QV Update

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Defense in a "Quality Bubble"

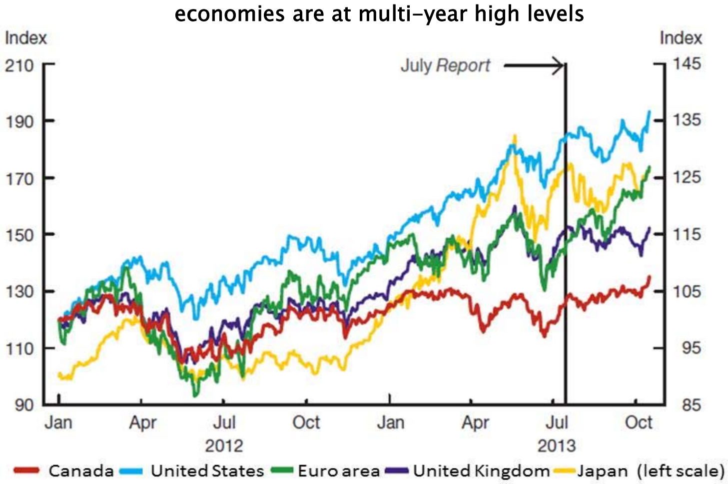
There have been many references to a "bubble" emerging in equity markets as of late. Recently Laurence Fink, the CEO of the world's largest money manager BlackRock, expressed concern about the "bubble-like" markets at a panel discussion in Chicago: *"We've had a huge increase in the equity market. We've seen corporate-debt spreads narrow dramatically…it's imperative that the Fed begins to taper."*

Bill Gross, co-Chief Investment Officer at PIMCO, remarked "*artificially high prices for risk assets"* when describing the current state of markets on his Twitter feed. From hedge-fund manager David Einhorn of Greenlight Capital: *"as the market continued its relentless climb, we've become more conservatively positioned."*

These cautionary views stem from the outsized returns generated in the equity markets over two years. Following the Fed's decision to maintain their $85 billion monthly bond purchase program on September 18th, the S&P 500 is up 1.8%, extending its year to date gains to 23.2%. The QV equity funds and balanced funds have also generated large double digit gains year to date, and over a two year period.

As shown in the chart from the Bank of Canada below, equity indices in developed economies are reaching new highs, led by the countries with most aggressive monetary policies, the United States and Japan. Canada has lagged due to its large exposure to underperforming resource sectors. Outside of resources, the Canadian equity experience has been similar to other developed markets.

Equity indexes in several advanced economies are at multi-year high levels



Source: Bloomberg Last observation: 18 Oct'13 Index: 3 Jan'12 = 100, daily data

Despite sluggish economic growth, a government shut-down, and a near technical default on its debt, US equities continue to reach new highs. The US Central Bank's bond buying program is forcing investors into stocks and other risk assets as savings rates and bond yields remain too low. Companies are using their elevated cash balances to buy back stock, or they are borrowing at attractive rates to do so. Margin debt by US investors is again at record levels, surpassing 2007 levels. Shareholders are benefitting from these trends, but for how long?

Of concern is the lack of meaningful net income and revenue growth to support these market gains. Absolute sales for S&P 500 listed companies are down 0.4% over one year, while earnings are up a meagre 1.8%. In comparison, the index has risen 24.4% over the same period. Further, re-investment rates are falling, a reflection of the weak macro environment. Business fixed investment remains weak, a factor that led the Bank of Canada to soften their stance on expected rate increases. The worldwide effort to suppress bond yields through a combination of large scale bond purchases, low interest rate policies, and moral suasion, has helped make the case for equities. But until we see encouraging signs of sales and earnings growth not aided by share buy backs, we argue that this rally is not sustainable.

There will be an end point to this rally. It may come courtesy of the Federal Reserve Bank under their new chairperson, Janet Yellen, re-announcing the taper. Unlike other previous market corrections, we do not expect bonds to provide the safe haven as they once did. And unlike other previous market bubbles that were led by one or two sectors, "quality companies" in the consumer, financial, healthcare and industrial sectors are leading this time around. Finding a safe haven in attractively valued quality stocks is now more challenging.

As we have mentioned in previous letters, we continue to actively trim our higher valued companies in our equity mandates. Multiple expansion without an underlying change to the firm's growth profile poses a risk to capital, even in defensive companies such as Winpak, Metro, or Jean Coutu. Our bonds remain short in duration to mitigate capital risk from rising bond yields. Increasing our cash and investing in companies ignored in this market rally will be our defense in this emerging quality bubble.