

## A Bull Market in Optimism

A year ago, pessimists were a dime a dozen. We would not sell ourselves so cheaply but we were among them. Some might accuse QV Investors of feeling good about feeling bad. We were bearish three years before the crack in equity markets in 2007 and the rout in 2008. We like to think a value-based approach to investing has provided stability and a reliable return for clients over the last few volatile years. Despite last year's market advance, we have not changed our cautious minds. However, last year "investors" became more optimistic with every notch up in commodity and equity prices.

At the outset of 2010, bulls had become a dime a dozen and hit a peak in zeal at the end of January. By almost any measure of investors' emotion e.g., cash holdings in mutual fund accounts, trailing valuations, bull to bear polls, rates of change in share prices, speculative commodity and currency positions, spread compression in the bond market and year over year value comparisons, we have had a bull market in good feelings. In the first week of February, the optimism is souring and rolling over.

## A Litany of Limitations

The failed funding of Greece appears to be unnerving markets and extending the list of countries in a fiscal fix. With the realization that the "Grecian Formula" may cover gray hair for a while, it is not an elixir for sound finances.

The source of good feelings last year was the notion that governments might have regenerated a recovery. We do not think so. They created a quick spurt in commodities, equities, some business stats, and in momentary good feelings. We can do that with lots of cheap money and aggressive spending. For durability we need a soundly cashed up and confident consumer.

Governments' policies of massive re-inflation are hitting the wall of disaffected voters and wary creditors.

Those who fund government spending are balking. Bond buyers are striking the markets of undisciplined governments. Iceland, Ireland, Dubai, California (?), Greece, Portugal, and Spain are hitting the closed wickets of the bank teller. The market for their bonds has cracked. Rumours abound respecting the fiscal welfare of France and the UK.

We find Canada calling for a review to reduce our deficit. Ditto Alberta. The US President has spoken to the need to limit spending and to raise taxes on the wealthy. Clearly, we are past our due date for living beyond our means.

Besides the constrained spending of countries exhausting their credit, economic and profit growth may be held back by tax increases, by bank reregulation, by the termination of exceptional buying of securities by central banks and by the end of incentive spending schemes.

## Yield Risk

Our "Litany of Limitations" said nothing of the yield risk to markets or borrowers. Governments have artificially dropped rates to drive the recovery through consumption and to rebuild bank capital through high profits earned from cheap funds.

The chart shows the record difference in global rates between short bills and long bonds.

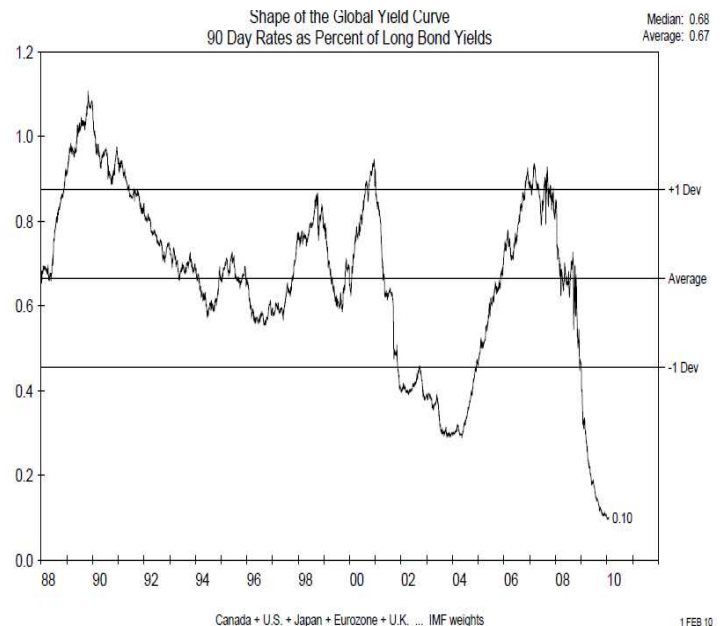


Chart - courtesy of John Aitken, TD Securities

Interest rates determine the ultimate price of an asset or the price we will pay for the cash flow from the asset. Low rates prop up asset values and allow cheap funding for speculative buying of assets. Short rates are as cheap as air. They have inflated the bubbles so prevalent in our markets over the last ten years.

At some point, as with the failing country bond markets, interest rates will normalize, and the chart will rebalance. Short rates will rise relative to long rates and will re-price all asset classes. We have no idea when we might see rate rebalancing. We know we will.

We are still in an asset bubble. We are in an economic bubble. We may see the continuance of the "recovery" story in North America, but in that event, the yield chart becomes a perilous torpedo.

Recovery implies more demand for credit and justifies an increase in rates by the banking authorities. In our highly indebted economies, the rate change would make a profound hit to asset prices.

Our thoughts may be seen as “lose-lose”, but so be it. We want our investment policies to emphasize capital preservation, income, and ample liquidity. We will take advantage of a decline in share prices to the level of their invested capital to invest. Meanwhile, we want to earn dividend income.

### Quality Dividends

The chart below shows the TSX dividend yield at 71.4% of long bond yield, a high level compared to most of the period in the 25-year chart. While it is no guaranty of price support, the higher the percentage the greater potential for support and superior returns.

