# QV UPDATE

Weekly Commentary I January 31, 2014

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## Cookin' up Some Safety Stew

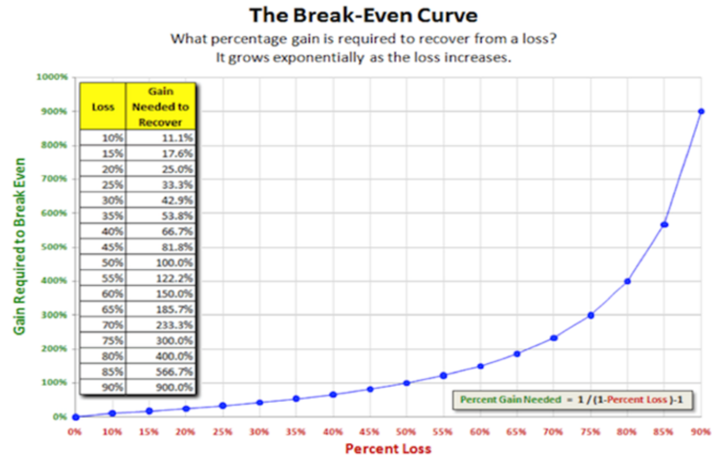
QV Updates this year, and the latter half of last year have had an increasingly cautious tone. Our assessment remains unchanged and we have positioned our portfolios accordingly. Among the myriad of elements that cause concern about future market returns is margin debt as a percent of nominal GDP. Investech Research does an excellent job of monitoring this. As can be seen below, historical peaks have a strong correlation with market tops. Both appear to be on shaky ground.


Source: Investech Research

As a reminder, there were many analysts calling for a terrible 2013 a year ago. Even some outright market crashes were anticipated. Obviously these scenarios did not come to pass. Despite our cautionary discourse and recent market malaise, 2014 could very well continue on its merry way to higher returns. Our process prepares us for both. The beauty of our recipe is that it does not oblige us to make big bets on our expected broad market movements.

This is how we prepare it. Start with equal parts of defensive balance sheets and reasonable valuations. Sauté some management assessments and upside/downside analysis. Mix in a healthy dose of profitability, attractive cash flow yields and a dollop of patience. Stir until ample diversity is attained. Some spicy risk can be used but must be monitored closely to keep the entire concoction quite mild. Bring to a boil and let simmer for years. Sample for great taste frequently and adjust as required.

What you get is a well-diversified medley consisting of return capability for the good years with a defensive layer of protection for the bad years. Our double layered approach inherently reduces long term volatility. We cannot stress the importance of the defensive layer enough, especially during today's unstable times. John Mauldin illustrates this point well with the following break-even curve.




Source: Mauldin Economics

The chart simply illustrates that you have to gain back more than you lost to break even on a percentage basis. For example, if you invest $100 today, lose 50% tomorrow, then gain 50% the following day, you would be left with only $75. A gain of 100% would be required to get back to $100. Effective downside protection limits the exponential climb required to get back to where you started.

Extending this line of thought further illustrates the cost of excess volatility. If you start with the same $100 and hold it for 25 years with a consistent eight percent annual gain, you would finish with about $685. If you factored in a ten percent alternating price move every six months (volatility) combined with the same eight percent annual gain, you would only have about $580. The volatility would cost over 20% of your gain! Decreased volatility enhances long term returns.

Turbulent global equity performance over the last two weeks has been a helpful reminder to ensure your portfolio is well positioned after the 2013 rally. Left unchecked, the winners will have grown over the last year to become larger weights than their increased valuations may warrant. A rebalance may be in order. Our process has this ongoing readjustment cooked in. It is necessary to revisit not only with individual security positions but also sector diversification, geographic diversification, and asset allocation. We have been curtailing the more expensive names in our portfolios and are finding it increasingly difficult to redeploy the cash in quality names with attractive valuations. This challenge, coupled with our skittish outlook, has bolstered our cash weights.

Our stew is ready. We hope that both you and Mr. Market like it.

Bon Appétit!