

Good Debt and Bad Debt

I recall watching a PBS documentary a few years back titled *Secrets of the Parthenon*; it described the historic significance and intricacies of this ancient Greek temple. It was and remains a majestic architectural achievement, made entirely of marble and limestone, and fabricated with such extreme precision in an age of manual technology. Built in 438 BC, this Athenian temple has survived centuries of harsh weather, rocking earthquakes, looting of its sculptures, and a damaging explosion when it was used for munitions storage in the 1680's. Despite all this, it still stands as a lasting monument of ancient Greece.

Today, it is apparent that the Greek Prime Minister, George Papandreou, is regretting the billions of euros wasted in government spending over the years, as he frantically seeks to reduce his nation's unsustainable debt. Recall that in May 2010, Greece received a €110 billion bailout package from the EU and IMF to be repaid in three years. The Prime Minister's plan to raise €50 billion through privatisation sales of government assets (utilities, infrastructure and state-owned land) in the next two years comes timely as the market pushes Greek bond yields to record highs. This week, the two-year Greek government bond yield rose to 25.4%, an extremity when compared to the two-year Canadian government bond yield of 1.8%. (Recall, rising bond yields equal lower bond prices) Clearly the market is losing faith that the nation can repay its creditors, forcing Mr. Papandreou to "sell the family silver" in efforts to lower national debt levels. Indeed, years of excess spending have caught up.

At the same time, a similar situation has received increased attention across the Atlantic in the United States. Last week, the credit rating agency Standard and Poor's, affirmed its AAA rating on the U.S., but revised its outlook from 'stable' to 'negative'. This announcement comes at a time when the American public debt level is nearing an unmanageable threshold. In Mary Meeker's report titled *USA Inc.*, the author explains how the current Federal debt level of \$9.1 trillion is dwarfed by the net present values of unfunded entitlements in social security (\$7.9T), as well as Medicare (\$22.8T) and Medicaid (\$35.3T) programs. Not to mention the nation's large defense budget, estimated to be 24% of total expenses, as it fights in multiple campaigns around the world. This was further commented on by PIMCO's Bill Gross in his April letter titled *Skunked*, that when accounting for these massive off-balance sheet liabilities, the unrecorded U.S. debt nears 500% of GDP! This is no secret as Ben

Bernanke, Chairman of the Federal Reserve, commented in this week's press conference that the American fiscal deficit remains a large economic threat to the nation. Now with S&P closely watching, Washington faces a potential credit downgrade if austerity measures are not effectively implemented.

There seems to be an ongoing theme here that both countries are over borrowing to support their economies. Borrowing is not necessarily a sin, if one is able to use the proceeds to invest and generate an adequate return to repay its creditors. The crux of the matter lies in whether an individual, a firm, or a sovereign borrows to consume, which we call bad debt, or borrows to invest, which in our view is good debt. The difference being that bad debt shuns the inevitable, while good debt not only welcomes it, but should reward as well.

Disciplined to Quality

At QV, we invest in firms with strong balance sheets and that are disciplined to use equity financing to generate consistent returns for shareholders. We also invest in quality debt securities of similar firms that do not over leverage, that spend within their means, and efficiently employ capital to make timely repayments.

The QV Small Cap Portfolio averages a long-term debt to equity ratio (D/E) of 38%, lower than the BMO Small Cap Index of 52% D/E. The QV Small Cap Portfolio also averages a cash flow to debt ratio (CF/D) of 48%, versus its BMO benchmark of 29% CF/D. Similarly, the QV Large Cap Portfolio averages a D/E of 50%, compared to the S&P/TSX Index of 51% D/E. As well, the QV Large Cap Portfolio averages a CF/D of 54%, higher than the TSX with 45% CF/D.

As we hold capital preservation as the first rule of investment, we prefer, amongst other things, companies with ample financial flexibility to weather unpredictable downturns. We believe that this disciplined investment style can generate consistently positive returns that will fare better in the long run than returns with higher volatility. We believe investors that realize consistently positive returns throughout all phases in a market cycle can fully capture the benefits of compound interest to grow their capital base over a long time horizon. In short, constructing a high quality portfolio that can withstand the tests of time and hold up to random systematic shocks is metaphorically similar, we trust, to building an enduring architectural achievement.