QV Investors

QV Update

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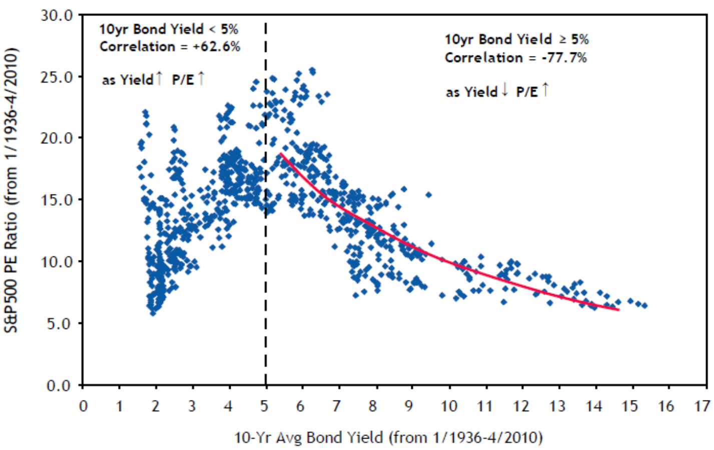
Staying Sober in the New Year

How does the adage go, "let us not drink to the past, but to the future"? The New Year remains an opportunity to reflect and to plan. In the investment community, managers, strategists, and analysts have been releasing 2013 reviews and 2014 forecasts. By and large, value managers warn that stocks are no longer cheap. It could be that the healing process from the wounds of 2008 is well underway, or maybe the market has just had one too many drinks since the '08/'09 crisis and is due for sobering up.

That being said, central banks remain accommodative in their policies. On Wednesday, the Bank of Canada came out with its Monetary Policy Report indicating that it would keep holding the overnight rate at one percent on the back of a weak Canadian dollar and inflation coming in below its two percent target.

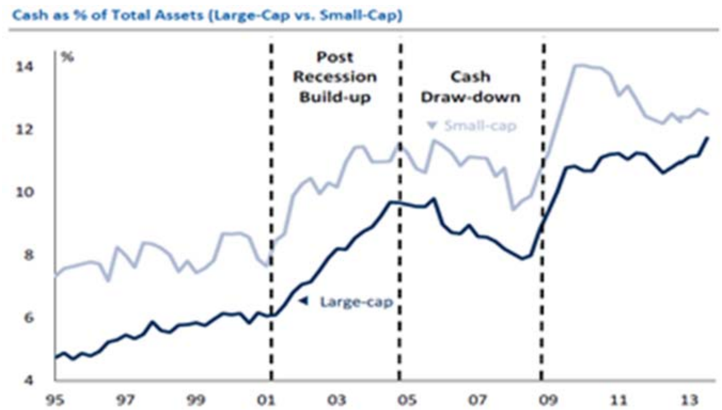
With low interest rates, low inflation, and slow global growth, the stage is set for equity valuation multiples to move into more risky territory. The chart below plots the relationship between S&P500 Price-to-Earnings (P/E) ratios and the 10-year US Treasury yield using 74 years of data.



Source: RBC Capital Markets

It highlights that when the 10-year yield is under five percent, rising interest rates are generally associated with rising P/E ratios. The 10-year yield is currently below three percent. Try to temper expectations of higher returns to come, and instead keep in mind that risks are growing. The point being, in a yield-driven market if rates are likely to remain low, the market may be willing to assume increasingly more [valuation] risk. The historical relationship suggests the market could pay between 20.0 and 25.0 times corporate earnings before higher yields lead P/E multiples to contract. The S&P500 is currently trading at 16.8 times current-year estimated earnings.

Overall, the health of the world economy has shown signs of improvement, mainly fuelled by developed economies, but is far from healed. And while investors remain punch-drunk and have bid up market prices, we are encouraged by the prudence that is displayed by businesses.



Source: RBC Capital Markets

Cash levels at corporations have grown to new highs following the financial crisis. Although the chart above displays data for the S&P500 excluding the Financials sector, we believe it speaks to Canadian companies as well. Both US and Canadian businesses have experienced a meaningful amount of balance sheet deleveraging since 1995. On average, businesses are in a healthy position and remain very conservative with deploying precious cash holdings.

In our recent quarterly reports we have touched on the benefit to our portfolios from corporate activity such as mergers and acquisitions (M&A). M&A is one measure of corporate risk taking. Although we experienced many deals over the past year, the number of large deals taking place in the market has not grown coming out of 2008. This could be an indication that corporations are still gun-shy, and even wary of current valuation multiples. With fewer opportunities to redeploy cash at attractive rates of return, companies have been returning capital to shareholders in the form of higher dividends and share buybacks.

As portfolio managers, one of our objectives is to select companies with the best business prospects and pay what we believe to be opportunistic prices. The QV portfolios maintain better valuation, growth, and leverage metrics than their respective benchmarks. While maintaining these advantages will be difficult, it is what makes today a stock picker's market. There are more businesses today with the balance sheets to support future growth than there were five or ten years ago. So the opportunities are ample. It might just take a little more time (and patience) to secure them at the right price.