QV UPDATE

Weekly Commentary | July 17, 2015

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Risky Business

One of the fundamental principles of investing (and life for that matter) is that in order to reap rewards, one typically must assume a certain degree of risk. Different people have different definitions and tolerances for risk. A race car driver going into the final lap and a school bus driver probably have different perceptions of what is risky. Dictionary.com defines risk as an exposure to the chance of injury or loss. Investopedia defines risk as the chance that an investment's actual return will be different than expected. QV Investors defines risk as the probability of enduring a permanent loss of capital.

Financial investment exposes one to a seemingly endless number of potential risks. Taking a page out of Bubba's book from the movie Forrest Gump, as he lists his favourite shrimp concoctions we must consider valuation risk, liquidity risk, risk from lack of growth, balance sheet risk, cyclical risk, diversification risk, political risk, geographical risk, risk from volatility, timing risk and the list grows on. These risks essentially boil down to the all-encompassing downside risk. We can actively monitor and somewhat limit certain risks while others are predominantly out of our control. Though we consider all risks for each investment, only a few of the more common ones will be discussed in this update.

One of the most difficult risks for us to avoid is liquidity. When we have great conviction in the companies we invest in we will own substantial portions of their shares outstanding. Although we offset much of this risk by holding at least 25 companies in each mandate and have soft-capped our Canadian Small Cap Strategy, we are still exposed.

As value biased investors, we take valuation risk very seriously. We mitigate valuation risk by trimming, or selling outright, companies when their valuations get too lofty and reinvesting the cash in companies that are trading at more reasonable multiples of their underlying earnings, book value and cash flow. Exercising copious due diligence is essential to avoid buying "value traps". A value trap is a company that is trading at a low valuation because it is fundamentally broken and will most likely never revert to average or higher price levels.

Balance sheet risk, or leverage, is also something we track carefully. By investing in well financed companies with strong balance sheets, we decrease the odds of owning bankrupt companies when the market falls. Although these companies will likely have somewhat muted performance in bull markets, they should emerge stronger from bears. For this reason, managing leverage lessens cyclical risk, as well.

An acute focus on valuation makes it easy to overlook growth potential. This is the essential difference between momentum and value investment styles. We keep an eye on return metrics in our monthly risk management review and aim to find a combination of stocks that provide future growth while maintaining attractive value.

Diversification is the exercise and healthy diet of investing. It offsets, in some capacity, just about all risks. Some companies have immense exposure to certain risks, but when they are considered in the context of an entire portfolio they can become great investments.

Our risk management practice is the primary tool for monitoring these risks and it forms the backbone of our investment process. Leigh Pullen and Wendy Booker-Urban instilled this discipline at our firm's inception almost twenty years ago. It has changed very little in that time and will remain as it is for many years to come. Because this process is firmly in place, all equity mandates from our Canadian Small Cap Strategy to our Global Equity Strategy bear strikingly similar fundamental characteristics.

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