QV Update

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Marching On

As we progress through our third-quarter reporting period, the tone of our outlook remains the same. We still favor equities over bonds on the basis of the yield differential between the two asset classes, but we feel that cash is becoming an increasingly important part of the asset mix.

The United States has avoided default [for now]. They have kicked the can a little further down the road on tapering of QE programs and fiscal deficit containment. These macro topics have dominated the news and created near-term volatility in markets. This week the S&P/TSX Composite Index breached 13,000 for the first time in two years with mining and metals stocks providing a lift on the back of lower-for-longer interest rates.

A ladder can be climbed only so high until the top is reached. Valuation multiples continue to expand to above-average levels while corporate earnings guidance are revised lower. Barron's indicates that "for the third quarter, 91 companies in the S&P 500 index cut their earnings guidance while just 19 raised them." With sales growth forecasted below 1%, consumer confidence waning, and downward revisions on earnings, more rungs are being pulled from the ladder – leaving the near historically high corporate profit margin at risk of sliding.

In doing our screening on the Canadian market we sense that if a business is not broken, it's expensive. We monitor the valuations and balance sheets of the businesses in our portfolios keeping in mind the facts above. However, we recognize that while 18% of companies have taken down expectations, still 82% are holding on and enjoying the ride.

The 20-Mile March

Last month we eliminated our position in BlackBerry – the highly publicized inventor of the smartphone. We had been scaling back our weight over the past three quarters as we saw an acceleration of the downward slide in its competitive position. We do believe that BlackBerry has a good product line in its BB10 devices. However, we also feel that winning the smartphone race as a laggard is like giving Usain Bolt a ten meter head start in the hundred meter dash.

Though it would be easy to avoid the subject of BlackBerry from here on, we were recently asked by a client: What did we learn about our process through our investment in, or challenges with, BlackBerry? My immediate response was that we have a greater appreciation for the pace at which change occurs in the hardware technology industry, and as a result we need management teams in these businesses to remain focused on innovation. I continued to contemplate this question following the client call.

In a piece titled "How to Manage Through Chaos," Jim Collins and Morten Hansen outline the concept of the '20-mile march.' Two individuals embark on a 3,000 mile walk across America. Person A marches strictly 20 miles a day under any and all conditions to reach the destination. Person B is less disciplined and varies their travel based on conditions. For example, walking 40 miles on a clear day and then pausing for two days until a snow storm passes before continuing. Needless to say, the consistent effort displayed by Person A rewards them with reaching the destination first. The authors' message is one of self-control; the ability to identify and follow a set of guidelines to stay the course. In a business this may involve setting lower and upper bounds and keeping within them in difficult *and* in good times.

QV's seven tests for investment selection assist us with identifying enduring businesses led by candid and capable managers. In 2008 BlackBerry had passed our tests, with the exception of paying a dividend. The business was in a position to continue leadership in smartphone sales, and the executive team had billions of dollars in shares at stake. From 2003 to 2007 the company experienced tremendous growth, with return on equity (ROE) rising from -17% to above 50%. From 2007 to 2011 the company took a pause in its innovation, but held ROEs above 40%. Meanwhile though, new industry participants were creating products that were gaining traction with consumers (i.e. the first generation iPhone released in 2007). BlackBerry's ROE fell to 13% in 2012 and is expected to decline to -16% in 2013.

BlackBerry took the direction of Person B. It set out with high ambitions, but somewhere along the way the discipline was lost. We were reminded that within our seven tests, a franchise is dynamic and depends on management's ability to maintain a competitive drive. Our tests originally identified elements of a great franchise in BlackBerry, but the outlook for the business changed faster than anticipated. Fortunately, our portfolio risk management process allowed us to manage this risk through the weight of the position held in the Fund. This is why the core of our strategy is built on the Empires, the TD Banks, and the Canadian Utilities of the market; businesses that avoid abrupt changes in business focus in constant pursuit of a clear strategy.

QV's seven tests in conjunction with our portfolio risk management process have allowed us to stay disciplined and generate consistent returns over time. We will continue to apply these processes as we move forward with our own 20-mile march.