January 27, 2014

Dear clients and friends,

Re: LCM Annual Letter December 31, 2013

I am pleased to be writing the sixth annual letter for Lewin Capital Management Ltd. In this letter I will review our activity and results for 2013, and pass along some words from Warren Buffett that support our approach.

Year in Review

This year the U.S. stock market had broad-based gains while the Canadian stock market was held back by a heavy weight in weak performing mining companies. The main story in the markets throughout 2013 was the impact of the U.S. Federal Reserve's unprecedented monetary stimulus and the eventual wind down, or 'tapering', of this program. It is likely that the prices of all assets (bonds, stocks, and real estate) have been pushed up by the stimulus program, but it is difficult to determine to what degree, and markets have been affected by this uncertainty. Long-term bonds, an area we previously highlighted as expensive, have dropped in price as yields have doubled (from 1.5% to 3%) over the past eighteen months. So far, this has had a nominal effect on equity markets. Should rates rise further, it is likely that (after long-term bonds) the worst performing assets will be the equities that are most "bond like" in nature, namely equities with high dividend payout ratios, high multiples and minimal growth in their core business. LCM has little exposure to these types of stocks (mainly because they are expensive); however, all stocks will likely suffer to some degree if rates rise. If the end result of the stimulus is inflation, then owning a portfolio of well-selected businesses through the stock market is a good long-term solution to protect the real value of our capital. However, it would be prudent to expect some disorder in the short term. As we have stated previously, regardless of Fed policy, an environment of uncertainty should create opportunity for a disciplined value investor.

The bulk of my time last year was spent researching current and prospective investments. I visited Omaha, London and the Southeastern U.S., and conducted interviews with the senior management of 26 companies. The most notable change in the portfolio in 2013 was the sale of one position at a small profit where the balance sheet had worsened considerably due to an acquisition. We had hoped to get an opportunity to build this position to a large size, and the prospective returns post-deal were equally attractive as pre-deal, but with the weaker balance sheet, the down-side scenario became unmanageable so we sold our position. Our cash balance rose to a level of 29% of the portfolio at year end, but we were pleased with our results.

Results[1]

In 2013 we earned a total return of 28.1%. These results are an attractive level of absolute return and are better than a simple average of the Canadian and U.S. stock markets. Canadian stocks earned 13.0% and the U.S. stock market finished the year with gains of 32.4% (up 41.7% in Canadian dollars).

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LCM has earned a cumulative total return of 126.0% since it was founded in 2008, or 16.0% per year on an annualized basis. We have accomplished our long term goal to earn in excess of 7% annually, and relative to a simple average of the Canadian and U.S. stock markets, LCM has earned 85.0% more than the market since inception. We are pleased with these results and view them as a product of our patient and disciplined approach.

A Confirmation of LCM's Approach

As LCM passed its 5 year anniversary this past June, I took a moment to reflect on our strategy and approach. I came across a letter[2] written in 1975 by Warren Buffett to the Washington Post's then CEO, Katharine Graham[3], providing advice on how to manage the company's pension plan (Buffett served as a director at the time). Going against convention, Buffett explained why a large manager was not the best choice. In his words:

> *I am virtually certain that above-average performance cannot be maintained with large sums of managed money. It is nice to think that $20 billion managed under one roof will produce financial resources which can hire some of the world's most effective investment talent. After all, doesn't the big money at Las Vegas attract the most effective entertainers to its stages? Surely $50 million annually of fees on $20 billion of managed assets will allow (a) an array of industry specialists covering minute-by-minute developments affecting companies within their purview; (b) top-flight economists to study the movement of the tides; and (c) nimble, decisive portfolio managers to translate this wealth of information into appropriate market action.*
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> *It just doesn't work that way.*
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> *Down the street there is another $20 billion getting the same input. Each such organization has its own group of bridge experts cooperating on identical hands – and they all have read the same book and consulted the same computers. Furthermore, you just don't move $20 billion or any significant fraction around easily or inexpensively – particularly when all eyes tend to be focused on the same current investment problems and opportunities. An increase in funds managed dramatically reduces the number of investment opportunities, since only companies of very large size can be of any real use in filling portfolios. More money means fewer choices – and the restriction of those choices to exactly the same bill of fare offered to others with ravenous financial appetites.*

