QV Investors

QV Update

January 03, 2014

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Like Shooting Fish in a Barrel

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

– Mark Twain

There are no truer words for investors. Human nature instinctively seeks definitive answers and investors have a way of convincing themselves they are right even though it is often to their own detriment. Over the last year we have begun to see a broad based resurgence in overconfidence. This leads us to be more circumspect about the investing environment in 2014.

Remember this time last year. There was widespread worry over Europe, Greece's impending default, the U.S. fiscal cliff, and sequestration. Go figure, once we finally learned to pronounce sequestration everyone stopped worrying about it! We digress. The point is there was little risk of overconfidence. This is not the case today. To offer an example – a prominent European fund manager who has spent the past five years convincingly and often arrogantly arguing his negative outlook has thrown in the towel. Now his viewpoint is "Just be long. Pretty much anything". In classic style, he's pieced together a wonderfully articulate story to justify his position. This thesis implies that making money will be as easy as shooting fish in a barrel. There is no need to worry about which stocks to own, they'll all go up.

The pendulum of fear and greed has swung from one extreme and seems to be quickly on its way to the other. Not surprisingly, this confidence has been building on the back of robust equity returns. This alone is not enough of a reason for our outlook to turn negative, but it does speak to where we are in the cycle (not at the beginning). The best opportunities often abound when the crowd is most nervous, and the opposite is true as well. What is unknown though is how far the chorus of optimism will carry the markets.

The Confidence Effect

Confidence matters. It's not as quantifiable as other stock market discussion points, but it's still one of the most important. Think about its effect for a moment. Consumer confidence leads to spending, spending increases corporate profits, and higher profits are reinvested into the economy driving GDP. Corporate confidence leads managers to hire new employees and offer wage increases to existing ones. Stock market confidence manifests itself in a greater willingness to invest in riskier assets and at higher prices. We know that during the financial crisis of 2009 investors fled equities for the perceived safety of bonds. Only in the last twelve months have we seen this trend start to reverse with investors buying equities at the expense of bonds. We expect this to continue.

One of the main drivers of the strong global stock market performance has been multiple expansion. The willingness of investors to pay more for the same $1 in earnings can have a very powerful effect. The bad news is stocks are not cheap (nor are they horribly overpriced either). We try to remind ourselves they can stay richly priced for quite some time. This is of little solace for investors who covet a margin of safety.

The bullish crowd points out that the stock markets' forward P/E multiple is near a long term average. Unfortunately, this multiple is contingent on rosy double digit earnings expectations being attainable. On forward projections it seems there's still time for one if not two more acts, while the market looks expensive on trailing earnings. Our experience with forward earnings estimates is they are repeatedly too optimistic. We have no reason to think this year will be any different. But really what drove the markets in the past 12 months had little to do with earnings growth. Multiple expansion played the lead role in last year's play. The longer this carries on the greater are the risks.

Earnings Quality

Earnings growth in aggregate has been rather weak in 2013, but many companies have been able to drive per share growth with continued large scale share repurchases. At some point investors may not be as keen to pay premium multiples for companies with average profit growth.

Other companies have achieved higher growth by purchasing earnings. Acquisitions have been rising steadily and acquiring firms have been receiving a premium valuation for their newfound earnings growth. Such activity makes us scratch our heads a little, ok a lot.

By giving a premium valuation to acquirers, the market is making the very bold assumption that these acquisitions will actually create long term value. Given the historically spotty record of takeovers, we are very cautious when we're told 1+1=3. Nonetheless, this honeymoon period doesn't seem to be going away any time soon.

The Ultimate Force – Low Interest Rates

The continued policy of bottom of the barrel interest rates and the proclamation by the Federal Reserve that they will stay low remain the biggest driver of global stock markets. In his last speech, Mr. Bernanke made sure investors understood the Fed's commitment when he stressed that "rates will remain at near zero well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the committee's 2% long run goal". Meanwhile it seems investors have renounced all other doctrine, except the mantra 'Don't fight the Fed'. The risk to this belief is that the longer interest rates remain low the more likely it is that asset prices will become dangerously overpriced (rather than just expensive). Warren Buffett stated, "interest rates act like gravity to all asset prices", acting as a powerful force that can lift prices when rates are low, and moderate prices when rates rise. Should these rates rise unexpectedly, asset prices could adjust quickly leaving overpriced assets more vulnerable to a correction.

In the interim, the Fed's current policy is potentially leading to dislocations such as inflation, spikes in long term bond yields, diluted stimulus options, or some other unknowns. To get shocks when markets are cheap and expectations are low is one thing, but to get them when investors' expectations are high is another.

Going Forward

While broad based strength in global stock markets stole the show in the past year, the lackluster performance of the bond market has received little attention. Our strategy in our bond portfolios has not changed throughout. We remain defensively positioned by maintaining short average term to maturities and focusing on quality in what we expect to be another challenging year. Our asset mix continues to favour equities over bonds, but has been scaled back from previous levels. Should we see continued zeal in the stock market and valuation risk outweigh potential return, we will be prepared to further reduce equity exposure.

The Canadian market lagged many international markets last year as Canada's heavy exposure to resource sectors weighed down on the broad index. Our portfolios remained highly diversified throughout sectors in 2013; this proved beneficial to our outperformance. The QV equity portfolios remain at an advantage relative to the broad markets when we review our risk management audits. Balance sheets continue to be very healthy, returns on equity remains above average but valuation levels, though better than the overall market on many measures, are not as attractive as they were over the past few years. We feel it is wise to pare back return expectations from equities, rather than hope for accelerated zeal. We will continue to reduce exposure to higher valued holdings and to businesses not performing to our expectations as we do not think the current market is anything like shooting fish in a barrel.