LEWIN CAPITAL MANAGEMENT LTD.

January 23, 2019

Dear clients and friends,

Re: LCM Annual Letter December 31, 2018

In LCM's eleventh annual letter I will provide a brief overview of key events in the markets in 2018, review our results and discuss what it means to have a long-term time horizon.

Year in Review

The stock market peaked in late summer causing plenty of positive headlines as it rose, and negative headlines as it fell. One prevalent concern was the threat of recession. Given the strong balance sheets of our holdings and our cash position, LCM would view an actual recession as opportunity. From my point of view, the two big risks to consider remain the 'normalization' of interest rates, and the potential for a debt/banking crisis in China. Short-term interest rates rose modestly, while long-term rates were volatile but remain too low to compensate lenders adequately. Inflation may be the simplest "solution" for an over-indebted society, but a rise in inflation is unlikely to be smooth for markets. A crisis in China would likely affect only one of our positions directly, but could affect the global supply and demand of many goods more broadly. The great trend towards indexation of investment funds has not been tested with any material drawdowns; however, watching how index funds function in a bear market is something to consider.

Last year I interviewed the management of twenty-seven companies and toured the operations of three companies. We continued to reduce two positions, which we had partially sold off in previous years as the fundamental outlook of both looked to be peaking, albeit for different reasons. Stretched valuations and poor fundamental outlooks in Canadian and US markets have sent us looking further afield for opportunity. We conducted a considerable amount of due diligence on a number of prospective investments, including some that conduct 100% of their business outside of North America; however, we have not yet found a truly non-North American business that meets our criteria. The key stumbling block for new buys has been LCM's prerequisite that a new idea must have limited downside at the time of purchase. This is due to our conservative view that the risk we are seeking to minimize is the risk of permanent loss of capital. Accordingly, our cash balance is on the high side, ending the year at 52%. In 2019, we will continue to deploy our capital with the same patience and discipline we have had since inception and we are confident that the market will offer opportunities.

Results[i]

In 2018 our portfolio earned a total return of 2.7%, with a modest gain in the first half partially offset by a small loss in the second half. These results were below our long-term goal for absolute return, but were positive returns earned against a fairly bleak market backdrop. LCM's results beat a simple average of the Canadian and US stock markets by 5.0%. The Canadian stock market was down 8.9% in 2018, while the US stock market dropped 4.4% (measured in Canadian dollars the US stock market rose 4.3%). The strong US dollar was the one bright spot for Canada-based investors, as the US dollar rose 8% in 2018, after declining 7% in 2017.

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Since it was founded in 2008, LCM has earned a cumulative total return 262.1%, or 13.0% per year on an annualized basis. In other words, $100 invested at LCM when we opened our doors before the financial crisis in mid-2008 is worth roughly three and a half times that amount today. We have accomplished our long-term goal to earn in excess of 7% annually, and LCM has beaten the market by 5.6% per year relative to a simple average of the Canadian and US stock markets since inception. We are pleased with these results and view them as a product of our patient and disciplined approach.

This year, with the return of volatility, I thought it made sense to spend some time discussing why a long-term time horizon is a key component of LCM's investment philosophy. In this letter I will explain briefly what it really means to invest with a long-term horizon, why it matters and illustrate how to put this into practice by way of an example.

What does it really mean to have a long-term time horizon?

While I doubt you could find any investor who claims to have a "short-term time horizon," the fact that the average holding period of a stock on the NYSE is less than a year suggests that short-termism is the norm. Investing with a long-term time horizon means giving an investment enough time for the business to demonstrate its earnings power. Stocks are not just quotes on a screen, but rather represent an ownership stake in a business[ii]. If we were the CEO of a company about to introduce a new product line or build a new factory, it would not be logical to judge the business solely on the basis of next month's sales. Just because stock prices are quoted every minute or every day does not mean that value creation from investing can be meaningfully measured on a short-term basis. A long-term time horizon makes sense because it takes time in business to make money.

Why does this matter?

A long-term mindset matters because it can translate into the biggest gains. If you set out to make the most money from stocks after tax and after commissions, owning a stock that goes up a lot every year over the longest period of time is a good place to start. So how does one find these investments? Deconstructing the price of any stock will reveal that price is a function of its fundamental earnings power and its valuation, most commonly the product of Earnings Per Share (EPS) and a Price Earnings (P/E) multiple, (i.e. Price = EPS x P/E). For the price of a stock to rise, either EPS or P/E (ideally both) have to increase. While valuation can swing wildly from year to year, over time fundamental earnings power can rise by a far greater magnitude. If you are focused solely on valuation or short-term fundamental changes, you will likely miss out on the opportunity provided by those stocks with an outstanding long-term fundamental trajectory.

How do you actually put a long-term focus into practice?