Buffett goes on to outline five different ways to manage the investment of the pension plan, with his preferred option being to approach the investment with the mindset of a business person. As the directors and officers of the Post were capable of assessing and making acquisitions of specific business operations, why not use these skills to invest the pension assets in a dozen businesses through the stock market at more attractive valuations than could be made if the board were to try to acquire whole companies? According to Buffett, this is

possible given that "*stock market prices may bounce around wildly and irrationally*" and, patience is important, "*If purchases could not be made on such a "bargain" basis, we would simply wait until they could.*"

He ends the letter by saying:

> *It might be asked what the difference is between this approach and simply picking stocks a la Morgan, Scudder, Stevens, etc. It is, in large part, a matter of attitude, whereby the results of the business become the standard against which the measurements are made rather than quarterly stock prices. It embodies a long time span for judgment confirmation, just as does an investment by a corporation in a major new division, plant or product. It treats stock ownership as business ownership with the corresponding adjustment in mental set. And it demands an excess of value over price paid, not merely a favorable short-term earnings or stock market outlook. General stock market considerations simply don't enter into the purchase decision.*

Buffett's reasons for advocating against large investment managers are as relevant today as they were some forty years ago, and his advice so closely parallels the design of Lewin Capital that it could be an advertisement for our company. As a reminder, 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. We think long term and consider an investment in a stock the same as an investment in a business. Applying a business-like mindset to investing and ensuring patience in the face of the short term distractions from the stock market differentiate our firm. I believe strongly that the structure and 'attitude' that LCM adopted almost six years ago is a key competitive advantage compared to the industry, and it is heartening to find our approach is aligned with that of such a wise person as Buffett.

<u>What can clients expect going forward?</u>

In every letter we caution that short-term results should not be extrapolated and that losses on an annual basis are unavoidable from time to time. We repeat that caution here. 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, the results of LCM will look nothing like the market on an annual basis. None of these thoughts bother us. Although we expect our performance to be different from the market from year to year, we anticipate generating returns in excess of 7% annually over the long term. The past few years may have seemed pretty easy, but experience has taught me that investing can be anything but that. So we will stick to our disciplined approach - patiently identifying opportunity and capitalizing on it in a focused manner should enable us to continue to achieve our goals.

I wish you all the best for 2014. If you have any questions please call me at 604-558-0070.

Sincerely,

Daniel Lewin CFA
President

P.S. We are grateful for referrals to friends where our approach might resonate. As a reminder, due to our segregated model we have a per client minimum of $2 million in investable capital.

[1] All stated returns are gross of fees. We take pride in ensuring that our fees are fair and reasonable for the service LCM provides. If you would like a copy of LCM's Investment Management Agreement that outlines our fees and services in more detail please contact us. 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. The S&P TSX Composite Total Return Index is used to represent the Canadian stock market returns, and has returned 1.9% per year over the five and a half years ended December 31, 2013. The S&P 500 Total Return Index translated into Canadian dollars is used to represent the U.S. stock market returns, and this index has earned 10.1% per year in Canadian dollar terms over this same period. Thus LCM's return of 16.0% per year has beaten the Canadian and U.S. Stock Markets by 14.1% per year and 5.9% per year respectively since inception. "Since inception" refers to the five and a half year period from June 30, 2008 to December 31, 2013.

[2] Through a subscription to a terrific service called Value Investor Insight I received a 19 page letter titled "Pensions" written on October 14, 1975 by Warren E. Buffett.

[3] Katharine Graham is the subject of Chapter 5 in LCM's 2013 holiday gift book, The Outsiders by William Thorndike Jr. If you did not receive a copy of this book and would like one please let us know.