

Dynamic in Approach, Grounded in Principles

This week is rich with illustrations supporting the old adage *“the only constant is change”*. Nortel’s market cap is less than \$100 million today compared to \$380 billion at its peak. Jim Flaherty’s estimate of the budget deficit is now projected to be a record \$50 billion compared to \$34 billion three months ago. Conan O’Brien is taking over the reigns from Jay Leno on the Tonight Show. Although all of these are tremendous headline grabbers, they aren’t the news getting the most airtime at water coolers. That spot is reserved for the famous red haired comic book character named Archie Andrews. Apparently after over sixty five years of chasing girls, he has finally decided to marry Veronica Lodge.

In portfolio management, adapting to change while being steadfast in principles is critical to success. There has been significant change over the past year. One positive development has been on the valuation front. Many people talk about how stocks are cheap after last year’s punishment, but how cheap are they? We monitor market valuation closely; it is part of our risk management process. Last year at this time our small cap portfolio was trading at around 1.6x book value. Today the situation is much different. The amount being paid for net assets has declined considerably. The price to book value for the Fund in March was the lowest level in more than ten years of history. The chart below graphically represents the compression in valuation:

A year ago approximately ten percent of the companies in the portfolio were trading at book value or less. Today, nearly half of the companies trade at book value or less. The price to book measure is not a valuation outlier. All of the portfolio’s valuation metrics look much better today than at this time last year. On a price to earnings (P/E) basis the fund is trading at 10.6x trailing earnings compared to 14.8x a year ago. The Fund now offers a dividend yield of approximately 3.5% compared to 2.9% at this time last year.

So how do we respond to this change? At this time last year the Small Cap Fund had approximately 12.2% in cash. Currently that level is less than 5%. We have many doubts related to sustainable “green sprouts” but a lot of risk is priced into the small cap market. We must always try to distinguish between what the risks are versus how much those risks are being priced into the market.

For clients with a long time horizon and a tolerance for higher volatility, small caps offer a distinct advantage to other areas of the market. The larger companies as measured by the S&P/TSX have declined in value but trade at a significant premium to small cap stocks at around 1.6x book value compared to 2.6x a year ago. QV’s large cap and balanced fund’s trade at an attractive discount to their large cap benchmark at approximately 1.3x book value.

Despite the ever changing environment, whether it is a bear market or a bull market we remain committed to our philosophy. A stock has to be more than “cheap” to warrant investment. We need to see a sustainable competitive position and good stewardship. We limit the number of investments to a maximum of 40-45 names. With those businesses, we need to be comfortable that their business models are not broken by the current economic hardship. Part of the approach we take is illustrated by another old adage: *“You can’t kiss all the girls”*. Maybe Archie Andrews is starting to think that way too.

