QV UPDATE

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Disruption

Change is the law of life. And those who look only to the past or present are certain to miss the future. – John F. Kennedy

I was on holidays recently and my son, who is five, asked me if he could watch his favorite cartoon, Team Umizoomi. I said that it was not on as I flipped through the channels on the hotel TV. He didn't understand. At home, he just has to select it on a service such as Netflix and he can watch it anytime of day. This is incredibly different from the days when I wanted to watch Miami Vice. I had to wait until Friday night and if I missed it, I had to get the update on Crockett and Tubbs the next day. I also didn't have the choice to record it and skip through the commercials as I watched at a later date.

One part of our job is to determine potential disruptions to the businesses we own. One of the biggest dislocations has been the advent of the internet and its delivery of TV programs.

In 2006, QV invested in Astral Media. At the time, it was the largest specialty and pay TV distributor in Canada. Through an exclusive long-term license with the channel owners, Astral offered specialty channels, such as HBO, by subscription. The stability of the business was enviable since 60% of Astral's revenue was derived from channel subscriber fees, which at the time were very stable. This was different from traditional network broadcasters like CTV, which were heavily exposed to more volatile advertising revenue.

In the summer of 2010, Netflix announced it would enter Canada. The pressure mounted over the following years on Astral Media due to the decline in the number of people subscribing to pay TV channels. Astral's strong management team was adjusting adequately with new offerings. Moreover, Astral was still very profitable. BCE was attracted to the high returns resulting in the takeover in 2013, at a large profit to QV.

In QV's balanced and large cap strategies, exposure to this disruption is now through our holding of Rogers Communications. Rogers' exposure to television is about 20% of total revenue. People are increasingly watching TV online or Over The Top (OTT) as it is called and cutting their cable. This reduces Rogers' cable subscribers and the revenue from its various channels. The one offset is as consumers use services like Netflix, they require the internet and additional bandwidth provided by Rogers.

Sports content has been slow to adapt to online. The reason: fans want to watch their teams live. It isn't much fun watching a game when you already know the final score, so Rogers has tried to mitigate its media content decline through sports. In November 2013, Rogers announced a historic 12 year deal with the NHL to broadcast games nationally. The first season was just completed and it was hailed as a success. However, we are still monitoring various disruptions. For example, this week the NHL signed a deal with an organization that will take over the rights and distribution of out-of-market games (smaller US cities and internationally) and the operation of NHL.com. The delivery of content is changing and although it may be offset as suggested above by charging more for the internet, it may not be enough. Declining clarity relating to the long term value of the TV assets is one of reasons we lowered our exposure to Rogers.

Other Changes

We reduced the asset allocation in the QV balanced strategies this week. We have moved our balanced strategy from 55% equities to 50% equities. We continue to bring the equity weight down since equity yields have declined further and remain below their respective averages. We also feel the more historically defensive areas of the market have higher than average valuations. The yields in the bond market continue to be at very low levels versus their history. A goal at QV is to try and protect capital in down markets. Reduced equity exposure, lower than average duration in the bond portfolio, and higher than average cash levels in the balanced strategy should assist in protecting capital.