QV Investors

QV Update

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Ian Cooke, CFA

Why the Materials Underweight?

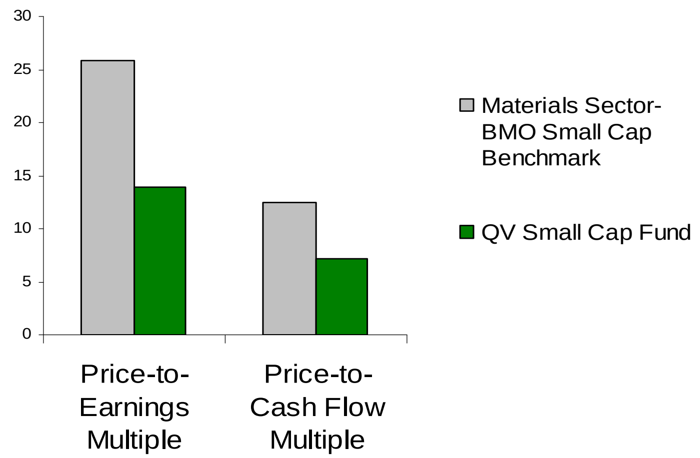
The index that we get benchmarked against has a 31.9% weight in Materials. The QV Small Cap Fund is underweight the sector with an 11.0% weight. Sometimes we get asked why we are taking on such a big risk by being so underweight. We don't see this positioning as a big risk. Our job is to preserve and grow capital, not to mimic the benchmark. Eyes at a race track tend to focus on the horse with the best recent race record. In investing, sectors with successive years of outperformance tend to garner the most attention. Indices can become overly skewed to areas of the market at exactly the wrong time. This is akin to betting on the fastest horse when the bookie is gladly offering the worst odds.

Investing in cyclical sectors tends to be riskiest when much of the investing public forgets about their cyclical nature. Today, material stocks are sometimes cited as secular growth businesses driven by an insatiable demand from emerging markets. Even if emerging market growth causes metal demand to grow at an above average rate, supply cannot be ignored. Take copper as an example. In an environment where US GDP is again expanding and Chinese GDP has moved back into double digit territory, copper inventories stored at official metal exchange warehouses have doubled during the past six months. Despite this, the price of copper has remained stubbornly high at $3.30/lb. The last time inventories piled up to current levels copper was trading at less than half its current price. For copper prices to remain high, other elements supporting the price must remain intact. Copper has benefited from a weak US dollar; it has acted as a store of value in a world that has less and less confidence in paper money. Although these support mechanisms could remain, our primary rationale for investment is not based on a broad macro call. Macro calls are difficult to get right repeatedly. We prefer to invest when we are confident to make money rather than when we are hopeful to make money.

For arguments sake, let's assume that the supply and demand equation was balanced. We would still maintain an underweight position for two reasons:

1) We can find better bargains elsewhere

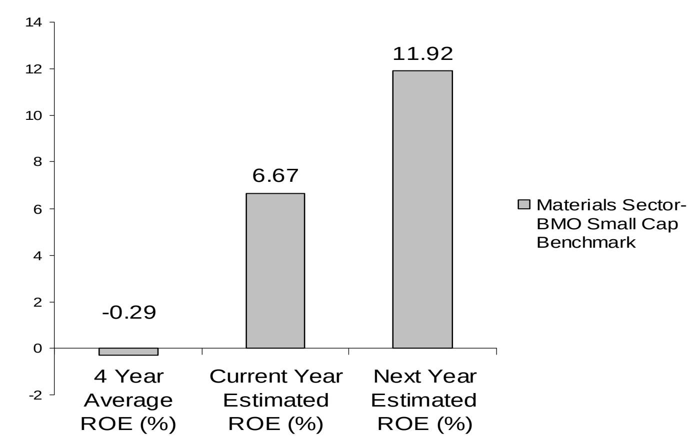
The following chart compares the price to earnings ratio and price to cash flow ratios of the BMO small cap materials sector to the QV Small Cap Fund at the start of the year. For the most part, we are finding much more value in investments outside of the Materials space.



Source: CPMS & QV Investors

2) Expectations appear dangerously high

According to analyst estimates, Material sector profits are anticipated to be plentiful in 2010 while accelerating further in 2011. According to CPMS, the Materials sector is expected to grow at a faster rate than any other segment of the market.



Source: CPMS & QV Investors

As a result, many Material stocks are garnering valuation multiples based on already high expectations. In investing, this combination is often as sturdy as building a five story building on a two story foundation. We are early on this call, and we may be wrong. If we are it won't be the first time and all would not be lost, as our portfolio is grounded with solid investments. When it comes to this sector, until value and expectations are more skewed in our favour, we believe there are better horses to bet on.