January 24, 2011

Dear clients and friends:

**Re: LCM Annual Letter December 31, 2010**

I am pleased to be writing the third annual letter for Lewin Capital Management Ltd. This letter will review our activities in 2010, summarize our results, and as a follow up to last year's letter, discuss the role quality plays in LCM's investment selection process.

Year in Review

Compared to the dramatic shifts in markets witnessed over the past two years, 2010 seemed rather tame, with both Canadian and U.S. markets registering decent gains. One big story driving the Canadian market this year was the resurgence of gold, as many investors were (and still are) concerned about the potential for runaway inflation in the U.S. and currency instability. In contrast, the U.S. bond market appeared to be pricing in a very different scenario, with long term treasury yields still below 4%. Bond investors appeared to be betting on deflation, de-leveraging and possibly, another depression.[1]

From LCM's perspective, at current prices, neither long bonds nor gold offered a sufficient margin of safety, and thus we turned our analytical attention elsewhere. We conducted one-on-one interviews with the senior management of 21 companies in 9 different industries. In addition, we conducted plant tours of 4 companies where we felt it would be advantageous to see the operations firsthand. From this work, we were able to identify and capitalize on some attractive opportunities.

LCM's portfolio is focused, yet well diversified across a range of industries. Market capitalization of LCM's holdings ranges from $150 million to $50 billion. All of our positions have been purchased at very opportunistic valuations and offer the potential to earn attractive returns over the next several years from current levels. Half of our current positions have zero debt or net cash on their balance sheets, and all are decent quality business models.

Results*

For the 2010 calendar year, we earned a return of 14.5%. This is one percent ahead of a simple average of the Canadian and U.S. stock markets, which is a decent comparison for LCM's flexible mandate and one we have used since inception. The Canadian stock

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[1] While inflation and recession are facts of life for investors, current worries seem to be based on the occurrence of hyperinflation and depression which are rare and extreme. Today's press talks about depression rather casually, but a read of The Great Depression: A Diary (2009) by Roth discussing the US experience in the 1930s shows it was quite unlike the situation we experienced in 2008/9. Similarly, for a more in-depth discussion about what hyperinflation looks like read When Money Dies (1975) by Fergusson. This book provides a frightening account of the failed monetary policy of Germany post World War I and makes current Fed policy seem responsible.

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market gained 17.6% in 2010, and the U.S. stock market was held back by the weak US$ delivering returns in Canadian dollars of 9.2% (up 15.1% in local currency).

LCM has earned a cumulative total return of 37.9% since it was founded in 2008, or 13.7% per year on an annualized basis. This compares with annualized returns for the Canadian and U.S. stock markets of 0.2% per year and 0.8% per year respectively over the same period. Relative to a simple average of the Canadian and U.S. stock markets, LCM has earned 36.7% more than the market since inception.

Any discussion of returns should also consider risk. LCM earned the above returns with a significant cash position which was approximately 30% of the portfolio at year end. This cash is not an explicit call on the market, but rather is a residual of our high degree of selectivity and our rigorous approach.

<u>The Importance of Quality in LCM's Investment Process</u>

In our 2009 annual letter, we outlined how two skills are required for a successful investment process: 1) the ability to value a business; and 2) the ability to identify quality. Last year we focused on the first skill. This year we would like to discuss the concept of quality.

LCM describes its style as a value investment philosophy with an important emphasis on quality. The essence of value investing is trying to buy one dollar for fifty cents. One of the key problems with a value mindset has been (and remains) that when you are focused primarily on purchasing things cheaply, sometimes you end up buying junk that ultimately turns out to be worthless. This situation has been aptly labeled the 'value trap.' Incorporating quality into one's process is an effective tool to help avoid this situation. Another benefit of quality is the potential for larger gains over longer holding periods. It has been said that it is the price you pay (the "value") that determines your returns in the short term, while it is what you buy (the "quality") that determines your returns in the long term. To better understand the concept of quality, it is useful to know where the idea came from.