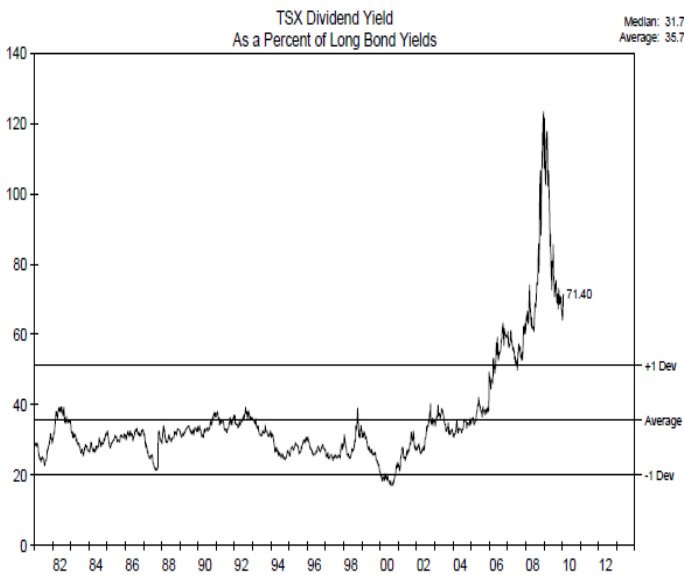


Chart - courtesy of John Aitken, TD Securities

Our theme is investment in quality dividends. It is not a change but a re-emphasis. All our equity portfolios carry dividend yields at or greater than the yield on the equity indices. We seek always to increase portfolio - yield without risking the principal. In the turbulent markets of the last three years and in a low growth environment, QV has concentrated stock selection on companies with predictable cash flow - electric utilities, telephone companies, consumer staples, and pipelines. We have sacrificed capital appreciation in speculative markets for sustainable and consistent income. Despite our focus, our share prices moved up.

At a time when five and 10-year Canada bonds yield 2.5% and 3.7%, some 75% of the TSX by market cap provides a yield in excess of the five-year rate and 21% of the TSX market cap yields over the 10-year rate. That is a temptation, and means we must discriminate in the selection of our companies.

A key test is the analysis of companies capable of growing dividends. The companies in the Canadian equity portfolios have grown their dividends between 15 and 16% over the last five years.

By way of example, the five-year dividend growth rates follow the names of some of our largest large cap holdings - Husky Energy, 107%, EnCana, 82%, CNR, 23%, Toromont Industries, 20%, Saputo, 17%, National Bank, 24% and TELUS, 29%.

### Franchise Defence

In support of a sustainable yield, we regularly assess the strength of a company’s balance sheet, and the actions of management in defending and building their business franchise. We want to be here for a long time, not just a good time.

### The Balanced Option

Looking back, QV Investors held 50% in bonds in Balanced Funds for the last five years, plus or minus. With dividend yields as high as they are, relative to bond yields you may ask, “Why?” Five years ago, interest rates were higher.

To the end of January mid term Canada bonds delivered the following returns compared to the TSX -

	Bonds	Equities
Two Years	5.8%	-5.2%
Five Years	5.0%	6.6%
Ten Years	6.3%	5.0%

It looks to us that the tortoise has given the hare a good run for his money. With dividend yields higher now, the hare may surprise, especially its trades down to more sensible value.

### Pooled Fund – Month End Unit Values<sup>^</sup>

Unit Values	Sep-09 <sup>*</sup>	Dec-09 <sup>*</sup>	Jan-10
Cdn Income Fund CI D	10.74	10.76	10.79
Cdn Balanced CI A	13.40	13.77	13.68
Cdn Equity Fund CI A	9.09	9.67	9.31
Cdn Small Cap CI A	18.77	20.17	19.72
Global Equity Fund CI A	8.07	8.20	8.13

<sup>^</sup> Fund NAVs reflect “full-fee” class \* Post distribution

### Total Return – Capital Gains plus Income (%)

To Jan 31'10	1 Mo	3 Mo	1Yr	3 Yr	5 Yr	10 Yr
<b>QV Pooled</b>	%	%	%	%	%	%
Cdn. Income	0.4	2.0	7.6	6.1	5.5	5.6 <sup>†</sup>
Cdn. Balanced	-0.6	4.3	16.1	3.8	6.3	10.4
Cdn. Equity <sup>†</sup>	-3.6	5.8	19.2	-0.4	8.2	15.8
Cdn. Small Cap	-2.2	4.7	27.8	0.1	7.6	16.1
Global Equity	-0.6	2.5	13.0	-2.6	-	-

<sup>†</sup> Historic equity returns from the Cdn. Balanced Fund

\* 7yr

### Benchmarks:

DEX Bond Unv.	1.8	1.7	8.4	5.9	5.4	6.9
Balanced Fund	-1.4	2.0	18.2	1.6	6.3	5.9
S&P/TSX Comp	-5.4	2.4	31.7	-2.4	6.6	4.9
BMO Small unwt'd	0.7	13.9	83.8	-1.6	4.7	7.0
MSCI World (\$CA)	-2.5	0.0	15.0	-12.3	-3.4	-4.8

- Pooled fund returns are gross of management and custodial fees. Returns over one year are annualized.

- The Balanced Fund Index reflects the total rates of return earned by the DEX 91-Day T-Bill Index (5%), the DEX Bond Universe (45%), the S&P/TSX Composite Index (40%), and the MSCI World Index (C\$) (10%)