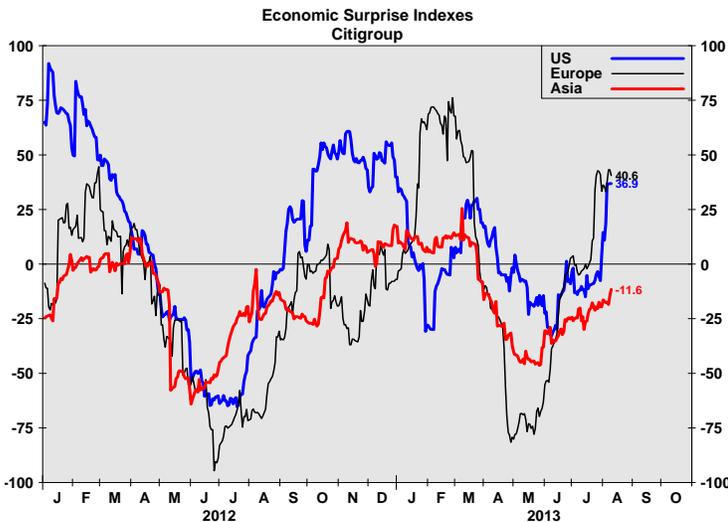


## Let the Good Times Roll!

The tone in the market seems to be improving as of late. Negative headlines are becoming scarce and economic data is generally improving. A fail-safe indicator for improving confidence reveals itself when I scan my inbox for the word “bullish” to find 21 emails this week versus half that number when I scan for “bearish”. The TSX Composite is up just shy of a modest 1% so far this year while the Dow Jones and S&P 500 are up 18% and 17% respectively and continue to set new highs. People are feeling good about it.

Recent economic data has also generally conjured feelings of comfort and confidence. In the last three months Consumer Confidence and Consumer Sentiment Indexes have broken out to levels not seen since before the financial crisis. Although the University of Michigan Consumer Confidence decreased slightly in July, it remained near the elevated pre-crisis heights. Mr. Bernanke is talking about “tapering” the stimulus and worries seem to have shifted from avoiding catastrophic crashes toward controlling inflation and bond yields as we ease back into better times. North American bond yields and equity index performance indicate that investment managers are selling bonds and buying equities. Even Europe seems to be looking better. As can be seen below, the most recent round of earnings reports has revealed positive European surprises, too. All of this happiness is making us a little bit nervous.



Source: John Aitkens, TD Securities Aug 09'13; Bloomberg

Investors try to foresee specific events before they happen and buy or sell in anticipation of what they believe is about to occur. This is why many announcements are priced or “baked” into the stock before the actual event occurs. It is for this reason that markets often lead actual economic

output. We have been in a reluctant bull market for over four years amid periods of dire headlines and concerns. Is it possible the market soon looks past these comfortable times of pleasant headlines and economic data and takes a turn for the worse based on the old adage that if it is too good to be true it probably is?

In the August 6, 2013 issue of Barron's Magazine, Oaktree Capital's Howard Marks wrote a very good note titled “The Long Term Remains Worrisome” about confidence that coincides with our beliefs. In the article he states that confidence is a self-fulfilling mechanism that has a profound influence on the market. Marks tells us that confidence is a good thing, but over-confidence is dangerous. Markets are mean reverting and they typically revert quite quickly from the upside during times of over-confidence. His partner Sheldon Stone nicely sums this up by saying “the air goes out of the balloon much faster than it goes in”. It is this hypothetical rapid deflation that worries us. In spite of the shift in tone we still feel that investor confidence is still fragile. It would not take a monumental incident to let the air out of the balloon.

At QV Investors we tend to worry more when we see that others are worrying less. We have somewhat of a contrarian element to our discipline. We believe that when investing, even if it is hard to stomach at times, going against the grain has benefits. It can fairly be argued that value investors are too early to both buy and sell, but we are willing to sacrifice some of the upside to avoid potential unforeseen problems.

We do not believe that this is the absolute top of the market or that near term devastation is imminent. High quality, well valued companies are not ancient history, but they are admittedly getting more difficult to find as markets continue to appreciate. During the last six months we have been bolstering our cash and defensive positions. Many portfolios have double the cash now than they did at the beginning of the year. Although the space has been aided by acquisitions, we also have significantly larger weights in grocery and drug stores than we celebrated Christmas with. We are not leaving the party with haste; we're just sipping water and eyeing the exit while the masses order another round.