January 17, 2013

Dear clients and friends:

Re: LCM Annual Letter December 31, 2012

It is a pleasure to be writing the fifth annual letter for Lewin Capital Management Ltd. In past letters we reviewed how the ability to value a business (2009) and identify quality (2010) are essential skills for making money in stocks. This year, following our usual overview of activities and results, we will discuss the merits of LCM's focused approach to structuring a portfolio.

Year in Review

In 2012, Canadian markets were held back by a number of factors we previously highlighted. In particular, slowing global economic demand placed pressure on economically sensitive resource investments which are a large component of the Canadian market. South of the border, after more than a decade of lackluster returns, the U.S. stock market experienced fairly broad-based gains. These gains are due in part to attractive valuations and, perhaps, to injections of liquidity by the Fed. Concerns about debt, deflation, China, and Europe persisted throughout 2012.

This year our research took us as far south as Texas and as far east as the U.K. in search of the best investments. We attended several interesting conferences, conducted four site visits of companies in which we are particularly interested, and interviewed the senior management of 28 companies. This work resulted in one new position in the portfolio. We sold one position (purchased in 2009) that did not perform in line with our original thesis, and trimmed one key holding (first bought in 2008) because the stock price increased faster than the business improved thus reducing our margin of safety somewhat. This activity left us with 27% cash at year end, up from a low of 16% at mid-year. In 2013, we will continue to allocate all of our time to ensuring we own the very best ideas we can find.

Results*

In 2012 we earned a total return of 25.1%. These are strong results, well in excess of 7% which is our long term goal, and significantly better than a simple average of the Canadian and U.S. stock markets. The Canadian stock market return was 7.2% in 2012, while the U.S. stock market rose 12.7% (up 16.0% in local currency).

LCM has earned a cumulative total return of 76.4% since it was founded in 2008 or 13.4% on an annualized basis. Since we opened LCM we have not had much of a tailwind from the overall stock market – the Canadian stock market is down (0.4%) annualized, and the US stock market is up 4.1% annualized over this period. Relative to a simple average of the Canadian and U.S. stock markets, LCM has earned 67.3% more than the market since inception. On an absolute basis, our clients have been able to protect and grow their capital by a meaningful amount through the financial crisis, while many investors' balance sheets have yet to recover their pre-crisis levels.

At year end we owned nine investments in nine different industries, ranging in size (by market capitalization) from $250 million to $75 billion. Half of the investments we own have net cash or zero net debt on their balance sheets. About one third of our ideas are U.S. listed, with the balance

from Canada. We are confident that our current portfolio is positioned to continue to generate attractive risk-adjusted returns over the next several years.

LCM's portfolio is the product of our rigorous and disciplined investment research process and we attribute our results to the focused approach we adopted when LCM was founded. Many people have misconceptions about what focused investing entails and thus we think it appropriate to discuss this approach in more detail.

A Focused Approach to Investing

A portfolio consisting of less than 20 securities can be described as concentrated or focused. At the core of a focused philosophy is the belief that there are a limited number of truly great investments at any given time and that this reality should be reflected in the composition of the portfolio. In other words, it is better to put more capital into one's first, second or third best ideas rather than owning one's 35th, 40th or 50th "best" idea. An obvious benefit of this approach is that with more capital invested in one's most attractive investments there is greater upside. What is perhaps less obvious is that a focused approach generally means the investor must engage in greater selectivity, employ higher standards, and conduct deeper due diligence, all of which can not only benefit the return, but also lower the risk of the portfolio. Subjecting each idea to greater scrutiny, or a more powerful microscope, can eliminate a number of inferior investments.

If you study the investors with the best long term track records many of them adhere to a focused approach, including Warren Buffett, Philip Fisher, Seth Klarman and Lou Simpson. Somewhat surprisingly, however, focused investing is not widely practiced in the industry. There are two main reasons for this: first, there is a common misconception that adequate diversification is not possible in a focused portfolio; and second, institutional constraints prevent many investors from engaging in the practice.

