# QV Update

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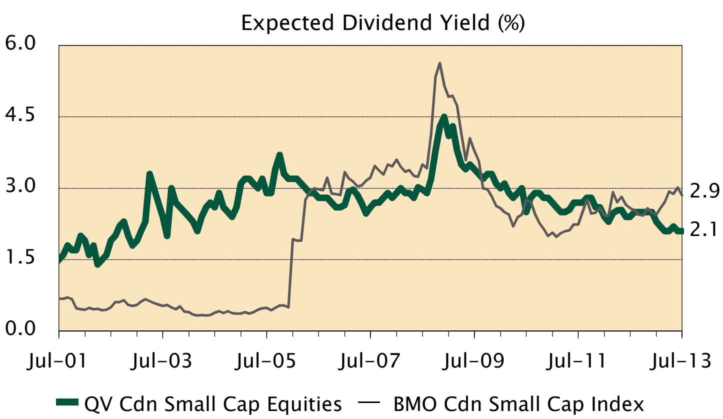
## Bucking the Trend

We often remind ourselves in good and bad times to be wary of whether investment performance has been driven by factors such as multiple appreciation or fundamentals. This is crucial to our goal of preserving and growing capital over the long-term. Valuations that stray too far from fundamentals can be a great opportunity, or conversely a large risk. When evaluating if the price investors are willing to pay for an asset has been bid up, or if management has grown the earnings power of the company, a key question is whether performance is sustainable. This thought process can lead to taking divergent views from others.

As highlighted by the latest QV Cdn Small Cap Fund's 2.1% dividend yield relative to the benchmark's 2.9%, many of the QV funds are approaching their lowest dividend yield levels in the recent past. The backdrop of low interest rates has led to expanding valuations for firms with flat yields and no corresponding cash flow per share growth. Our discipline to the risk management process, and consideration of the price we pay for businesses has lead us to buck the trend and to focus on companies with better balance sheets and valuations over absolute dividend yields.




Source: Capital IQ, QV Investors

Qualcomm's CEO was recently cited in a Bloomberg article as saying "rather than following others into the bond market, he prefers to stay debt free. That will enable the company to keep investing in research and development even if the economy worsens". While not a holding, this circumspect approach to the balance sheet and respect for the business cycle, exemplifies the leadership we are looking for. As simple as these concepts are, more often than not we find managers who display these attributes are the exceptions.

The goal of sustainable investment performance means the search for companies that can both survive downturns and grow in the long run never ends. A few QV holdings led by teams that have been bucking trends are highlighted next.

Mullen Group, an oilfield services and trucking/logistics company, is one of the few firms in the Energy sector that has consistently generated cash flow in excess of their capital expenditures over the past five years. This can be attributed to ensuring an economic case for each dollar of investment, and not spending more than is generated by the business in any given year.  To withstand tough periods, Mullen's variable cost structure has allowed it to protect profitability. In 2009, although revenue decreased 26%, operating margins held in well, decreasing from 21% to 20%. Oil & gas activity has declined in this past year, but we take comfort in Mullen's ability to survive and generate enough cash flows to prepare for an increase in activity if it comes.

In late July, we sat down with the CEO of Major Drilling, Frances McGuire. The firm specializes in providing drilling services to both large and small mining companies. Mr. McGuire has resisted the urge to increase spending and debt during the good times. This differing financing perspective is paying off in the present environment of falling commodity prices and reduced drilling programs. Now, Major is in a net cash position while some of its major competitors have significantly deteriorated balance sheets and cash flows. As a result, the company is poised to continue to re-invest in strategic growth initiatives and potentially take market share, while other firms are downsizing.

These past examples have highlighted leadership that have bucked trends in deploying capital and balance sheet prudence, while Home Capital Group has been strategically fighting an industry trend. Concerns over an indebted Canadian consumer and inflated housing prices have most expecting flat to low single digit consumer loan growth for the financial industry. In contrast, Home Capital posted 10% growth in total loans under administration in Q2. During the financial crisis as other institutions tightened credit, Home Capital stepped into the lending dearth, and grew its insured mortgage book significantly. Currently, larger financial institutions are facing stricter lending regulations and capital requirements. Once again, Home Capital has re-positioned itself to prudently grow at above average rates through an underserved area of the lending market.

Continually striving for capital preservation and replicable growth over the long-run has raised some difficult questions at QV. It is our belief that following Mr. Market is likely a losing proposition. As investors, critical self-evaluation and conviction to buck the shorter term market trends is paramount, and we seek similar qualities in teams that lead QV businesses.