QV Investors

Small Cap Update

May 23rd, 2008

Joe Jugovic, CFA

Don't you guys get it ?!?!

Here we go, we're ready for the criticism, as they say, "Bring it on". What has been the area of the stock market which has been hugely successful in the past three to four months? The answer, commodity stocks particularly energy companies. What has been the area of the market which has been painful, disappointing and aggravating? The answer, almost everything but energy stocks.

What have we been doing recently? You guessed it, we've been selling the only things that have been making money as of late. This is not easy to do; emotionally you are going against the marketplace and having to forego what may be continued gains. You take the risk of seeing the indices going higher being driven by the very stocks you are selling. Short term you are likely to look like a fool, no problem our skin is thick. You are very likely to hear all the reasons why you are wrong, and there is good rationale behind these reasons. The classic comment we will get is, "don't you guys get it?" What's the matter with you, haven't you heard about the emerging countries and the need for commodities? Haven't you read the papers and the projections for future prices? You get the picture.

Yes, we are aware of all those good things but so too is the market. Just consider the movement we've seen over the past five years in both the commodities themselves and the shares of the commodity companies. We are not saying they cannot go higher, maybe they will and maybe they won't. But what we are saying is we have a discipline as investors and that we are not changing regardless of the potential opportunity which may be foregone.

I ask you this, if today you had to invest all your families' savings in the stock market would you be comfortable putting 50% of it in commodities after they have just had the largest price increase in history? Well if you say no then you probably wouldn't care that the index has that exposure and you're underweight the group. Our priority as investors has to be preserving capital and then making an adequate return, not the other way around.

In the past week we have completely sold out of our shares in Major Drilling Group. Some tears were nearly shed as this has been such a fabulous investment for us. To remind our readers we have always said selling is a much more difficult discipline than buying, especially if you're selling your winning positions. Major Drilling has been one of those winning positions.

Why would we sell out of this company? We look to trim or sell positions if: 1) we have lost confidence in management 2) the company has changed its focus and is dabbling in new ventures 3) the company has taken on excessive debt 4) the risk/reward trade off does not make sense 5) there are more attractive opportunities to preserve capital and still earn an adequate return.

Major Drilling is a combination of excessive valuation and other opportunities which we believe offer a more attractive risk/return trade off. We look back at this business when we bought it and saw an opportunity in which an industry leader was trading at 50 cents on $1.00 of book value. We were presented with the opportunity to buy the shares at 4-5 times previous peak earnings. Why were the shares so cheap? Because at the time, commodity related issues had as much chance of attracting investor interest as Paris Hilton did of joining a convent. Today, the market values this business at near 5 times book value versus the 0.5 times we paid, and 20 times earnings.

Are we leaving money on the table if base metal, gold, and energy prices continue to increase? The answer is yes. The last time we completely sold out of a base metal company was Aur Resources, a few weeks later it was acquired at a 30% premium. If you think that doesn't stick in our memory you're lucky you didn't have to sit next to us and hear us wallow in our misery about selling too early. We know though that successful investing is disciplined investing. That is why we are putting our process ahead of our egos yet once again with the Major Drilling trade.

We don't really look at it as leaving some upside on the table, what we look at is the relative value and risk we are taking. Today we see much better relative value in other areas of the market. The 1000% increase we have seen in the shares of Major Drilling over the past five years have been fabulous for our unit holders. We continue to believe that these are still cyclical businesses. In the last cycle, investors saw the company's share price fall by nearly 90% from peak to trough. Good luck making up a few of those losses in a portfolio; it's just not worth staying in for the extra 15-20%.

Before you think, well at least they've only sold one of these winning names, we have also been aggressively trimming back some of our oil and gas positions this week. For those who remain very bullish on this sector you may be right about higher prices. For QV, we will look to where we can judge the downside risk and in many of these names that is very difficult to do. Joe wrote this letter but I'm sure Leigh, Ian, Darren, or Wendy would be just as happy to take the flack. After all, what are friends for?