QV Update

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Quality companies…at a price.

As most of our readers know the Q in QV Investors stands for quality. Our goal is to build high quality diversified portfolios which both protect downside and provide an adequate total return. That all sounds nice, but really what is "quality" and why does it matter?

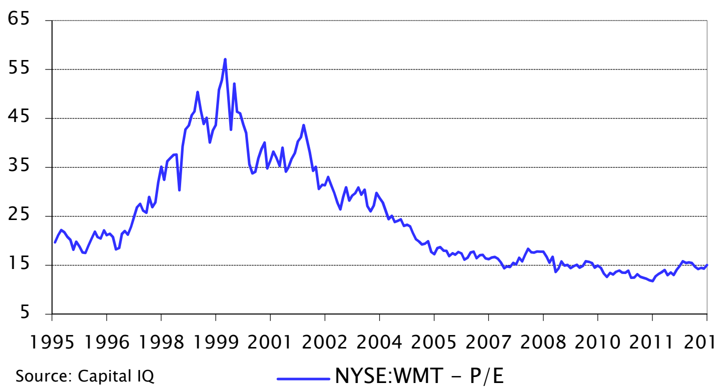
We start with the simple observation that our odds of investment success are dramatically improved if we invest in a quality business. Speculating in pre-revenue or concept stocks may work at certain points in a cycle but they leave you very little margin of safety, therefore we don't do it.

We define quality as a sustainable business with a defined track record of building shareholder wealth. We're looking for companies which allow us to take out much of the guesswork in forecasting economic growth, technological change, commodity prices etc. This leads us to companies we define as being durable. A durable company can survive in many different economic circumstances. By studying how a company has generated returns on capital in the past, particularly in difficult periods, it gives us confidence in the future.

So does quality ensure a good return? Here comes the twist… sometimes. The other part of the equation is value. If you overpay for a speculative company or a quality company, you still take on valuation risk in your investment. The difference though is that the quality business may absolve your buying sins by growing into its valuation (higher earnings will shrink your P/E). The speculative business may never do this. This aspect of the company being able to grow into a higher valuation provides somewhat of a safety net for the investor.

Quality usually commands a premium, but not always. The question we tend to battle over internally is how much more would we pay for these better businesses. Does the fact that it's a good business allow you to turn a blind eye to a very high valuation?

Don't be fooled, investors can lose a lot of money in so called "high quality" businesses if they are bought at extremely high multiples (Microsoft in 1999). Alternatively, they may be what is referred to as "dead money", which is a share price that over time just goes sideways. Consider Wal-Mart which we currently own in the QV Global Fund. The return on equity over the past couple of decades has consistently been above 20% with sustainable growth in earnings. Yet in 1999, the shares were trading at over 40 times earnings creating over a decade of "dead money". It took more than ten years for the earnings to grow to justify the multiple. Back in 1999 the ROE was 22%, today the ROE is about the same. What is different today is that the valuation multiple is about one third of what it was back then. Wal-Mart is still a quality business, but now with a much more reasonable valuation.



Source: Capital IQ

We find many high quality and desirable companies trading at what we consider rich multiples. Businesses with P/E's of 20-25 times plus only provide a 4%-5% earnings yield, this generally provides a very small margin of safety and we've steered away from introducing such ideas. When investors pay these types of multiples there is very little that can go wrong. If we own such names we have either trimmed or sold these holdings in the past couple of months. There are still a number of quality businesses that trade at reasonable multiples and we have been adding to them.

In the QV Global Equity Fund we have added to China Mobile which has an excellent track record, no debt, a 4% dividend yield and trades at 10 times earnings. They are facing competitive pressure but the multiple indicates the worries are built into the price. In the QV Canadian Equity Fund we have added to our holding in Shoppers Drug Mart. It is one of the few companies we know our macro thesis will prove correct; people get older with time and will spend more on healthcare. The shares have been held back with the government clawing back fees on generic prescriptions. This is a short term headwind and will not impact the franchise value of shoppers. In the QV Canadian Small Cap Fund we have added to Empire Co. as it still only trades at 1.2 times book value and has a very consistent record of growth.

Quality matters as it allows you to invest in companies which consistently compound returns. Value matters because it protects the compounding.