QV Update

September 27, 2013 Ian Cooke, CFA

Fair Value Doesn't Mean No Value

We are habitually cautious about commenting on broad market valuations. Large pockets of the market can become overvalued while small segments of opportunity remain. Broadly speaking, during the technology bubble, stock markets were trading at record valuations. During that period, tech stocks acted as a vacuum, sucking up investor money from old economy stocks. This resulted in deep valuation discounts in numerous high quality bricks & mortar businesses, setting the stage for tremendous gains once the bubble popped.

Today, we are over four and a half years into the current bull market. With the average post Great Depression bull market lasting approximately 3.8 years; it's easy for one to conclude that the current bull market will soon fade. Journalists jumped on Warren Buffett's words last week when he stated:

"[*Stocks*] *were very cheap five years ago, ridiculously cheap. And that's been corrected. They're probably more or less fairly priced now*."

We agree with this observation but it does not mean that there are no opportunities to invest. We also believe that fairly priced high quality businesses still have ample opportunity to compound attractive returns for shareholders going forward.

Some Examples

Laurentian Bank's (LB) CFO Michel Lauzon provided QV with an update earlier this week. The Company was founded in 1846 and operates the third largest bank branch network in Quebec. In addition, the Bank has built a solid reputation across Canada in the area of real estate and commercial lending with teams in Ontario, Quebec, Alberta and British Columbia.

Over 50% of LB's loans are residential mortgages. At first blush, this could be a concern with Canadians currently carrying record levels of debt compared to disposable income. Mr. Lauzon reminded us that over 60% of LB's mortgages are insured by CMHC and that uninsured mortgages have an average 50-51% loan to real estate value, providing ample collateral.

Laurentian Bank has also proven its prudence, with loan losses as a percentage of total loans increasing from 0.35% to 0.40% during the credit crisis while the Canadian industry overall saw a near doubling of loan losses that peaked out at more than twice LB's ratio.

The recent bull market has not been very kind to Laurentian Bank shares. The stock price today is similar to where it was five years ago. This doesn't appear to be any fault of LB's. Over the period, book value per share has grown at an annual rate of approximately five percent and dividends per share have grown at an annual rate of approximately nine percent. The stock, which wasn't expensive five years ago, now trades at approximately nine times last year's earnings and one times book value. Promising value compared to the S&P/TSX trading at a trailing P/E ratio of 18.4 times and a price-to-book value multiple of approximately 1.8 times.

We like the 45-50% discount to the overall market's multiple and the current dividend yield of 4.5%. We also like where the business is headed. Laurentian Bank is making strides in growing income through other services including credit cards, mutual fund sales, credit insurance and brokerage operations. All told, the Bank's other income grew 19% year-over-year in the most recent quarter. We expect efforts in growing these higher margin parts of its business will result in improved profitability over time. This should help to accelerate earnings growth and improve its valuation in the stock market. We have recently added to our investment in Laurentian Bank. It is currently one of the QV Small Cap Fund's five largest positions.

This week we also had a chance to sit down with Home Capital's President, Martin Reid and CFO Bob Blowes. Home Capital is one of Canada's leading mortgage lenders, focusing on home owners who typically do not meet all the lending criteria of traditional lenders. The bulk of their customers are new immigrants and the self-employed. Like Laurentian Bank, we get the impression that Home Capital is prudently growing, staying disciplined from an underwriting perspective with 68-70% loan to values on the uninsured portion of their lending while demonstrating excellent loan loss characteristics with very few loans in arrears. The Company is constructively growing their business in numerous markets in Canada while being cautious of the high-end condominium market. Home Capital has demonstrated commendable performance in both good times and bad, with 15 consecutive years of returns on shareholders equity above 20%. Home Capital is owned by both the QV Canadian Small Cap Fund and the QV Canadian Equity Fund.

Consistent with Mr. Buffett's comments, when we screen the S&P/TSX for companies that are trading at less than 10.0 times trailing earnings while providing a four year average return on equity in excess of 10%, fewer names appear on this list today than four years ago. We take solace in both Laurentian Bank and Home Capital showing up as two of the top four names on this list. Despite the duration of the current equity rally, there still appear to be several quality-value opportunities.

Inside the Firm

17 years ago today, QV registered with the Alberta Securities Commission and our doors first opened for business on November 11th of that year. After numerous years of succession planning, in December of last year, our Founder and Chairman, Leigh Pullen, officially announced his retirement as of November 11th of this year. Leigh will write his final letter as a full time employee of QV next week. Avid readers of this letter have enjoyed Leigh's insight and writing skills throughout the years. Be sure to catch his letter next week.