January 21, 2015

Dear clients and friends,

Re: LCM Annual Letter December 31, 2014

In LCM's seventh annual letter I will provide a brief snapshot of the markets in 2014, review our results, and discuss some perspectives on holding cash.

Year in Review

U.S. market returns were solid in 2014 and Canadian returns were decent, though hindered somewhat by weakness in the energy sector. After weak metals prices in 2013, the drop in the price of crude oil made for another year of headwinds for the resource-heavy Canadian market. As for copper and oil, what remains unclear is whether the future is going to look like the last ten years (a "super cycle" period of tight markets, robust global demand and record prices), or whether it will return to conditions resembling the fifty years prior to that, which saw surpluses, shorter peaks and comparatively low commodity prices. It is impossible to predict these matters with any accuracy and thus it is wiser to find investments where economic forecasting is less important, or where the worst case scenario is already priced in.

I spent the vast majority of my time researching new investments and ensuring that our current investments still make the grade. I toured 8 plants across North America and conducted interviews with the senior management of 20 companies. Overall activity at the portfolio level was light; we harvested some gains during the year by trimming three positions modestly and reducing one position by about one third as considerable insider selling at that company warranted increased caution. We ended the year with a cash position of 30% in the portfolio.

Results[1]

In 2014 we earned a return of 23.3%. These results are an attractive level of absolute return and are well ahead of a simple average of the Canadian and U.S. stock markets. Canadian stocks earned 10.6% and the U.S. stock market gained 13.7% (in Canadian dollar terms U.S. stocks were up 24.5% due to the stronger U.S. dollar). The bulk of our returns last year were generated from a common theme – increases in intrinsic value driven by the opportunistic deployment of capital by company management. Half of our holdings, including our three best performing investments, benefited from either significant "organic" reinvestment in their core businesses at high returns on capital, or from a few intelligently considered "tuck in" acquisitions (a riskier approach but with similar effect). These actions by management grew the normalized earnings power of their respective businesses (and thus increased the value of our shares).

LCM has earned a cumulative total return of 178.7% since it was founded in 2008, or 17.1% 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 9.0% per year more than the market since inception. We are pleased with these results and view them as a product of our patient and disciplined approach.

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LCM's Perspective on Holding Cash

Each year in LCM's annual letter I discuss a topic that relates to our investment process. In past letters I have written about valuing a business versus predicting the economy (2009), the importance of quality (2010), leverage (2011), and the merits of using a focused approach (2012). This year I will briefly address the topic of holding cash. This is not a controversial subject; however, there are two distinct perspectives on the matter and thus it is worthy of discussion.

The first perspective is that cash must be avoided in equity or balanced portfolios. This position is supported by data that show the long term returns of stocks (and bonds) have beaten cash, and well-documented studies that cite the futility of trying to time the market. This view is held by most of the industry, and many funds have a policy to be fully invested in stocks (or bonds) all of the time.

The second perspective is to put the investment process first and treat cash as a residual of that process. It begins with the investor identifying opportunities that meet rigorous selection criteria. After purchasing the proper amount of each suitable investment, some cash may be left over. This cash remains in the portfolio until the next suitable investment is identified. This is not a "pro-cash" policy nor is it a call on the short-term direction of the market. Rather, a cash position is seen as preferable to investing in lower quality or more expensive securities that don't meet the investor's standards. The result of this approach is that the levels of cash in the portfolio bounce around over time. Sometimes cash will be high and sometimes it will be low based on the ability of the manager to identify opportunities and how high the bar is set for new ideas.

Now what about the effect of cash on performance? One might logically conclude that as long as returns on stocks are higher than cash, returns of the first group should beat those of the second because the fully invested cohort owns more stocks on average over time. Interestingly, however, studies show that managers who are not fully invested have performed better than their fully invested peers. One explanation comes from a recent academic study[2] which found managers that carry excess cash compensate for the low return on cash by making superior stock selection decisions. Another contributing factor might be that managers who set higher standards, and treat cash as a residual, benefit from increased focus. The benefits of a focused approach were outlined in our 2012 letter and corroborated by a Harvard paper[3] which showed managers' best ideas far outperformed the market.

As a portfolio manager, it makes sense to me that setting a rigorous standard for one's investments can result in higher overall portfolio returns. A policy of treating cash as a residual puts the emphasis on the right things. There are a number of potential benefits including: 1) not being forced to buy a marginal idea just to "get invested," 2) owning more of one's best ideas, 3) higher scrutiny on losing positions, 4) less distraction from following too many (marginal) investments, and 5) not needing to pair a good sell decision with a good buy decision. LCM's experience has been consistent with these findings, as we have earned decent absolute and relative returns despite our cash position. For example, over the past three years to Dec. 31, 2014, LCM has earned a total portfolio return of 25.5% per year despite holding a cash position of 26% on average over that period.

James Tisch, a contrarian investor and CEO of Loew's Corporation[4] has joked that "We have asbestos lined pockets, we will not let cash burn a hole in them." Viewing cash as a valuable option to take advantage of a future bargain is a useful way to stay patient while waiting for the next good idea rather than being tempted by the slew of marginal investments constantly on offer. While you won't lose money on cash in the short run, surely in the long run the best use of cash is to be invested in a decent business at an attractive price. Experience has shown repeatedly that the market offers up these opportunities to people who are patient.

What can clients expect going forward?

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. Despite conservatism, rigorous due diligence, greater selectivity and the ability to hold cash, investing in the stock market entails enduring some bleak periods along with the good ones. Given that owning shares in a company is analogous to being a part owner of a business, just as no business owner can expect to increase their net worth in a straight upward line, neither can an investor in stocks. Despite this fact, investing remains one of the best ways to protect and grow one's capital. Today, extra caution is warranted given the current environment of low interest rates, where many asset classes are picked over and leverage is often required to generate an acceptable return on one's capital. LCM does not use leverage, and we ask each client to consider their results over a five year horizon. 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 that the market can offer. Although we expect our performance to be different from the market from year to year, we continue to anticipate generating returns in excess of 7% annually over the long term.

I wish you all the best for 2015. 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 3.2% per year over the six and a half years ended December 31, 2014. 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 12.2% per year in Canadian dollar terms over this same period. Thus LCM's total portfolio return of 17.1% per year has beaten the Canadian and U.S. Stock Markets by 13.9% per year and 4.9% per year respectively since inception. "Since inception" refers to the six and a half year period from June 30, 2008 to December 31, 2014.

[2] Cash Holdings and Mutual Fund Performance – paper authored by Mikhail Simutin from University of Toronto. Latest draft July 8, 2013. Previous version of paper by the same author while at University of British Columbia was titled Excess Cash and Mutual Fund Performance dated November 22, 2009.

[3] Best Ideas – paper authored by Randolph B. Cohen of 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.

[4] The King of Cash: The inside story of Laurence Tisch (1995) by Christopher Winans, is an interesting biography of Larry Tisch and the history of Loew's Corporation.