QV Update

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Yellow Signs

All throughout Banff National Park are coloured signs that communicate the threat level of a potential forest fire. Green indicates a low threat, blue for moderate, yellow for high, orange for very high and red for extreme. In terms of the market, I think we are in the yellow phase. Now my intention is not to frighten. Rather it is simply to communicate what we see as a growing adoption of risk.

In his latest issue, James Stack of InvesTech Research summarized certain historical elements that distinguish a healthy bull market from a dangerous bubble. He observes that a healthy bull market is supported by a "healthy respect for risk", while a dangerous bubble is characterized by investors "having no respect for risk". A healthy bull market sees investors "buying based on intrinsic fundamentals", whereas a bubble sees investors "buying based only on the anticipation of rising prices or profits." We are not yet seeing the extreme behaviour Mr. Stack characterizes in a dangerous bubble, but are definitely seeing a rapidly growing risk appetite. Our binoculars reveal some anecdotal evidence.

Corporate credit bond spreads have narrowed considerably over the past two years and have returned to pre-recession levels. Further spread tightening limits the differentiation between strong and weak credits, eroding the premium for taking on credit risk. Both investment grade and non-investment grade corporate debt markets have experienced this reach for yield as underlying government rates remain suppressed. This behaviour exposes bondholders to the risk of capital loss should credit spreads increase unexpectedly. In response, we have trimmed our corporate bond exposure from 50% in Q1 of this year to 40%, upgraded into more liquid and higher quality government bonds, and lowered the duration of our corporates relative to our governments. We remain invested in stable credits with additive yields and will upgrade further if needed.

We have also noticed a common trend towards greater shareholder-friendly initiatives at the expense of bondholders on an issuer specific basis. This too is an indication of greater market risk. In August, Tim Hortons Inc. (TSX:THI) announced its intention to raise debt levels by 2.5x to repurchase up to 10% of its common shares outstanding. This leveraged recapitalization resulted in a credit downgrade, but the new Timmy 10-yrs were met with strong demand for its 4.52% coupon. In the same vein, Thomson Reuters (TSX:TRI) also announced its intention to raise its leverage target to fund a $1B share buyback. New Thomson 6-yrs at 3.37% were also quickly absorbed and highlight a growing tolerance for risk at both the company and investor level. We prefer debt be invested in assets that generate cash flow, rather than borrowing to purchase company shares at a high valuation. We did not participate in the new issues.

On the equity side, a recent update with Intel Corp. (NasdaqGS:INTC), a holding in our global portfolios, highlights a particular instance of exuberance. One of Intel's competitors, ARM Holdings (LSE:ARM), is currently trading at excessive valuations. ARM has benefitted from the strong structural shift to mobile computing. Its sales per share has grown at a 5-yr compound annual growth rate of 17%, while its earnings per share has grown at a 5-yr CAGR of 35%, reflecting increasing profitability over time. However, its valuation is reflective of this growth. Its enterprise value-to-sales of 20.0x and trailing price-to-earnings of 93.0x is reliant on continued growth of ~20% per annum. At these valuations, missing street expectations places significant capital at risk.

On the other hand we have Intel, a laggard in the mobile semiconductor space, but a leader in technology and manufacturing of microprocessors for data centers and PCs. The growth in other segments has been offset by the struggling PC market. Its new management team reiterated its commitment to leadership in manufacturing and refocusing the business on mobile, where its chips offer superior performance at much lower power consumption. It has a net cash position and generates ample free cash flow that supports its 3.8% dividend yield. Its 2.2x EV-to-sales and 12.9x trailing P/E ratios offer better relative valuation that limits the risk of capital loss.

While our sample size is too small, these are just some specific examples we wanted to highlight that indicate the market has quickly swung from being risk averse to being risk tolerant. We cannot predict the future, but our value discipline will guide us through the cycle. We are reminded from our good friend Warren Buffett to *"Be fearful when others are greedy and greedy when others are fearful".* With the heat map pointing to yellow we believe there is still room for the market to grow, but we move forward cautiously at this point in the cycle.