

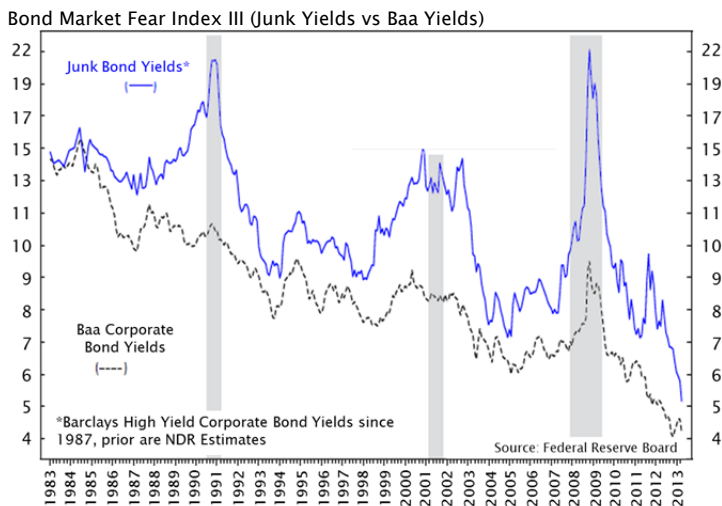
## This Time is No Different: Avoid Complacency

We've been uncomfortable equity and corporate bond bulls for over four years now. Early in our stance, discomfort spawned from headline after headline related to the credit crisis and economic recession. Investor sentiment was downright awful, reflected by corporate bond spreads that offered record wide yields and stocks trading near record low valuations.

The future, as always, was uncertain but QV was being offered very compelling potential returns to increase our exposure to risky assets. In the spring of 2009, the cash level in the QV Small Cap Fund was reduced to levels below any point in the prior ten years and the corporate bond exposure in the QV Balanced Fund was moved to its highest weighting on record. Those were uncomfortable things to do in the thick of the market's noise but it simply came down to buying quality assets at distressed prices.

Now here we are in the spring of 2013. Our angst has grown, owing to entirely different circumstances. The market pendulum has swiftly swung to a point where investors are being compensated increasingly negligible amounts to take on risk. We don't need to look further than US junk bond yields to get an appreciation for this. The chart below from the astute team at Ned Davis Research shows that over this period, junk bond yields have moved from record high levels of 22% to a meagre record low yield of 5%.

Junk Bond Yields (1983–Present)



Source: Ned Davis Research

We may have just witnessed the largest and swiftest vanishing act on record when it comes to eroding risk premiums in the junk bond market. Has the credit quality of the companies backing these junk bonds all simultaneously shifted to a new paradigm where risks associated with future default are no longer? We don't think so and we aren't alone in our thinking. In Barron's this past week, Randall W. Forsyth quoted Leon Black, who is a private equity authority with vast credit boom and bust experience:

"We're selling everything that's not nailed down. And if we're not selling, we're refinancing...The financing market is as good as we have ever seen it. It's back to 2007 levels. There is no institutional memory"

–Leon Black, Chairman and CEO of Apollo Global Management

When markets are jubilant, we need to be increasingly cautious. In QV's balanced fund we are reducing our corporate bond exposure with a marked effort to improving credit quality.

In equities, our angst is also growing but equities are still our favoured asset class. QV continues to be attracted to the compounding features of high quality companies and the relative earnings yield offered by stocks compared to bonds. For example, our largest holding in our large cap equity fund, Shoppers Drug Mart, has a proven ability to grow earnings and dividends in good and bad times alike, has an investment grade credit rating, yet offers an earnings yield of around 7%. This is well above bond rates offered by many less attractive business franchises. Valuations in our equity funds are higher than they were four years ago but are similar to long term averages. Below is a snapshot of the P/E ratio for the QV Small Cap Fund:

QV Small Cap Fund P/E Multiple Summary

	15 Year			
	Average	Apr 30'13	Minimum	Maximum
P/E Multiple	13.65x	13.70x	9.00x	17.71x

Source: QV Investors, Capital IQ

It is increasingly difficult to find new high quality investments that can generate attractive absolute returns over an investment cycle. We can't be complacent, simply because equities look relatively good compared to bonds. At this point in the equity bull market, now is a good time to correct past investment mistakes and shun equities with debt levels that could become problematic in more difficult periods.

When others are leveraging up (margin debt recently hit a record high), we don't need to follow an increasingly exuberant herd. Debt levels carried by companies in our equity funds remain at the low end of historic ranges. This should position our funds better than others during an eventual downturn. A desperate reach for yield in junk bonds and high dividend paying equities has caused us to reduce exposure where valuations are becoming excessive. This is moving our equity fund dividend yield lower than the market but has allowed us to maintain better valuation, growth and balance sheet characteristics.

As the old saying goes, "What the wise man does in the beginning, the fool does in the end". Chasing yield whether in junk bonds or equities at this point in the market cycle feels like a game for greater fools. We make no predictions of an end to the current bull market but are making adjustments where necessary. We expect our increasingly defensive actions to payoff over time.