Investing long-term requires the investor be on the lookout for those rare investment opportunities that can provide long-term earnings growth. When looking at the market through this lens many businesses just don't get a passing grade. When assessing the prospective returns from owning shares in a business, LCM typically calculates the return over a three-year horizon and weighs that against a potential downside scenario. One of the biggest misconceptions about long-term investing is that a successful investment involves one good decision at the outset, and then leaves a lot of free time for golfing. In fact, successful long-term investing is a continual process that requires a pragmatic and objective reassessment of the situation as it evolves. It is vital that the investor remain free of "confirmation bias" throughout – i.e. seeing and interpreting things as you'd like them to be rather than as they are. It requires much analysis, as the task is not simply to assess a company, but to

understand that company's position in the context of its industry and of the broader market, both of which are always changing. To illustrate my point I will provide an in-depth look at an investment I made in CN Railway between 1997 and 2007, when I was a partner at a previous firm.

CN Railway - 1997 to 2007

When I began analyzing CN Railway in 1997, the initial investment thesis was a cost cutting story. It then shifted briefly to a growth by acquisition story. This was followed by a change in management philosophy, after which pricing power developed. Finally, the investment thesis was based on asset velocity[iii]. To an outsider, CN may have appeared to be an easy investment – an initial purchase, followed by some more buying, resulting in annual total returns in the low 20% range for a decade, and ultimately adding up to a few hundred million dollars in capital gains. Having been involved in the process, I can attest that it was never that simple - there were plenty of opportunities to take the wrong turn along the way. Let me explain.

The initial thesis and background

CN Rail was a former crown corporation that was privatized by way of an initial public offering (IPO). The North American rail industry was a mature, low growth business where revenues could be expected to grow at a few percentage points less than the growth in GDP. Before the IPO, Canadian railway companies were not really on investors' radar; CN was owned by the government, and CP Rail was part of the CP conglomerate, a holding company that included interests in oil, hotels, ships and coal. The consensus amongst the US analyst community was that the profit margins of Canadian rails were destined to remain lower than their US peers for structural reasons, as long routes across a mountainous, sparsely populated country with cold winters meant challenging operating conditions. Our initial investment thesis on CN assumed modest revenue growth, but we thought that future cost cuts due to the fact that it was no longer government-owned would provide us a multi-year runway of EPS growth. The expected returns based on this scenario were attractive, despite expecting valuation to remain low consistent with the nature of the business. Under then-CEO Paul Tellier, the cost cuts came through and the operating ratio[iv] dropped from 89.0 in 1995, to 72.0 in 1999.

Growth by acquisition?

As CN began to get their costs in line, the investment thesis began to shift. Looking to expand through acquisitions, the company bought a US railroad called Illinois Central (IC) in 1998. In 1999, CN proposed a much larger deal – namely, a merger with Burlington Northern, a major Class 1 US railway. The competitors were not enthused by a merger, nor were the regulators. The Surface Transportation Board ultimately called a moratorium on mergers and effectively scuttled the deal. All was not lost for CN, however, because with the IC acquisition came a new manager, Hunter Harrison, who had a different operating philosophy. Tellier saw Harrison's talent and promoted him to COO. In 2003, Harrison became CEO when Tellier left to pursue another opportunity.

A new operating philosophy – the scheduled railroad

The thesis shifted yet again when Harrison proposed a new idea. He believed that trains should not leave the station when they were full, but rather at an appointed time. If the customer did not deliver their goods to the station on time, the train would leave without them. This sounds simple, but it was a revolutionary idea at the time. Harrison's view was that a network of trains running on schedule could run faster, and shortened delivery times could provide more competition with trucking. The benefits from scheduled railroading were faster trains, happier customers, continued low costs and

ultimately growing revenues. The biggest leap of faith was required at this stage in the investment, as the benefits of scheduling were as yet unproven, but a forecast of modest revenue growth coupled with some improvement in costs still generated attractive prospective returns thus meriting a continued investment in CN.

Pricing power
While Harrison was putting his plan in place, another change was afoot in the industry. The key metric for pricing in the rail industry is yield, quoted as cents per revenue ton mile, put simply as the amount a railway charges a customer to move one ton of goods one mile. Yield had declined each year since the 1980 Staggers Act deregulated the industry. High fixed costs and excess capacity made for a tough combination in the decades that followed deregulation. Around 2001, yield began to increase. This unexpected benefit took a few quarters to sink in, however it gradually became apparent that rather than this being a temporary cyclical phenomenon, pricing might actually be rising. This was a significant positive change to the entire North American rail industry - enough capacity had been removed from the system and the rail service had improved such that demand finally outpaced supply. And once again the thesis for owning CN demanded revision. It was easy to miss the impact of this change, as increased price had a big advantage over increased volume. An extra dollar of revenue from price dropped right to the bottom line, whereas revenue from moving extra volume had more associated costs.

