

Q&A with QV Investors

We present this month's strategy review in a Question and Answer format. We address key questions from our clients on the financial markets and on our investment strategy.

Q: The equity markets are behaving in a manner that you expected. On Index, over the past three months, the S&P/TSX Composite is down 9.5% and the BMO Small Cap is down 12.8%. Is it time to increase our equity exposure?

A: We are selectively but slowly buying stocks that have sold-off to levels we believe make sense compared to their underlying assets and earning power. Transcontinental and Metro Inc. are two recent examples. Both companies are trading close to their book value per share. The market as a whole is not. As investor's optimism turns to fear, as it did in January, the market provides the opportunity to buy stocks at much lower values.

We recognize that the current equity correction is less than a normal bear market. We recognize too that profitability in Canada and the US has been high relative to long-term averages. We think profitability will fall. We recognize that the "US credit crunch" could result in sharply reduced business. We think more time must pass for the markets to reach values reflecting lower profits.

Q: What is the "worst-case" scenario for the Canadian stock market?

A: The worst case is a "catharsis" situation, where stocks trade down to their book value. The book value for the S&P/TSX Composite Index is currently at 5,300.

If the TSX earned 10% on equity, the historic norm, a reasonable expectation would be for the TSX to trade at 1.5 to 2.0 times book value. From current levels, at 13,000, that would still equate to between a 20 to 40 per cent further decline in the Composite Index.

In contemplating such seriously low results we must remember, valuations and dividend yields would be very attractive to the long-term investor.

Q: If we continue to remain concerned about a further correction in the stock market, why do we not move to 100% cash?

A: Timing market bottoms and market tops is difficult to do. In our careers, we have tried to "time the market" and we always miss.

QV's Pooled Fund – Month End Unit Values

Unit Values	Sep-07	Dec-07	Jan-08
Cdn Balanced	14.17	13.72	13.48
Cdn Small Cap	24.09	23.28	21.73
Cdn Equity Fund	10.57	10.37	9.85
Global Equity Fund	9.10	8.96	8.98
Cdn Income Fund	10.31	10.23	10.35
<i>* Post distribution</i>			

We will continue to focus on owning companies with strong management teams and sound balance sheets and that are able to find a way of meeting daily business challenges. These types of companies are always of interest to value conscious long-term investors as compared to traders. We are prepared to be patient. We have positioned the portfolios with more cash and/or bonds to withstand the worst of the sell-off.

Q: If we expect further weakness in the US dollar, and the US economy, why invest in the US market?

A: As the US dollar falls, US exporters benefit. Their products become more competitive. Additionally, US companies with operations abroad, such as Johnson and Johnson, Kimberley-Clark and Microsoft, benefit from the translation of their foreign currency earnings into more US dollars. We have maximized our exposure to US companies with global operations. Our macro forecast calls for lower earnings growth, but that will not prevent us from buying great companies when prices reflect an attractive long-term investment opportunity.

Total Return – Capital Gains plus Income (%)

To January 31, 2008	1 Mo	3 Mo	1Yr	3 Yr	5 Yr	10 Yr
QV Pooled Funds:	%	%	%	%	%	%
Canadian Balanced Fund	-1.6	-2.7	1.6	7.2	9.6	8.9
Canadian Small Cap	-6.6	-9.8	4.0	14.3	20.8	16.1
Canadian Equity Fund	-4.9	-8.5	-1.6	13.1 ⁺	18.2 ⁺	19.8 ⁺
Global Equity Fund	-0.2	-0.4	-8.3	-	-	-
Canadian Income Fund	1.2	2.6	5.6	4.9	5.2	-
⁺ Historic equity returns from the Cdn. Bal. Fund						[^] 8yr

Benchmarks:

Balanced Fund Index	-2.2	-4.5	3.8	10.3	11.9	7.8
BMO Small Cap Index (unwtd)	-6.5	-12.8	-8.9	6.3	14.2	5.9
DEX Bond Universe	0.6	2.7	4.5	4.6	5.9	6.2
S&P/TSX Comp. Index	-4.7	-9.5	3.5	15.2	17.3	8.9
MS World Index (\$CA)	-6.4	-8.0	-16.9	1.3	4.6	0.5
S&P 500 Index (\$CA)	-4.7	-5.6	-17.0	0.0	3.0	1.3

- Pooled fund returns are gross of management and custodial of 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 (CS) (10%)

Q: Is it time to look at the corporate bond market now that corporate yields have increased while Canada bond yields have fallen?

A: *Credit spreads in Canada have widened since the first announcement of write-downs related to the US sub-prime mortgage market. Investors are now demanding higher yields from corporate bonds given the weakening economic environment.*

This distress is an opportunity. We will continue to examine select bond issues that offer higher yields to our bond portfolio, without jeopardising overall credit quality. However, we expect yield spreads to widen further if economic conditions continue to deteriorate. We will not chase high yields for the sake of short-term gain.

Q: Will the Central Bank rate cuts help?

A: *Yes. The rate cuts will provide relief to the commercial banks and to borrowers. As bad debts are written off, the rate cuts will stimulate economic activity. Short-term interest rates in the US are now below the rate of inflation and below long-term interest rates, conditions that typically give rise to nominal economic growth and price inflation.*

This should also give support to share prices, however, we have seen four rate cuts that investors heeded by simply selling more stock.

The current credit tightening caused by the collapse of the undisciplined lending practices in the United States over the past five years should take more time. The average recession is 10 months in duration and we are probably only one month in. The massive US rate cuts and fiscal actions are indicators of how challenging the current credit conditions are and how seriously the administration is facing the challenges.

Q: What makes this US recession different from other recessions?

A: *The last US recession was short-lived. The recession resulted from increasing interest rates collapsing the technology stock market bubble.*

In the current market, we are seeing the consequences of the largest debt boom in the post-war period in the US. The US consumer's house became the lending institution and their home is no longer available for borrowing against. Consumer spending is the growth engine for the US economy. Their retrenchment should have a more negative effect on the US economy than the bursting of the technology bubble in 2001.

Wealth escalation in the Asian and petroleum producing economies partly offsets the contraction of wealth in the United States. We will seek companies capable of benefiting from the strength in other regions as the Western economies retrench.

Q: With the aggressive rate cutting designed to stimulate the economy, should we be worried about inflation?

A: *It could be a risk. In the near-term, Central Banks are trying to avoid a deflationary spiral caused by the US housing market collapse. Central Banks are trying to act pre-emptively, even though some indicators show continued strength in the economy. The contraction of credit can have negative implications on the economy. Banks do not lend and both consumer and business spending turns negative. Deflation is a greater worry than inflation at this time.*

If the "ease" the Central Banks are providing becomes excessive, and some might argue the very low rates is an indicator of that, higher prices will be the outcome.

Q: Canadian bank stocks have fallen over 9.0% in the past year. The shares of Bank of Montreal, CIBC and National Bank now trade at dividend yields in excess of 4.0%. Is it time to buy bank stocks now?

A: *This year will be a tough year for Canadian Banks. We expect higher loan provisions, slower loan growth, narrower margins, and less profitable capital market condition. We feel we can be patient on the banks in the context of weakening fundamentals. As with the market as a whole, we feel valuations could come down farther to reflect much lower earnings growth. We do not expect the same type of dividend increases for shareholders as we have received over the past decade.*

As indicated, the yield alone is becoming attractive relative to bonds. Bottom line - better prices to come.

Q: What type of return can I expect from my portfolio this year?

A: *We would be happy to make the coupon on bonds and the dividend yield on stocks. Our expectations are modest, in accordance with the sharp reduction we expect in economic and profit growth.*