Record Highs, Record Lows, and Somewhere in Between

We all operate in a world of uncertainty; not knowing very much is a terrible untold truth. Yet, the energy that goes into trying to figure things out can be downright exhausting at times. It seems logical to assume that the more we research and study, the greater our confidence will be in our outcomes. The irony of investing is there is no guarantee that deeper analysis will result in more accurate conclusions. We have to accept that when investing, uncertainty is a given, and anything else is often a delusion.

The current environment has a number of issues which will impact future outcomes. This is evident in the daily market swings surrounding the discussion of the Federal Reserve raising rates, Greece's potential bankruptcy, and the continuing tug of war between inflation and deflation. We consider how these issues may impact our portfolios, but don't base our investments on the certainty of any of these outcomes. Our crutch has been to focus on businesses which can manage through the next crisis. We assume it's coming, but don't know when, nor why.

RECORD HIGHS – With the continued focus on the above mentioned uncertainties, volatility and dispersion in global equity returns characterized the past quarter. U.S. markets closed near all-time highs, Asian markets were some of the best absolute performers, and Europe finished lower. The Canadian stock market was down as well during the period.

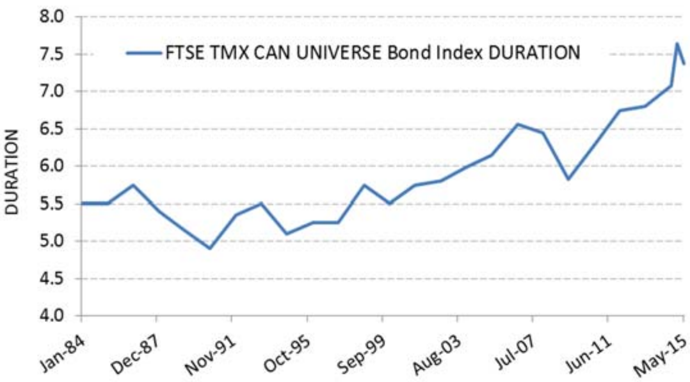
Canada seems to be losing its lustre with global investors, not to mention domestic ones. During the 2008/2009 recession, Canada became a safe-haven marketplace admired for its stable and conservative banking system. Prior to that, for nearly a decade it was a source for global investors to leverage off a massive commodity cycle. Today, more and more we hear the reasons investors should look elsewhere. On a daily basis, there is no shortage of articles featuring the debt load of Canadians or the upcoming real estate crash.

Oil prices add to the nation's economic uncertainty, and with oil's fall we've seen the associated weakness in the loonie. The negative sentiment on the Canadian economy and stock market is creating opportunity for investors willing to withstand volatility. The benefit that comes with volatility is an improved margin of safety as valuations are becoming more attractive.

Our equity mandates struggled to keep up with their respective benchmarks in the past quarter and in some cases posted negative returns. Our small cap Canadian equity strategy increased by approximately 1.1%. Our large cap Canadian equity strategy declined by approximately -2.9% on stock specific weakness, while our global equity strategy decreased by -0.8%. The Canadian balanced strategy was down by -2.0% as both the equity and bond component lost ground during the past three months.

RECORD LOWS – In our most recent quarterly review we highlighted the extremely low yields investors were settling for in Europe and the resulting impact on global bond yields. This trend continued briefly into the 2nd quarter before sharply reversing. Ten-year German Bund yields were as little as 0.07% before surging to nearly 1.0% in less than two months. Bonds sold off in most geographies, leading to losses for bond investors in the quarter.

Our defensive bond strategy minimized losses given our short duration positioning. As a reminder, duration measures how sensitive your bonds are to changes in interest rates; the longer a bond's duration, the more sensitive it is to changes in rates. Our current duration sits at 4.3 years versus the index at 7.4 years. This hampered our relative return last year as yields fell. The following chart illustrates that for much of the period in between 1985-2005, the duration of the market benchmark was between 5-6 years. It is only in the past decade that the index duration has moved up to this new all-time high in Canada. Investors mimicking the bond index are exposed more than ever to changes in interest rates at a time when rates are near record lows. We remain positioned to minimize losses rather than maximize returns.



Source: FTSE TMX Global Debt Capital Markets, QV Investors Inc

SOMEWHERE IN BETWEEN – We remain cautious towards the global asset price reflation fueled by continued easy monetary policy. Our view has not changed in this respect and we are concerned on how the economy and markets will eventually operate as stimulus is removed. This assumes stimulus actually gets removed. We know there has been a marked response by investors to these low rates, but global economies remain mixed and the majority of them are struggling to sustain growth. We expect global economic growth to be maintained at the lower end of historical ranges as aggregate demand continues to be weak. If this is correct, stimulative policies may be with us for some time yet, providing continued support for asset prices. The longer this continues, the more challenging the transition back will be.

Investors have been waiting for quite some time for a market correction as this bull market has continued to climb the proverbial wall of worry. The popular averages, such as the S&P 500, continue to resist a broad based sell-off. Underneath the surface, though, the market has been going through what some refer to as a rotational correction. In this type of pull-back, certain industries or similar types of businesses see their share prices decrease while the majority of the market either treads water or edges up. We highlight a few examples.

- Early this year we noted that many large, multi-national U.S. companies sold off as the strength in the U.S. dollar negatively impacted their earnings. As the overall market marches upward, these companies' valuations start to look more attractive.
- Energy related businesses have seen a sharp sell-off from their highs last year and rightfully so. There are many businesses which have strong balance sheets and high quality assets. They will survive this downturn and offer better value today than this time last year.
- Banking and insurance franchises have been challenged in this low interest rate and uncertain regulatory environment. We think there is little optimism priced into their shares.

Market corrections don't always look the same. They can either be a swift sharp drop, or a meandering sideways movement that over time accomplish much of the same. Many businesses we own have not been moving to new highs alongside the market. In fact, a number of our holdings have experienced the types of corrections we mention above. We are confident that they will provide support in a different market environment. Alternatively, the very expensive companies which are playing the role of market darlings in this cycle will likely not fare as well.

For every highly priced company, sector, or geography, there is usually $1.00 that has been transferred from another asset. We continue to look for those assets that are somewhere in between the extremes, and offer us the ability to build sustainable portfolios at reasonable valuations.