QV Update

QV Investors

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"Where are the tens at?"

- asks Leigh, who sits behind the Bloomberg terminal. "Up five beeps and it's the same across the curve." I reply. We nod and revert to our screens. We're not traders so daily moves are not of great concern. But as long-term investors, structural shifts are top of mind. The consequences of higher interest rates are important to highlight as their effects span borders and cross assets.

Both the Canadian Government and U.S. Treasury 10-year bond yields have been in decline for three decades. We finally saw an uptick last month after Chairman Bernanke hinted the Federal Reserve might slow its bond purchase program should the economy improve better than expected. After years of manipulated interest rates, we ponder the consequences as the market readjusts to a positive real interest rate environment.

We saw mortgage refinancing activity decline down south as 30-year U.S. Treasury bond yields rose to levels not seen in two years. 30-year fixed mortgage rates rose from 3.5% to 4.5%. Raising the price of capital and lowering demand, a detriment to banks that rely on fees from mortgage refinancing to offset current low interest income. But a boon for higher interest income in the future. Short-term pain for long-term gain. We favour the financial sector as valuations remain attractive and a higher rate environment will eventually improve profit margins.

Chairman Bernanke admitted that an objective of quantitative easing is to create a wealth effect. An artificial sense of prosperity, if you will, that uses "mind over matter" to grow an economy out of a slump. Suppressed interest rates forced investors to reach for yield where they could, effectively pushing them out the risk spectrum. As government bonds provide near zero returns, capital flowed into corporate bonds, pushing prices higher and expected yields lower. High dividend yielding equities welcomed the influx of capital too, raising their valuation multiples. Our value discipline triggered profit taking, while de-risking the portfolio from excessive valuations. We trimmed our corporate bond exposure as corporate spreads narrowed to pre-recession levels. We sold our position in **BCE Inc.** (TSX:BCE) from our Canadian equity portfolios. BCE's 5.5% dividend yield and stable business were attractive. But its limited growth profile, increased competitive threat, and enterprise value-to-EBITDA multiple (6.7x) near its long run high made us exit our position to preserve capital.

Investor sentiment has improved as risk asset prices have been bid up. However, higher bond yields are likely to correct those markets that have enjoyed strong capital inflows from yield seeking investors. The wealth effect may prove ineffective when investors find its effect temporary.

Low interest rates helped many entities survive bankruptcy, so a shift in higher rates may reveal those still left scarred from the crisis. Detroit is a case in point; now the most populous municipality in the U.S. to have declared bankruptcy. City of Detroit bondholders learned the importance of credit analysis and the dangers of debt abuse. Should yields move higher, the receding tide could reveal other debt laden entities that have not kept their finances in order.

So where should rates be now? We took a risk premium approach that starts with the real risk-free rate and essentially layered inflation and maturity risk premiums to arrive at an estimated fair yield. Our 2013 estimate of the Canadian government 10-year yield stood at 3.1%, while the U.S. Treasury 10-year yield came at 3.3%. With both rates today at 2.5% and 2.6%, respectively, we anticipate higher rates still. Foreign investors are currently the largest purchasers of Canadian bonds and have been net buyers of our paper since Q1 2008, according to Statistics Canada. We view this with caution as capital can flow out of the bond market as quickly as it flowed in. Our focus towards shorter term bonds should mitigate losses from rising rates and allow us to reinvest quicker at higher yields. We remain underweight fixed income in our balanced funds.

Our focus towards businesses with good balance sheets and strong fundamentals is essential. Our internal risk management keeps us disciplined to this process. For example, as of June 2013 our Canadian large cap portfolios had a current year estimated price-to-earnings multiple of 12.7x versus the S&P/TSX Composite of 13.9x. The portfolios had a 4-year average return on equity of 17.7% versus the TSX of 14.0%. Lastly, the portfolios had a cash flow-to-debt measure of 0.6x versus the TSX of 0.4x.

We resist the urge to buy at less compelling market valuations. We weigh long-term reward with the risk of capital loss and adjust our portfolios with opportunities that surface. As the talk of tapering increases, the slow removal of the QE bandage may reveal more than the market wants to know. Our emphasis of strong business franchises with balance sheets that can withstand higher interest rates should ensure lasting value for our clients, however high the tens end up.