QV Update

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Truths for the Long-term

New years are usually rung in with market gurus providing predictions for how investors can outwit the market. It can also be a time to challenge ourselves to think about the uncertainties the future brings. A good quote that recently made the rounds in the inter-office email from Charlie Munger was:

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

Instead of trying to outwit others and maybe ourselves in 2014, three concepts will provide guidance in the attempt for our small cap investing 'to be consistently not stupid'.

Diversification

Sector diversity will remain imperative. The 2013 Cdn small cap performance highlights why. The BMO Small Cap Index had close to flat performance in 2013 with a total return of -0.5%. However, eight of ten sectors within the index posted double digit total returns. Unfortunately, the largest sector allocation, materials, experienced negative returns of -38.8%. This offset the positive contributions from other sectors.

Allocating capital with consideration of diversification is never a bad decision. Devoting thought to sector diversity and economic exposures will also help prepare for the inevitably of being wrong. For instance, while a lower overall materials exposure has helped us side step some of the pressure in the gold space, we could be susceptible if the space snaps back in 2014.

Risk AND Reward

Investors today have multiple definitions of risk. But a truth that holds constant is to consider return in relation to the risk to generate that return. Whether making an asset class or stock allocation, best practice is to not think of return or risk in isolation. Most of us are prone to a recency bias and emphasize the latest news. We are wary that last year's outsized S&P 500 performance, can lead to focusing on return, while understating risk.

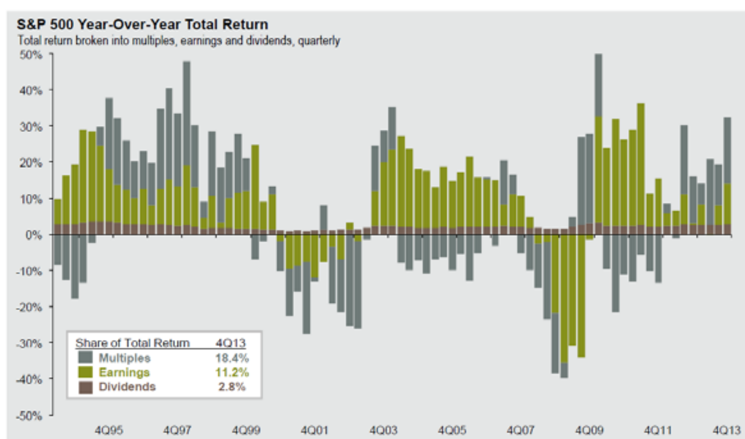
Delving further into risk, the late Peter Bernstein's definition is especially helpful. Risk, means the chance of being wrong. Contemplating being wrong is crucial in this industry because according to Mr. Bernstein:

"Effective risk management starts with the recognition that any forecast can be wrong, then weighs the consequences of being wrong. Only then can we decide whether to make a bet, whether to hedge that bet and how to execute the hedge if needed."

When planning investment decisions in this year, effectively managing risk should reduce the probability of permanent capital loss. Back to our Materials exposure. In our opinion, there is a lack of attractively priced firms that demonstrate cash flow per share growth while maintaining balance sheet strength. As a result, the return profiles of many of these companies do not provide adequate compensation for the commodity price, leverage, and operating risk being undertaken. We will continue searching for these opportunities but will be significantly underweight the resource sectors for the time being. Equally important, spending time on the chances and consequences of being wrong will foster a trait most of us investors need more of, humility.

Self-restraint

As a prospective business buyer, which is a preferential time to invest? In an environment of slowing earnings growth and increasing prices, or growing earnings and declining prices? As we get later in this bull market, the former has been true. Below is the S&P 500's total return breakdown since 1995. The chart highlights the contribution to total return of increasing multiples (grey), earnings growth (green) and dividends (maroon).



Source: J.P. Morgan: Guide to the Markets 1Q 2014

Over the past four years the trend of earnings growth as driver of return has been steadily declining. Despite this, the asking price for businesses has increased. The S&P 500 trades at 15.4x earnings now vs 12.6x one year ago. Looking ahead, we don't know whether markets are just rounding the corner or are closer to home stretch. Regardless, we believe discipline while allocating capital is especially important as the current risk of paying more than intrinsic value is unquestionably heightened. This doesn't mean there aren't any opportunities in today's market, but relating what you are paying for to what you are getting is of greater importance.