QV UPDATE

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Digging a Hole

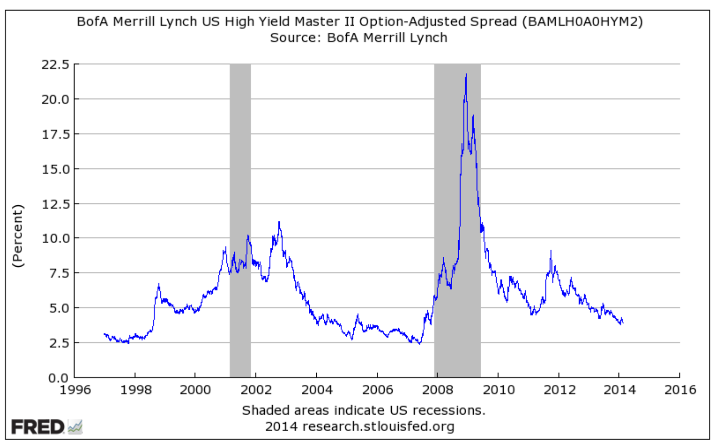
Last weekend I had the good fortune to go on my first cat-skiing trip at K3 Mountain in BC. For those who have never been, it is absolutely bucket list material (75cm of fresh powder helps too). Although our guides ensured we were never exposed to even the remote possibility of danger, the trip began with an avalanche safety lesson followed by a test where our group used avalanche transceivers to locate and extract two dummies buried in the snow. In about two minutes (a pretty short time for us but likely a very long time if you are the one buried), myself and four friends found and extracted the first dummy one meter down in the snow. Meanwhile the other 10 people in our group were 40 feet away digging furiously in a big hole in the snow. Scratching my head, I walked over to their location and consulted my avalanche transceiver. It said the buried dummy's signal was still 4 meters away. Either someone had buried a dummy 12 feet under the snow or 10 diggers had all decided to dig in the wrong spot. As it turned out, it was the latter. The transceiver revealed the dummy was 3 meters to the left and only under a couple feet of snow. Apparently one person had decided 4m was close enough to start digging, he took out his shovel and everyone else just followed suit despite having their own transceivers pointing them in another direction. Talk about a great example of herd mentality and its risks - in this case, me having to depend on this herd to dig me out of an avalanche!

The other day I was talking to a friend from out of town. Near the end of the phone call the conversation drifted to investments. He mentioned that he was trying to decide how to invest new money with his investment advisor (don't worry we'll convert him to QV one day!). His advisor had him heavily invested in a high yield bond fund for some time and my friend had made an attractive return following this advice. The notion however, was that a good portion of this new money would also be allocated to high yield bonds as well.

Investing large proportions of an investment portfolio in income producing products like high yield has been a popular and rewarding proposition over the past few years and is very much indicative of investors' ongoing reach for return in a yield constrained environment.

However, with significant high yield exposure in investor portfolios more a platitude than an exception for a long time now, the situation seems to have taken on an element of herd mentality in what is essentially a low quality, speculative asset class.

Generally high yield bonds should only be purchased at marked discounts to par in order to compensate investors for the elevated risk of default that accompanies loaning money to companies of lower or questionable credit quality. As is now typical of the high yield market in general however, the high yield fund in question trades at an average weighted price of 107 - far in excess of par. Some may argue that default rates and thus risk is currently very low. While it's true that default rates are low, this will change with time. The fact remains that high yield spreads are extremely tight, meaning the margin of safety in high yield is lower than it has been in years. Sure you may be able to get a 4-5% current yield to maturity in a high yield fund for the time being, but in doing so you place yourself at risk of future capital loss given current valuations. Although high yield returns have been great, with spreads where they now are, it's time to question what a suitable allocation to high yield in a portfolio looks like. To us, it looks like investors may be digging for returns in the wrong spot.



As a policy, QV does not invest in high yield junk bonds. As well, our exposure to the lowest rate investment grade bonds is capped at 10%. While we do hold a significant percentage of high quality investment grade corporates in our bond funds, these holdings have been steadily reduced as bond spreads have tightened.