# QV UPDATE

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## Quality Conundrum

Numerous high quality companies are trading at or near record high valuations. High quality traits include earnings stability, above average earnings growth and superior returns on capital deployed. QV's portfolios have abundant exposure to businesses exhibiting these traits. For the most part, they have been strong contributors to portfolio performance over the past five years. Going forward, we suspect contributions will be more subdued.

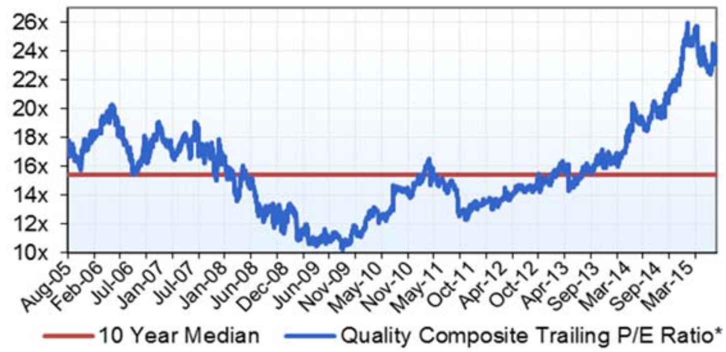
Below are ten-year stock charts of three high quality businesses owned in QV's Canadian equity portfolios. The first is Metro Inc., one of Canada's largest grocers. The second is Winpak, a consumer goods packaging company. The last is Stella Jones, a railway tie and utility pole producer. Each business provides unrelated services targeting different clientele. Despite significant underlying business differences, each chart looks remarkably similar.


Source: StockCharts.com

QV admires each of these businesses but we must be cognizant of today's quality conundrum. With near record high valuations, many quality businesses offer less downside protection today than investors have historically been accustomed to.

To provide some context, below we have blended the aforementioned equities' trailing P/E ratios over the past ten years:

**High Quality Canadian Companies Are Trading Well Above Historic Median Valuations**




*consists of Metro, Stella Jones and Winpak

Source: Capital IQ, QV Investors

We recognize that this is a small, three stock sample. Nevertheless, we are witnessing the quality premium phenomena across numerous non-financial, non-cyclical businesses. Why is quality currently commanding a lofty premium? First, in a slow/low growth economy, growth is hard to come by. As a result, some investors are increasingly willing to pay a greater premium today for tomorrow's expected growth. Second, Canada is not a very broad market so non-resource, high quality companies have garnered an increased amount of investor interest as money has flowed out of resource equities. Because of these dynamics, high quality stocks are increasingly vulnerable to negative growth surprises, or sector and style rotation.

To mitigate heightened valuation risk, we have exited some investments and reduced exposure in others. For example, the average weight of Metro, Stella Jones and Winpak, in their respective portfolios three years ago was more than 4%. Today, the average weight is less than 2%. We still see a path to positive returns in these businesses, but are mindful that each carry augmented valuation risk. There are a number of high quality companies that will grow out of hefty valuations, others will not. High quality companies are not always high quality stocks. We remain focused on investing in quality businesses, but not at any price.