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An Exercise in Patience

Over my four years at QV I have studied and used various techniques to value businesses, listened to strategists describe the condition of market cycles, and engaged with experienced managers on their past investment actions. While these opportunities have been instrumental to my development as a practitioner, it is the current market environment that helps me understand best what it takes to be a value investor. Patience is certainly a key ingredient; especially in markets testing new highs and making the contrarian element of value investing a challenge.

While high quality value opportunities are limited, we are still responsible for allocating our clients' capital to the best sources of potential return. The businesses we own in our portfolios hold the same accountability to their shareholders. An interesting method for determining the total return from a company's capital allocation decisions is the concept of shareholder yield. This method was developed by Bill Priest of Epoch Investment Partners – a U.S. based asset manager owned by TD Bank, which is a top ten holding in the QV Canadian Large Cap and Balanced portfolios. Shareholder yield is essentially the sum of a company's shareholder friendly initiatives reflected as a proportion of the company's market value. These mainly include distributions in the form of dividends, buybacks and debt repayment. But in its extended form also includes investments, such as capital expenditure and mergers and acquisitions. The higher the percentage, the higher the current and future capital returned to shareholders.

	2011	2012	2013
Share Repurchases	6.9%	18.2%	40.3%
Debt Re-payment	-5.4%	22.7%	44.8%
Dividend Payment	9.7%	15.6%	29.3%
Capital Expenditures	2.0%	15.1%	24.8%
Mergers & Acquisitions	-1.0%	15.4%	25.9%
Cash	0.4%	0.2%	0.0%
S&P 500 Index	0.0%	13.4%	29.6%

Source: Strategas; December 2013

The table above shows which uses of cash have performed the best in each of the past three years for S&P 500 stocks. While companies that repaid debt in 2013 saw the best share price returns at 44.8%, over the past two years, share repurchases, dividends, and debt repayments have all been meaningful drivers of returns. In Mr. Priest's words, "investors rewarded companies for returning assets to shareholders. This makes sense in a slow economy." Not to mention in an economy of uncertain policy. As a result, the market bid up the valuations on businesses with high cash distribution policies, such as high dividend yielders.

The more than $120 billion of share repurchases by U.S. companies has received much attention. QV does not oppose the use of share repurchases, which is a quick method of lifting earnings per share (via lower share count). But we agree with the views of James Grant, editor of Grant's Interest Rate Observer, who in his March 7th report states that "the most prolific buyers of stock in bull markets are among the most reluctant buyers in bear markets," indicating that company share buybacks are rarely completed effectively and often at inopportune times. That is, the average business is not a value investor. Whereas in the past three years investors favored businesses that simply repurchased stock, brokerage firm Barclays points out that "a basket of the highest repurchasing yield stocks has underperformed since the beginning of the year." The market could now be looking to reward companies that can instead successfully reinvest cash to grow their operations.

We think this return to investment is necessary to drive corporate sales growth. Canadian businesses are poised to benefit as many either remain flush with cash or have recapitalized to strengthen their balance sheets. These businesses have also refocused their immediate capital programs towards the highest returning projects. Sentiment has been stronger in the Canadian small cap space in the first quarter of 2014, as observed by the year-to-date outperformance of the S&P/TSX Small Cap Index (7.6%) against the S&P/TSX Composite Index (5.2%). However, we remain constructive on Canadian large caps. The QV Canadian Large Cap mandates trade at a below-average P/E ratio of 13.7x, and maintain above-average four-year average ROE and reinvestment rate at 16.4% and 9.4%, respectively. An attractive opportunity from a contrarian perspective.