secret among the investment community. Attendance at the conference appeared to be even larger than usual this year. In presentations where companies' performance had been particularly strong, investors were packed into the sessions, often with standing room only.

Today many stocks' valuations resemble conference rooms too full with eager investors. Much as a good story draws a crowd, so does it also precipitate a full valuation. This is not necessarily problematic provided expectations are met. When they are not however, investors drawn by stories of outsized growth tend to head quickly for the exits. With the median price to earnings ratio of the NYSE now at 20x[1], the margin for error is the lowest it has been in a long time.

Slow and Steady Wins the Race

As of today, we have owned Aflac Inc. in the Global Fund for two years. Aflac is a US listed insurance company which generates more than 75% of its earnings in Japan. Over the last three years I've attended the conference I've had the opportunity to speak with members of Aflac's management as well as attend the company's presentations. While the conversations can be insightful, the presentations are almost identical. This is because very little changes at Aflac. Management has been largely the same for well over 20 years. Their dominant market share and competitive advantages in Japan are firmly entrenched as indicated by a stable, peer leading return on equity. Meanwhile, book value and dividends plod steadily upward year after year while earnings remain strong and predictable.

Apparently though, this story is too dull for most investors as Aflac's presentations are never more than half full. We disagree. While it's true that earnings growth has been somewhat subdued in the last two years and yen devaluation has been a near-term headwind, the company's competitive advantages have allowed it to compound at satisfactory rates over a long period of time. Looking forward, a lucrative deal with Japan Post, high capital levels driving meaningful buybacks and a significant untapped opportunity in large client channels in the US offer a number of interesting avenues for growth. In the meantime the book value of our investment has grown 24% in two years and when we include the $2.96 in dividends received, our investment has produced an annualized return of 13.9%. More importantly, Aflac continues to trade at an attractive 9.8x trailing earnings versus its 10 year median of 12.6x and the S&P 500's 20.7x. Perhaps this is too bromidic for those crowding into other conference rooms for stories of larger promise, but at QV, owning a high quality franchise absent significant expectation driven valuation risk gets us pretty excited.

Although the corporate environment remains quite constructive, the 'good times' story has drawn quite a crowd. This has reduced investors' margin of safety and likely predicates increased future volatility. As long term investors we take solace in owning companies like Aflac where valuations are still reasonable and their ability to compound over time mitigates the risk of permanent capital loss. But we also realize that for every Aflac there are many more rooms overcrowded with investors eager for a good story.

[1] InvesTech Research; Kenneth R. French Data Library; Wells Capital Management