Ryan Watson, MBA, CFA

QV Investors Inc.

Healthy Developments

A balanced diet is part of a healthy lifestyle. In many diet programs the periodic "cheat meal" is encouraged in order to stay on track with the long term goals. Like the cheat meal, volatility is a necessary part of maintaining a healthy stock market. When a high level of negative volatility occurs, it usually reminds us of the realities of market risks and how complacent investors have become.

The frequently cited volatility indexes, or 'fear gauges,' created by the Chicago Board Options Exchange spiked earlier this week to levels in excess of 50. This is a six-year high. The average reading going back to 1997 is 20, and markets are deemed fearful at levels above 30. Consider that over the past 19 years the market (in this case, the Dow Jones Industrial Average) has been fearful in one out of every nine trading days. As we would imagine, investors are typically more optimistic than they are fearful. However, over the past five years the ratio has moved to 1 fearful day out of every 27 trading days. It is reasonable to assume that a lack of adequate options for yield has forced investors to hold on to equities for longer. As a result, when concerning news emerges, such as a slowing Chinese economy or a potential U.S. rate hike in September, equity market volatility is amplified as complacent investors are given a jolt.

That being said, equity markets can also bounce back very swiftly on positive headlines, such as a revision of U.S. second quarter real GDP from 2.3 to 3.7 percent or an unlikely U.S. rate hike in September. Following the rally in the second half of this week, the Dow is down nine percent from its peak in May 2015, and the Dow Volatility Index (VXD) has settled back under 30. It seems that for now, fear has again subsided.

We don't know if the end-of-week rally is sustainable. However, we do expect more frequent spikes in volatility given the last five years of complacency. In such an environment there is greater potential for market noise to lead to corrections. But we believe this will help realign company valuations with their fundamentals, thereby creating opportunity for stronger long run returns. The key is to be advantageous with these corrections. As Mr. Buffett says, "Be greedy when others are fearful and be fearful when others are greedy."

Rather than track the above mentioned volatility indexes, QV prefers to monitor equity valuations as a measure of investor sentiment. As we have stressed for some time, we feel valuations in most markets are at the upper end of fair value. Therefore, we get excited by the potential to increase our ownership of excellent businesses at attractive entry points, which market corrections can provide. There are plenty of businesses still generating attractive returns on equity (ROE). Many of which can be found across sectors in the worrisome, resource-centric Canadian market.

The S&P/TSX Composite Index (TSX) has an ROE today that is near its historic median level of 10 percent (see table below). The 2016 estimated ROE is not far above this level either. ROE has normalized from the average of nearly 15 percent achieved between 2005 and 2014, when robust resource prices prevailed. Deconstructing the TSX into its sectors we find that seven out of ten continue to exhibit healthy double-digit ROE's. To roughly gauge the sustainability of this growth, several sectors are within five points of their historic medians. When we consider valuations alongside ROE, only four sectors seem to provide an earnings yield in excess of today's 5.9 percent on the TSX: Industrials, Consumer Discretionary, Financials, and Telecoms.

TSX Sectors Return on Equity* - Today & Historical

Sector	Today - Aug-15	Historical (2002-2015)		
		Median	High	Low
TSX Index**	11%	10%	17%	4%
Energy	5%	15%	49%	0%
Materials	4%	10%	16%	3%
Industrials	22%	15%	24%	10%
Discretionary	15%	11%	16%	7%
Staples	12%	13%	41%	11%
Health Care	48%	12%	71%	5%
Financials	12%	14%	25%	11%
Technology	14%	13%	30%	-31%
Telecoms	20%	15%	60%	9%
Utilities	6%	10%	42%	2%

*Calculated as 12M trailing EPS over book value per share
**TSX data starts in 1981

Source: Scotiabank GBM Portfolio Strategy, Thomson Financial, CPMS

Canada remains a good place to invest in sustainable ROE businesses. Though, a little more volatility may not be a bad thing if it facilitates a healthy balance between growth and value.