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Jenga

If you were a child of the '80s, had children or grandchildren at that time, you likely remember playing the wooden block game, Jenga. If you don't remember, here's a refresher:

Take a block from the bottom and you put it on top. Take a block from the middle and you put it on top. That's how you build a tower, you just don't stop… It weebles and it wobbles, but you don't give up…'Til someone knocks it over, and that's when you stop. But you can start all over putting blocks on top.

You're welcome for putting that little ditty in your head for the weekend. As we move further into the current market cycle, the Jenga lyrics seem to increasingly parallel risk seeking behaviour by investors.

The most recent example is in China where the Shanghai Composite Index, led by its alarmingly hot technology sector, has more than doubled over the past ten months. Parallels can be drawn to the excesses of the US dot.com bubble, only the magnitude of the bubble in Chinese tech stocks is even more excessive. According to Bloomberg, the Shanghai tech sector is trading 220 times reported earnings. This makes it not only the most expensive among its global peers, but much higher than that of the NASDAQ's peak of 156 times earnings back in March 2000.^

The vigorous rally in China has been fueled by not only low interest rates and record setting single day Initial Public Offerings, but also a substantial increase in margin debt to the tune of US$264 billion. This represents a remarkable 50% increase in less than three months. To provide context, that is double the outstanding margin debt on the New York Stock Exchange today after adjusting for relative market size.+

Investing on margin allows an investor to buy more stock than they would be able to otherwise, through borrowing from their brokerage firm. Although this amplifies returns, it also amplifies losses. Given the speed and magnitude of China's margin debt growth, it is apparent that little concern has been paid to the risk of loss if the market falls. We are already seeing signs that the *weeble and wobble* has started to surface as was evidenced by today's 4% selloff in after-market trading on the Shanghai Index.

Source: Macrbond, BNP Paribas

^ http://www.bloomberg.com/news/articles/2015-04-07/u-s-dot-com-bubble-was-nothing-compared-to-today-s-china-prices
+ http://www.bloomberg.com/news/articles/2015-04-13/china-walks-264-billion-tightrope-as-margin-debt-powers-stocks

China's tech sector is not the only perilous tower being built. There are other areas spanning the globe that are also pricing in very high expectations. As we pointed out in our February 27th QV Update, even the US market is now trading above its long-run average price-to-earnings. However, we have still been able to find pockets of opportunity.

One such pocket is the US financials sector, which is an area that we have been adding to in the Global Equity Fund. One of the holdings we have recently bolstered is Citigroup. Citigroup is one of the world's largest financial institutions. It is in a strong financial position with the ability to sustainably grow earnings and reach its targeted 10% return on tangible capital employed, but is still trading below tangible book value. In addition, the management team is executing to plan on many important milestones, including passing the Comprehensive Capital Analysis and Review (CCAR) test. Passing this test allowed management to significantly raise its dividend and approve a substantial share buy-back programme. The company is now held at a 4.4% weight.

QV's risk managed approach to investing is why you won't see high flying stocks like China's tech companies in our portfolios and why you will see more of the types of companies just described. We are not willing to reach for return at any cost. Rather, we look for those companies with reasonable return profiles for the underlying risk taken so that our investors never have to *start all over*.