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Welcome back to…

Investors and many school children alike were treated to an unhappy summer end as September began. Some (un)fortunate children began the school year prior to Labour day, and close to -3% one day returns in the S&P 500 and TSX Composite welcomed investors into September. For many, the recent volatility likely heightens the probability of psychological misfires and poor decision making as investors misuse two of the most powerful assets in their arsenal, time and risk. Although somewhere, astute children eagerly awaiting new teachers and friends, and investors who successfully executed the 'sell in May and go away' trade, likely cheered and jeered.

Time, when utilized effectively can be an investor's best friend. The beauty of compounding works over years, as 'returns' on 'returns' start to multiply. Total returns benefit further from lower trading costs. Losing sight of the long-term and focussing on the short-term can make time a frightening concept as the markets whipsaw by the minute. The threat of further near-term losses begins to loom much larger and more painful than the potential for long-term purchasing power protection. There should be no mistaking that at QV, we collectively believe equity valuation risks are higher today than in the past several years, supported by the manipulated bond yields across the globe. However, we are equally ardent believers that chasing Mr. Market has a lower likelihood of success than managing the risks of being invested in the equity markets. So when it comes to making investment buy, sell and hold decisions, we believe time is going to prove a much more faithful advisor than Mr. Market in this upcoming year.

With the market's volatility and 'down' days picking up steam relative to the past few years, investors' loss aversion also becomes more acute. The S&P 500(USD) is down ~8% year to date; however, this is following four out of five calendar years posting healthy double digit returns. A poll of academic and practitioner estimates on long-term equity returns would likely peg them in the mid to high single digit range. Today, factoring in the past five years of above average equity returns combined with valuation expansion, record margin debt levels, and cheap debt fueling acquisitions, a correction or check back would seem more normal than abnormal. Perhaps even healthy. Given this proposition, although time is an investor's friend, we believe timing has a more mixed record for most. Therefore, how is an investor to utilize time in this current investment environment? Regardless of investment style, philosophy or definition of risk, risk control or management and consistent process are going to be crucial.

It would be a mistake to allow the recent returns and potential loss aversion to translate into complete risk aversion. An essential aspect of investing and future returns is accepting unknown outcomes and taking risk. Risk can come in many forms: market risk, valuation risk, credit risk, industry risk, and company execution risks, to name a few. The backdrop of a double digit return profile of the past five years and generally lowered return hurdles has had QV on guard. As a result, we have been lowering balance sheet risk across most portfolios and reducing valuation risk. That said, we are also selectively taking risks when appropriate.

A prime example is QV Small Cap holding, Yellow Pages. The firm is facing industry and company specific execution risk. Yellow is managing the secular decline in the telephone directory business and must transition its core offering to an online and service oriented platform. Led by CEO Julien Billot, who was involved in a similar process in France, the firm now generates 57% of revenues from online sources compared to 33% three years ago. Over this period, Yellow has also generated enough free cash flow to repay over $300mm in debt. The firm's current balance sheet with ~$500mm in net debt is not as strong as the overall Small Cap portfolio's leverage position. A few factors mitigate this risk. Cash flows and a commitment from management to repay debt will put Yellow in close to a debt free position by 2018. Also, in aggregate the portfolio maintains historically low debt levels. Trading at 6x earnings relative to the TSX Composite at 17x, we believe Yellow has a profile which offers over time, both continued risk reduction and eventual growth in earnings and multiple.