QV Update

July 05th, 2013 Joe Jugovic, CFA

QE's on first……

"Who's on First, What's on Second, I Don't Know is on Third…"

It seems the investing world is as confused as poor Costello was during Abbott & Costello's classic satire "Who's on First?" This quarter we've had Fed Chairman Ben Bernanke lay out the game plan for future monetary stimulus. Unlike his predecessor, Alan Greenspan, you can actually understand the relatively plain English he uses. Nonetheless, investors seemed more confused after Mr. Bernanke spoke than before. Makes us wonder how Abbott and Costello would have played this investing skit out:

Mr. Bernanke (Abbott): QE's on first, GDP's on second, and we've got Unemployment on third. If our player on third, Unemployment, improves enough we can just get rid of our first baseman QE. GDP will round out the bases for us.

Market (Costello): Hold on, hold on. You say you can get rid of our first baseman QE, but who'll play first?

Mr. Bernanke (Abbott): GDP will.

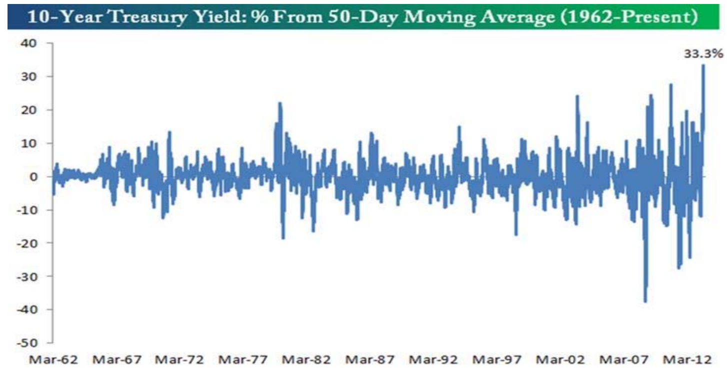
Market (Costello): But I thought he's on second?………

To many of us investing in global equity and bond markets this is what the past few months have felt like. Quantitative Easing (QE) seems to have become a permanent member of the economic team. The markets obsession with the current stimulus program and the dreadful thought that the economy would someday have to return to operating on its own seems too much to handle for some investors. How could it be that GDP could stabilise and grow on its own without QE?

The problem we have with investors' dependency on these artificial stimulus programs is the long term logic. The common perception today is if the Federal Reserve removes stimulus it's bad for the stock market. Our viewpoint is the exact opposite. Sure in the short term there will be an adjustment period, but we want the economy to stand on its own two feet sooner rather than later. We believe an exit from stimulus will likely take more time given the fragile U.S. recovery and continuing challenges globally.

Equities and Bonds Sell-off

Both equity and bond markets reacted negatively to the news that the monthly $85 billion bond buying program by the Fed would be reduced if their benchmark targets of unemployment and inflation were being met sooner. The bond market in particular has been selling off sharply for the past couple of months and this recent announcement accelerated the drop. The chart below shows the extreme volatility in bond yields we've witnessed this quarter. The level of recent volatility is higher than it's been in over five decades.



Source: BNY Mellon Global Markets

We've been concerned about the low interest rate policies and how small upward adjustments will impact a highly levered economy. We have been stress testing our businesses to ensure they can withstand a "normalizing" interest rate environment. But we must keep in mind that even if the businesses themselves can withstand these changes the economy as a whole may be much more sensitive.

Our asset mix continues to favour equities over bonds, but not to the same extent as in the recent past as we have increased our cash reserves. During this quarter we moved to further defend against the potential of rising yields by shortening the term of our bond portfolio and reducing some of our highly successful corporate bonds which offer a diminished risk/return profile. This more defensive posture allowed our bond portfolio to mitigate the large losses we may have sustained with a portfolio of longer term bonds. That being said, the recent spike in rates still resulted in our portfolios posting negative results in the period. The sell-off in the bond market has not changed our defensive strategy given our long term view.

On the equity front, the Canadian equity market as measured by the S&P/TSX Composite fell by over 4% this quarter and dragged the year-to-date return in Canada into negative territory. The Materials sector was the undisputed loser posting over a 20% loss in the quarter and a 30% loss year-to-date. Gold itself vindicated many of the frugal QV'ers who have refrained from buying jewellery for their significant others based on gold's overvaluation (or their own personal cheapness), collapsing a record 25% in the quarter.

This sector bears further discussion. When we run our equity screens many gold companies are now coming up to the top of the lists based on valuation discount. This is also true for other commodity producers such as steel and base metal companies. Yet when we take our analysis the next step we are often dismayed by what we find.

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After one of the greatest commodity booms on record many businesses have stretched balance sheets, are writing off over-priced acquisitions, and can't finance their future operations.

At the other end of the spectrum we have some high quality businesses in the utility, telecommunication, and consumer staples sectors. These sectors are typically defensive areas of the market, but not always. The investor enthusiasm for dividends and stable businesses has led to risk through stretched valuations. We have continued to trim back our exposure to these areas of the market and hold more than average cash weightings in most of our equity portfolios.

In our Canadian equity portfolios we steered clear of some of the major pitfalls in the marketplace and were able to generate a near 1% return in the QV Large Cap Fund and over 6% in the QV Small Cap Fund.

Globally, equities were mixed. The US equity market continued to lead the way, Europe was a mixed bag, and Asia (ex-Japan) and other emerging markets were dreadful with many countries positing double digit losses. The QV Global Equity Fund managed a return of nearly 6% for the period aided by our overweight in large cap US companies. Canadian investors with exposure outside of Canada benefited from the continued weakness in the Canadian dollar.

Our strategy over the remainder of the year is to continue to tread cautiously and look for opportunity to put cash reserves back to work. We continue to have confidence in the quality and positioning of our portfolios over the long term. That being said, the short term direction of markets will likely be more impacted by economic and political news. Don't be surprised to see the Abbott and Costello investing skit continue to play out for some time yet.