The origin of quality as an investment characteristic hails from Philip Fisher, whose book, <u>Common Stocks and Uncommon Profits</u> (1958), changed the way leading minds (including Warren Buffett) thought about investments. Up until then, Ben Graham's quantitative approach was the dominant paradigm in value investing circles. In a nutshell, while Graham's view led investors to focus on buying one dollar for fifty cents, Fisher's approach was to find a business that could be worth twenty dollars in the future and pay one dollar for it today. Fisher expanded security analysis to include qualitative attributes of a company such as management depth, potential for future growth, adequacy of profit margins, and the efficacy of research and development. His work introduced an important, but subjective, component to investment analysis. In addition, he pioneered ideas such as how to measure innovation by calculating what percentage of a company's current sales are derived from products that were internally developed in the last five years.

In LCM's view, the most useful measure of quality for a business is return on invested capital, which indirectly captures many of the attributes Fisher outlined. The accounting definition for return on capital is the amount of profit earned by a business divided by the amount of capital invested in it; it is an important link between the income statement and the balance sheet. As investors, the quality we are interested in is a forward looking assessment – we are looking for the potential to earn attractive returns on capital *in the future*. The implications of a high return on capital are broad and far reaching for a business. At the most basic level, if a company is able to earn an attractive return on assets, it means more profits to pay down debt and more income for shareholders. A less obvious implication is the potential for management to reinvest in their core business at attractive rates of return to make even more money for shareholders over time. The longer one's investment time horizon, the more important return on capital becomes.

There are two caveats to be mindful of when assessing quality. First, it is important not to confuse price with quality and this is harder than it sounds. For example, looking at the ten most expensive stocks in North America, the average person would be convinced they are all high quality without doing any analysis. Indeed, stocks often exhibit reverse price elasticity – the classic example given in economics class is jewelry that becomes more desirable as the shopkeeper raises the price. This is not logical, and to make money investing we must fight this unprofitable yet innately human tendency. Second, fantastic quality is not a prerequisite for a great investment idea – decent quality will suffice. The best money-making ideas rarely appear to exhibit pristine quality at the lows.

So what are the benefits of quality? In addition to avoiding value traps, investors who incorporate quality into their investment processes fare better in tough markets. When unforeseen trouble occurs, owning decent quality businesses often softens the blow. Furthermore, over the longer term, if you identify quality correctly it can facilitate larger gains over longer holding periods and lower taxes. Along with value, quality is an important component of LCM's investment philosophy. This philosophy, coupled with our patient and disciplined approach enables LCM to earn attractive risk-adjusted returns.

<u>Custody change</u>

We have a new arrangement with our custodian. Effective mid-2010, clients earn a modest interest rate on cash balances. At prevailing bank rates this interest will more than offset the fees paid for custody on the cash portion of our accounts. This is not a huge savings, but it is still worthwhile.

<u>What to expect from LCM going forward?</u>

Clients should continue to expect that the level of due diligence and sophistication of our analysis is among the highest in the business. With a short list of investments, clients should expect nothing less. Our "narrow and deep" approach inevitably means that we will not always own what is "hot" and, indeed, sometimes it may appear that the action is passing us by. Furthermore, to reiterate what we said last year, it is not realistic to expect that we will generate a positive return in all periods. Given our focused approach it is likely that on an annual basis our performance will look nothing like the market. None of these thoughts bother us. Despite our best efforts it is the nature of investing to lose

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money periodically and this will not interfere with our goal to earn attractive returns over the long term. Although we expect that our performance will be different from the market from year to year, we anticipate generating absolute returns in excess of 7% annually over the long term. With a bit of insight and some patience, the returns from exploiting opportunities using a focused approach will enable us to achieve our goals.

I wish you the best in 2011 and if you have any questions please contact me at 604-868-4390.

Sincerely,

Daniel Lewin CFA
President

P.S. Renovation of LCM's new office at Suite 211 – 2150 Western Parkway (in UBC Village) started last week. In a few months we look forward to giving you a tour.

*All stated returns are gross of fees. "Since inception" refers to the period from June 30, 2008 to December 31, 2010. The S&P TSX Composite Total Return Index is used to represent the Canadian stock market returns, and the S&P 500 Total Return Index translated into Canadian dollars is used for the U.S. market returns. Returns for LCM are from a representative account as all client assets are held on a segregated basis. Small differences will occur between accounts due to rounding and the timing of cash flows. Please find attached the spreadsheet outlining the exact performance for your segregated account.