January 17, 2012

Dear clients and friends:

Re: LCM Annual Letter December 31, 2011

I am pleased to be writing the fourth annual letter for Lewin Capital Management Ltd. This year's letter will outline LCM's activities over the past year, review our results for 2011, and discuss LCM's perspective on leverage.

Year in Review

2011 was a difficult year to make money as global events continued to rattle North American markets. In Europe, there was the potential dissolution of the Euro and the possible collapse of the European banking system. In China, where the economy has driven gains in Canada's resource-heavy markets over the past decade, there was concern over whether the capital spending boom would become a bust and push many commodities into oversupply. Finally, in the United States, the market continued to face challenges stemming from large fiscal deficits and too much debt at both the individual and government levels. Overall, markets were preoccupied with negative macro-economic themes.

Pessimism and uncertainty can prove useful to investors employing a long-term value strategy, as markets tend to extrapolate near-term trends and over-emphasize recent events creating bargains. As such, LCM was able to put more capital to work at attractive levels during the year. We spent 2011 researching ideas and identifying value. To this end, we conducted interviews with the senior management of twenty companies, attended conferences in New York, Whistler and Omaha, and toured the plant of a company that is of significant interest to us. In the spring, we trimmed one position in a cyclical company which traded at book value for a short period of time after we initially purchased it at one quarter of book value in February 2009. This was a good decision; however, we should have sold more of it while we had the chance. During the market decline at the end of the summer, we identified two compelling investments that are now our second and third largest positions. Our cash balance has declined to 22% from 30% one year ago in spite of the above-noted selling activity. The portfolio is positioned well and the investments we have made to date should translate into attractive risk-adjusted returns over the next several years. LCM continues to follow a conservative, focused and disciplined approach, and the bulk of our energy in 2012 will again be directed toward the research and investing side of the business.

Results*

In 2011 we earned a return of 2.3%. LCM's results were well ahead of a simple average of the Canadian and U.S. stock markets. The Canadian stock market declined -8.7% in 2011, while the U.S. stock market gained 4.5% in Canadian dollars (2.1% measured in U.S. dollars).

LCM has earned a cumulative total return of 41.0% since it was founded in 2008, or 10.3% per year on an annualized basis. This compares with a cumulative loss of -8.4% for the Canadian stock market and a cumulative gain of 6.5% for the U.S. stock market over that same period. Relative to a simple average of the Canadian and U.S. stock markets, LCM has earned 41.9% more than the market since inception. Our long term target is to earn an absolute return in excess of 7% per year on average, and we have achieved this goal in spite of a bleak market environment.

Our portfolio is the product of our rigorous and disciplined investment research process. Currently we own nine investments in eight different industries, which range in size (by market capitalization) from $150 million to $50 billion. Half of the investments we own have net cash or zero net debt on their balance sheets. One third of our ideas are U.S. listed, with the balance from Canada.

LCM's Perspective on Leverage

The use of leverage has become a widespread practice in the hedge fund industry today. LCM does not use leverage in its portfolios, and given the turmoil in markets this past year it is an appropriate time to discuss our perspective.

As a bit of background, leverage can be introduced directly, through borrowing money, or indirectly, by maintaining a high gross exposure. The direct approach is straightforward – instead of investing what a client gives you, you leverage that amount in hopes of achieving bigger gains when your investments move in the right direction. Unfortunately, it also means bigger losses when the market does not cooperate. The practice of maintaining a high gross exposure refers to short-selling stocks to offset a substantial long position, with the idea of profiting regardless of the direction of the market. With this practice, leverage is indirectly introduced when the value of the long and short positions taken together exceed the value of the portfolio. For example, a typical long/short fund might have long positions totaling 125% of the portfolio value offset by short positions of 50% and advertise a 'net market exposure' of 75%. To an investor concerned about losing money, however, a position of 'net 75%' is very different than being 75% invested. Given a potential for losses on both the long and short sides we calculate this as 175% exposure (125 long + 50 short), or 2.3 times the risk of being 75% invested (175/75). The effect of this high gross exposure of 175% is the same as borrowed money – it magnifies returns both good and bad.

So why do many investors follow this practice? Putting aside incentives, it is interesting to note that the main reason stems from how risk is defined. If risk is thought of as a relative concept – as it is by most of the investment industry – one can see why the idea of offsetting longs with shorts has some intellectual appeal as it can reduce volatility or the 'beta' of a portfolio. Because LCM considers risk in an absolute sense, namely the potential for losing money, our perspective on leverage is evident. Any practice that increases the potential for loss is riskier, even if it might reduce the volatility or beta of a portfolio.

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Leverage does not fit with LCM's investment philosophy for two main reasons. First, above all, LCM seeks to avoid the permanent loss of capital and thus refrains from practices that can exacerbate losses in bad markets. This necessarily means giving up the benefit of leverage in good markets; however, this is more than made up for by the fact that we tend to lose less and thus are in a better position to capitalize on opportunities that arise when markets decline. This is consistent with our value approach.

Second, LCM's philosophy emphasizes patience and a long term time horizon and leverage can have the effect of shortening one's time horizon. This is because interest costs start the moment money is borrowed, placing an investor under additional pressure to get the timing right. Interest costs incurred over an extended period can add up and eliminate the benefit of having additional money invested. Leverage can also shorten an investor's time horizon as the lender may demand the money back before the investment has had a chance to play out. Indeed, the banker's phone call often occurs at the most inopportune times. As Keynes famously stated, "The market can stay irrational longer than you can stay solvent."

In summary, leverage does not fit with LCM's conservative framework or our long term mindset. In fact, LCM's returns have been earned with an extremely under-leveraged portfolio. On average, since inception, LCM has been approximately 51% invested (we are 78% invested today), with the balance in cash. Thus, if you consider returns in a risk-adjusted sense, comparing LCM's returns with firms that use leverage is a comparison of apples and oranges. LCM is focused on capitalizing on our best ideas and our cash position is a residual of the rigorous standard we apply to our investments, not the result of an overriding macro view. Of course our position on leverage will not always be a benefit to LCM – frothy markets require patience. However, this perspective suits our temperament and ensures that LCM will be around to protect and grow your capital over the long term. Even without leverage, losses from time to time are inevitable in investing. Considering our investments over a time horizon of at least five years should help us deal with any periodic losses that arise.

What can clients expect going forward?

Clients can 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, it is not realistic to expect that we will generate a positive return in all periods. What is most likely is that by following a focused approach, on an annual basis the results of LCM will look nothing like the market. None of these thoughts bother us. Although we expect that our performance will be different from the market from year to year, we anticipate generating 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 all the best in 2012. If you have any questions, please contact me at 604-868-4390.

Sincerely,

Daniel Lewin CFA
President

[*] All stated returns are gross of fees. "Since inception" refers to the period from June 30, 2008 to December 31, 2011. The S&P TSX Composite Total Return Index is used to represent the Canadian stock market returns, and S&P 500 Total Return Index translated into Canadian dollars is used for the U.S. stock 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.

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