QV UPDATE

Weekly Commentary | May 1, 2015

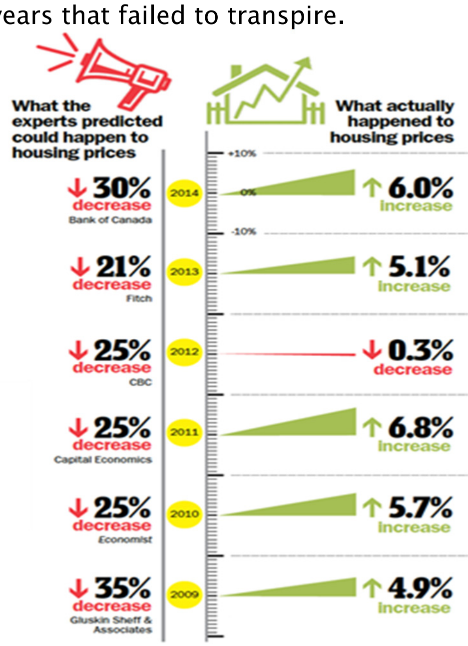
Ryan Watson, MBA, CFA

QV Investors Inc.

What to do about Housing?

In a recent interview with Ray Dalio, co-Chief Investment Officer of hedge fund Bridgewater Associates, the veteran manager was asked to what he attributes his success. Dalio's response was, "People think that my success is because of what I know. It's not. It's due more to how I deal with not knowing."

On April 30th, Canada Mortgage and Housing Corporation released the results of its analysis designed to detect the presence of problematic conditions in Canadian housing markets. The verdict was a "modest overvaluation." We understand why Canadian housing is frequently in the spotlight. Household debt to disposable income is at a record 163.3%, low interest rates are supporting mortgage demand, and mortgages are the largest component of household debt at around 60.0%. In terms of analysis, however, housing prices are yet another example of how time spent predicting their direction and magnitude could be unfruitful. The illustration below shows how experts predicted double-digit declines in home prices in each of the past six years that failed to transpire.



Source: MoneySense, Feb/Mar 2015

We are not suggesting that the Canadian housing market will not experience a correction. [History shows that corrections periodically occur, and the concerns felt today are warranted.] Rather, similar to Ray Dalio, we prefer to spend our time assessing the risks to our relevant investments. The QV Canadian Equity strategy has a weight of 16.6% in Canadian banks compared to the S&P/TSX Composite Index at 21.6%. Although underweight, this is still a meaningful exposure.

The banks clearly benefit from increased consumer borrowing, as they are the originators of most loans. On the flipside, they are at risk in the event of a housing downturn. With elevated concerns around consumer debt and housing overvaluation, why does QV continue to hold a significant weight? There are a few reasons. Firstly, the forward price-to-earnings ratio of the TSX Banks sub-sector is at 11.8x versus its 15-year median of 12.3x, and 19.2x for the TSX as a whole. The sector represents reasonably good value. Secondly, bank balance sheets are sufficiently above regulatory minimums on a Tier 1 capital basis. Thirdly, it is nice to own an oligopoly. For instance, this week we saw two of the Big 6 banks flex their pricing muscles by increasing various service fees for personal and business bank accounts. Nevertheless, we are all likely to continue needing chequing and savings accounts. Overall, the Canadian banks are an attractive area to invest. We believe a high single-digit return is possible given expectations of 5.0% earnings growth plus dividends that yield roughly 4.0%.

We try not to speculate on when the next housing correction will occur. To deal with this potential risk, we look to buy these businesses at low points of their valuation. In conjunction, we meet with bank leaders to understand the cracks they are looking for in the system, and the scenarios where profitability is threatened. A takeaway from recent meetings with CIBC and Bank of Nova Scotia is a focus on the debt service ratio sitting near 24-year lows, suggesting some market stability. Paying a below-average valuation for an above-average business with strong leaders and a sensible strategic plan is a simple recipe that can drive good returns over the cycle. Attempting to time market corrections is difficult, even for the experts. More often than not, it results in good returns being left on the table.