Asset velocity
The final chapter in CN's decade of transformation was asset velocity. By 2003 the operating ratio had dropped below 70 sustainably, making CN the lowest cost railway in North America. At this point, many investors made the mistake of abandoning CN for other railroads, thinking the best gains had already been realized. In investing, it is often a mistake to underestimate the best company, as a smart management team doesn't just sit around waiting for their competitors to catch up. Harrison and his team had another plan in the works. Now that the railway was running well, why not truly optimize the network using the scheduled railroad concept? If the assets moved faster, theoretically you would need fewer of them to earn the same revenue. This phase provided another lever for the CN management team with which to increase return on invested capital beyond the early cost cutting phase. To model increased asset velocity, the investment thesis from this point included more revenue, or more benefit from the constructive use of the excess capital (i.e. share buybacks or dividends, etc.) that would be released, and again these forecasts yielded attractive returns at still reasonable multiples. This phase turned out to be even more profitable for investors than the initial cost cutting phase.

Conclusion
It is important to remember that between 1997 and 2007 there was a war, an oil crisis, the dot com boom, 9/11, and a recession. Naturally stock prices went up and down daily during this period. Cost cuts at CN Railway drove earnings per share growth of 21.9% annualized from late 1997 to late 2002, and the scheduled railroad concept propelled further growth at 20.5% compounded from 2002 through to the beginning of 2007. The prospective valuation multiples I had used to estimate returns in the decade under discussion never got much higher than 14X EPS. Although not the ultimate conclusion of CN's or Harrison's journey[v], in 2007 I left to start LCM, and chose not to buy CN for my new clients. After Warren Buffett bought Burlington Northern in 2009 the market caught on to the idea of railroads as good investments and we found other places to invest. This CN Railway

example demonstrates a few key points about long term investing. Firstly, it shows how long-term investing requires active analysis and constant assessment and revision of the investment thesis. Secondly, it illustrates how focusing on the fundamentals of a business over the long term can allow one to reap the most rewards from an investment.

What can clients expect going forward?

It is important that investing is approached with a long-term mindset so that when turbulence arrives it will be viewed correctly as opportunity. From the outset, I have asked each client to consider only investing capital with LCM that has a five-year minimum horizon. Because the short term is unknowable, this can guard against the scenario where a client needs to redeem capital at a low in the market. While we are conservatively positioned with a high cash position today, and we do not own the market, in every letter we caution that losses on an annual basis are unavoidable from time to time. Given our focused approach it is likely that on an annual basis our results will look nothing like the market. Our "narrow and deep" approach inevitably means that we will not always own what is "hot" and sometimes it may appear that the action is passing us by. None of these thoughts bother us. Owning shares in a company is analogous to being a part owner of a business, and just as no business owner can expect their net worth to increase in a straight upward line, neither can an investor in stocks. Despite this, owning stocks remains one of the best ways to protect and grow one's capital. 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 2019. 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 with whom our approach might resonate. Due to our segregated model we have minimum of $5 million in investable capital for new clients.

[i] 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 returns of the Canadian stock market, and has returned 2.9% per year over the ten and a half years ended December 31, 2018. The S&P 500 Total Return Index translated into Canadian dollars is used to represent the US stock market returns, and this index has earned 12.0% per year in Canadian dollar terms over this same period. Thus LCM's total portfolio return of 13.0% per year has beaten a simple average of the Canadian and US Stock Markets by 5.6% per year since inception. "Since inception" refers to the ten and a half year period from June 30, 2008 to December 31, 2018.

[ii] The idea of considering stocks as part ownership in a business first appeared in 1949 in Chapter 8 of Benjamin Graham's The Intelligent Investor.

[iii] The CN investment had an unusual number of twists and turns, but an evolving investment thesis is not that uncommon. However this is very different from "thesis creep" which is when an investment mistake is rationalized with a new thesis instead of facing the facts. For example, after suffering a major capital loss on an investment, my old bond department would always look at me straightfaced and say that the good news was now that the price had dropped, the yield going forward is excellent.

[iv] The operating ratio is a measure of costs used in the rail industry. It is calculated as operating costs divided by revenue X 100. One hundred minus the operating ratio equals the operating profit margin percentage. For instance an operating ratio of 90 corresponds to a 10% EBIT margin. A lower operating ratio is better, signifying lower costs and higher profits.

[v] CN's EPS grew at 21.2% compounded for the ten years under discussion up to 2007, and continued to grow at 12.5% per year for the next decade. Hunter Harrison passed away on December 16, 2017. After IC and CN, he went on to transform CP and finally CSX and became a legend in railroading. As my clients were one of the top 5 shareholders of CN from 1997 to 2007 I had a front row seat and learned a great deal about business from him. He was a hard-charging, charismatic individual with a strong Southern accent and a lot of folksy sayings that were packed with wisdom. Some of the favorite things I heard him say:

- "You don't build the church for Easter Sunday."
- "Do not ask the customers what they want. I already know - more services at lower prices. Instead, tell the customer what we can profitably provide."
- "People ask me if I will ever be satisfied. I tell them, no! I will be continually dissatisfied."