QV UPDATE

Weekly Commentary | February 07, 2014

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Concern Brings Opportunity

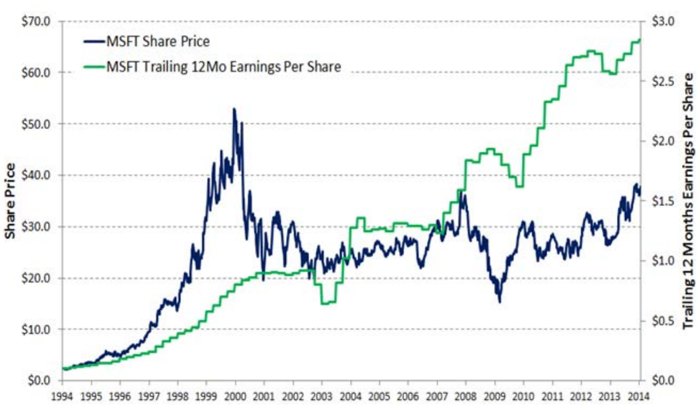
"When written in Chinese, the word "crisis" is composed of two characters – one represents danger, and the other represents opportunity." – John F. Kennedy

Last Friday ushered in a new lunar year in the Chinese calendar. According to some strategists, the year of the horse could prove dangerous if the stock market runs away from its fundamentals.

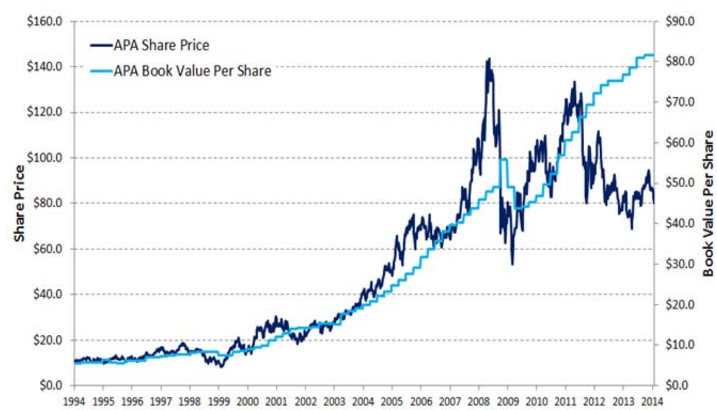
Ned Davis Research writes that a -17% correction in the S&P 500 is needed to return prices back to fair value. At 1793, the S&P 500 is currently trading at a median price-to-earnings ratio of 20.2x. This is well above the fair value of 1477 for the S&P 500, which Ned Davis Research calculates based on a 50-yr median ratio of 16.7x. Industry surveys also indicate excessive levels of optimism and low cash-to-assets ratios. Indicators that often have been followed with market corrections.

But the broad stock market is not an accurate representation of our QV portfolios. The market consists of hundreds of stocks. We are much more selective, investing in only 25-40 businesses that meet the QV criteria. Our portfolios are designed to be different. While strategists are warning of market overvaluation, we still see some attractive opportunities.

Take Microsoft (NasdaqGS:MSFT) for example. Concerns over slowing PC demand have weighed on the stock price. But at 13.4x trailing price-to-earnings, we make the investment case for a global franchise with high switching costs. Some claim that PCs are dead, we argue that the usage of computing devices is more ubiquitous than ever. A slowing consumer division has been offset by strong demand in commercial enterprise offerings, which make up 2/3 of operating income. MSFT pays a 3.1% dividend yield and after adjusting for cash, its PE multiple improves to 10.2x. Its new CEO has the potential to improve earnings and in the meantime, we are not overpaying for a strong franchise with attractive growth potential.



A recent purchase in the QV Global Equity portfolio is Apache Corp (NYSE:APA). APA is an independent oil and gas producer with international assets. Egyptian unrest and concern over production growth appear to be reflected in its stock price. Now trading at a price-to-book ratio of 1.0x and price-to-cash flow of 3.5x, we see a compelling opportunity to buy a business that has achieved steady production growth for over 20 years. Management has refocused its efforts in assets that provide greater cash flow predictability. This resulted in a 25% dividend raise this week. Growth may be flat in 2014, but we believe management has a clear plan to compound shareholder capital over the long run.



Source: Bloomberg & QV Investors

While it is difficult to ignore negative influences, it is essential to control emotions when investing to achieve strong risk-adjusted returns. Our long time horizon will help us realize the benefits of fundamentals eventually being reflected in their share prices. As the year of the horse charges forward, we remain steadfast in our risk managed approach to assessing opportunities that surface.