Achieving Diversification in a Focused Portfolio

A common misconception of focused portfolios is that adequate diversification is unattainable with fewer than 20 securities. Given that the average mutual fund owns 110 securities it is not surprising that an observer may conclude that large numbers of stocks are required for a portfolio to be diversified. However, it is not simply the number of securities that matters because funds often own many securities and are still not diversified. Consider, for example, a portfolio of 50 junior oil and gas companies, or perhaps the Toronto Stock Exchange Index (249 stocks) with 76% of its value represented by resources and financial services – arguably neither of these are adequately diversified. Just how many different securities are needed for adequate diversification is the subject of much debate. Phil Fisher thought that 5 well-selected large companies with little overlap in their businesses was sufficient, and suggested that perhaps 10 investments would be required if the companies were mid-sized. In his now famous book, *Margin of Safety*, Seth Klarman says that as few as 10 to 15 different holdings can provide sufficient diversification. LCM's view is that adequate diversification can be achieved in a focused approach by constructing the portfolio across a range of industries.

In the 1950s Fisher made the following statement:

> *"…among investors…the percentage who own twenty-five or more different stocks is appalling. It is not this number twenty-five or more which itself is appalling. Rather it is that in the great*

> *majority of instances only a small percentage of such holdings is in attractive stocks about which the investor or his advisor has a high degree of knowledge. Investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much into others about which they know nothing at all."*[1]

Fisher advocates diversification, but astutely points out that lining one's portfolio with stocks that are not well understood brings its own problems. An investor must be cognizant that owning too many stocks can introduce additional risks to the portfolio and perhaps more troubling, it will lessen the impact of one's best investments. Indeed, the dictionary opposite of "focused" or "concentrated" is not "diversified" as many people might believe – rather, it is "unfocused" or "diluted."

Dilution, in fact, may be responsible for the poor overall performance of mutual funds. A recent Harvard paper examining the mutual fund industry found that managers' top five high-conviction ideas consistently outperformed the market while the rest of the stocks in the portfolio did not perform as well.[2] The study concluded that institutional constraints within the money management industry were compelling managers to own too many stocks and more importantly, that investors would be better served if their managers held more concentrated portfolios.

Institutional Constraints

Having worked for large money managers for almost 20 years prior to starting LCM, I can attest to the fact that the organization of the mainstream investment industry makes it difficult for managers to follow a focused approach. First, much of the capital in the investment industry is managed by large companies, such as banks, and it is hard to invest $10 billion or more in less than 20 securities. Second, quarterly reporting is a standard convention and frequent comparisons of short-term results to the market index will inevitably lead to managers owning more securities. Finally, consultants often define risk as tracking error, not as losing money, and this drives managers to construct their portfolios to more closely resemble the index.

LCM's Focused Approach

LCM was created largely free from the constraints that impede the mainstream investment industry. We focus on the long term, engaging in annual rather than quarterly reporting and we do not define risk as tracking error. LCM's investment philosophy centers on the belief that a focused approach, combined with a value discipline and an emphasis on quality, is the best way to protect and grow one's capital. To ensure adequate diversification, our portfolio is carefully structured across a range of industries and types of businesses. In addition, each potential investment must be sufficiently compelling to bother owning in the first place. Diversification will never be used as a reason to justify the purchase of an expensive or inferior quality asset. Holding cash in lieu of a marginal investment is a more effective way to lower the risk of loss in the portfolio.

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[1] Quote is an excerpt from Common Stocks and Uncommon Profits by Philip A. Fisher. Page 114 of the first edition published 1958.

[2] Best Ideas – paper authored by Randolph B. Cohen from MIT, Christopher Polk from London School of Economics and Bernhard Silli from Goldman Sachs. First draft November 7, 2005. Latest draft dated May 1, 2010.

We believe one should approach investing with the mindset that one is not simply purchasing stocks, but stakes in businesses. Imagine, for example, that you are a billionaire and want to buy whole companies with the intent of making money. You hire an investment banker to help you select the companies who, after much work, presents a list of 50 or 100 businesses for you to buy. Wouldn't it be logical or reasonable to ask the banker to winnow down the list a little? Wouldn't the billionaire be better off owning just a handful of the best opportunities? If you think of a stock not as a piece of paper, but as part ownership of a business, then an investor with a few million dollars to invest in the stock market would likely come to the same conclusions as the billionaire who buys whole companies. This is the rationale for a focused approach.

It should be noted that despite conservatism, rigorous due diligence and greater selectivity, nothing can reduce the probability of loss to zero. Just as owning a business necessarily entails some risk, so does investing, yet it remains one of the best ways to protect and grow one's capital. Being emotionally prepared in advance for the inevitable setbacks that will occur and considering one's investment results over the long term are useful ways to stay the course and reap the rewards of a focused approach.

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 2013. If you have any questions, please call me at 604-558-0070.

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, 2012. 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.