

Investment Indigestion

The 2010 Canada Budget includes an end to the medical expense tax credit for liposuction. Could there be a more symbolic gesture for “cutting the fat”? Unfortunately, fiscal imbalances require much more than a tummy tuck. In the US, Barack Obama has promised to trim discretionary spending (excluding defence and homeland security) by \$250 billion over the next ten years. With the US deficit tipping the scales at over a trillion dollars, this too looks more like cosmetic surgery than a permanent weight loss program.

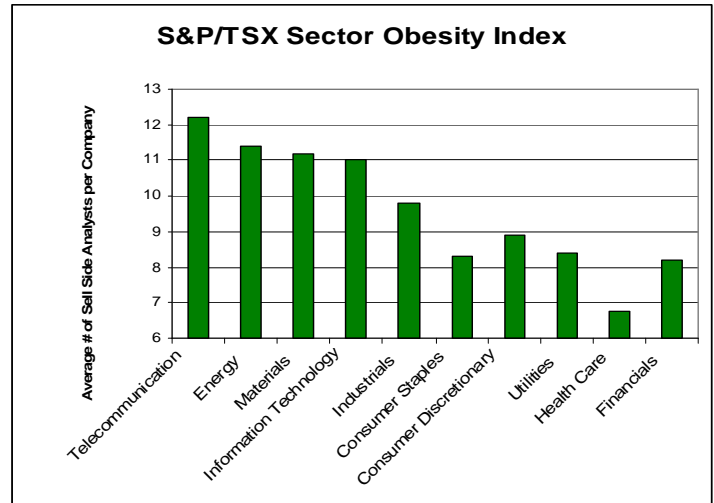
Staying with the omnipresent theme of over indulgence; in his most recent commentary, portfolio strategist Don Coxie reminded us of his maxim: “The Obesity Index”, based on the following premise:

“Avoid investing in stocks where the weight of analysts on the street is heavy in relation to that group’s weight in the stock market”

In essence, when a company or sector is excessively followed, great risk of herd mentality exists. Herd mentality is one of the most dangerous investment traps out there. This mentality pushes the limits on reasonable valuation as more and more gamblers pile into over-populated areas of the market. Imagine people scrambling over each other to buy shoes from a shoe shop when shoe prices go up rather than down. Bizarre isn’t it?

Below we have attempted to construct our own Obesity Index by comparing the average number of analysts covering stocks listed on the S&P/TSX to the companies held in the QV Small Cap Fund.

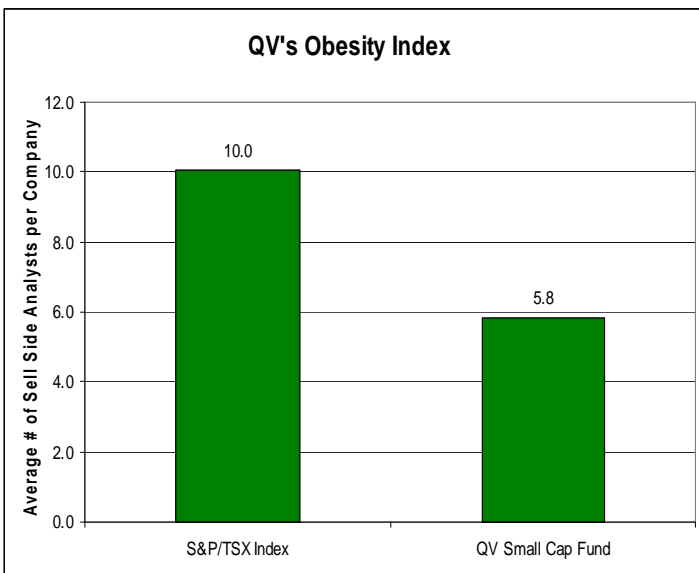
In the QV Small Cap portfolio, we are looking for high quality “shoes” being offered in the discount bin. To find bargains, we often have to look at companies that are under the radar screen or temporarily out of fashion. From a sector perspective, the areas that appear to be the most over covered are Telecommunications, Energy, Materials and Technology. Don’t be surprised if we spend most of our time researching companies outside of these sectors.



Source: QV Investors Inc, CPMS

One reason why our investments garner less analyst interest is related to their balance sheet rectitude. Fund holdings E-L Financial, Pason Systems, Winpak, ATS Automation, Richelieu Hardware, Le Chateau, Leon’s Furniture, Corby Distilleries, Paladin Labs, Astra Technologies, Axia Netmedia and Genum Corp all have excess cash reserves that can be deployed to fund growth initiatives alongside their cash flow generation. When a company needs external capital they raise it through the brokerage network. An often generous financing fee makes providing analyst coverage economically worth the broker’s while.

Although we focus on investments that can fund their growth initiatives internally, a few exceptions exist. Sometimes companies have short term capital requirements tied to a recent acquisition or development plans that go beyond internal means. Not coincidentally, within the Fund the three companies that have the most analyst coverage; Savanna Energy Services (12 analysts), Cominar REIT (12 analysts) and Vermilion Energy Trust (11 analysts) have all issued equity in the market over the past twelve months. With so much attention being drawn to these companies, they must achieve attractive returns on the capital they are investing. We believe they will. If not, we understand their stock prices may need to slim down.



Source: QV Investors Inc, CPMS