LEWIN CAPITAL MANAGEMENT LTD.

January 16, 2020

Dear clients and friends,

Re: LCM Annual Letter December 31, 2019

In LCM's twelfth annual letter I will discuss the markets in 2019, review our results and present a brief analysis of some recent buys and sells.

Year in Review

The headlines were dominated by talk of tariffs, trade deals and politics, but after stumbling in the fourth quarter of 2018, the stock market bounced back strongly in 2019. An individual stock rises because its earnings are growing, or because the price people are willing to pay for a dollar of those earnings (its valuation multiple) increases, and the same holds true for the market as a whole. Somewhat unusually, all the gains in 2019 were due to increased valuation. While gains due to increased earnings are more predictable and sustainable, changes in valuation are more a function of sentiment, which is more fickle and can drop just as quickly as it can rise. The trailing multiple[i] on the S&P 500 rose 28% from 22.5X earnings to 28.7X at year's end, taking the market from 'fully priced' to 'expensive' in a historical context. The priciest stocks rose the most - technology companies, utilities and real estate investment trusts (REITs) were the market leaders, further raising the average valuation for the market. The impact of technology cannot be understated, with Apple and Microsoft up 85% and 55%, respectively. These two companies combined ($2.3 trillion) are larger than the smallest 197 companies in the S&P 500 combined.[ii] The underlying earnings for the US market increased by only 2% last year, and over the past two years earnings growth has been driven primarily by the drop in US corporate tax rates, which may not persist if there is a change in government. Two factors contributing to pushing valuations higher are monetary policy and index fund flows.

Monetary policy, which is a central bank's attempt to control interest rates through the supply of money, has been unprecedentedly stimulative given the current low levels of unemployment. Interest rates act as financial gravity on stock, commodity and real estate prices. With global interest rates close to zero, and some negative rates in Europe and Japan it is hard to imagine a more aggressive posture, and there is seemingly no upper limit on asset prices. The ultimate impact of this stimulus is hard to handicap as it is without historical precedent, warranting caution. Charlie Munger said it best – if you think you understand what is going on with monetary policy and the economy, you haven't studied it carefully enough.

The shift to passive investing and related index fund flows have also contributed to high valuations. Today, over 40% of fund assets are now passive, and the enormous fund flows into passive investing have dwarfed all other fund flows over the past several years. With large active investors seeing outflows, the marginal buyer setting the price in this market has been index funds. While a normal buyer, if the price moves too high, might change his or her mind and decide to buy something else, the index buyer is indiscriminate – if it is in the index it gets bought regardless of price. While this boost to valuations might sound like a "free lunch," the potential for indiscriminate selling should not be dismissed. There is no natural buyer amongst active managers to bid for the whole market should the passive investor ever desire some liquidity, thus the price discount required for the market to clear might be alarming. Liquidity is often overlooked until you need it.

Last year I travelled to Toronto, Calgary and New York and interviewed the management of twenty-two companies. In the portfolio, we sold one third of one of our largest holdings immediately after an unexpected change in management. This stock subsequently dropped 25% in the uncertainty that followed acting as a drag on performance. The balance sheet of this company is strong, and the pedigree of the new management is excellent, but it will take time to prove. We identified and capitalized on one new idea, a conservatively-run small-cap company with a great balance sheet and good competitive position in a depressed industry. One of the most difficult constraints to satisfy with a new idea in the current market is limited downside potential at the time of purchase, but this idea has this in spades with extremely negative sentiment toward its industry creating a compelling valuation and a margin of safety – LCM paid roughly 30% of the book value of assets, or 3.5X my estimate of future earnings. It will likely take some time for this investment to work, and if it conservatively takes 5 years, we calculate an expected total return of 19.1% per year over that period. We often say that good ideas are rare - consider how rare an unlevered 19.1% five-year prospective return with limited prospect for permanent capital loss is compared to a 1.5% five-year Canadian government bond yield. In 2020, we will continue to deploy our capital with the same patience and discipline as we have done since inception and we are confident that the market will offer up opportunities.

Results[iii]

Last year we earned a total return of 6.2% or 11.8% measured in US$. Our returns in 2019 were below our long-term targets and lagged the markets. The Canadian dollar returns were held back by owning US$ investments, as the US$ weakened over 2019 versus the Canadian dollar. In every letter we have cautioned that sometimes it will feel like the action is passing us by and 2019 has been one of those years. Going back a year, relative to the Canadian market, LCM did not lose money in 2018 while the market was down considerably, so a good portion of the Canadian index returns in 2019 are simply recouping past losses. The US market has been stronger and harder to beat, however, due to the aforementioned increase in valuation multiples.

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 284.5%, or 12.4% per year on an annualized basis. We have accomplished our long-term goal to earn in excess of 7% annually, and LCM has beaten the market by 3.6% 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.

I am often asked questions[iv] about the cash LCM holds in its portfolio. These questions are important and link directly to LCM's investment approach. In our 2014 letter we reviewed how we think about cash as a residual of the investment process - if we have more buys than sells our cash will go down and vice versa. Sometimes, if not often, selling opportunities occur at different times than buying opportunities and the result is a period of time where cash remains in the portfolio. To better understand our current position, I will briefly review LCM's recent buying and selling activity.

Why do we have any cash in the portfolio? A look over the past five years
At the end of Q1 2015 cash was 26% of the portfolio versus 48% at the end of 2019. Although it may appear from reading our letters that there has not been much change in the portfolio, the reality is that LCM has done a significant amount of selling over the past five years. This has been coupled with a lower than usual number of buys over the same period, thus resulting in the higher than normal cash position.

The selling
LCM has sold or substantially reduced five positions since early 2015. These sells were significant with cumulative total sales adding up to approximately 48% of the portfolio. In each instance, the decision to sell was driven by a combination of worsening or maturing fundamental outlook, increased risk, and lower calculated expected total return. Those five sales realized gains of up to 1,050%, 930%, 470% and 68% of original cost, while one sale generated a loss of 10% versus our cost.[v] The original purchases of these securities date as far back as August of 2008, with the most recent purchase occurring during summer 2016. Although selling typically is harder to get right than buying (see 2015 letter), in each instance the shares we sold are trading at lower prices today, having declined by roughly 3% to 53% since we sold them. Hence, our sell process has been working and adding value. Said differently, while we'd be fully invested today with no cash had we hung on to all the shares we sold, we would have made less money as the returns from the portfolio would also have been lower.

The buying
Since Q1 2015 we have found two new ideas and added to one existing position. These buys added up to 12%[vi] of the portfolio cumulatively when they were bought. It is too early to judge these investments, but the 3 buys are up 18%, 23% and 25% since purchase. The frequency of good ideas is rare, perhaps one per year, so the last five years were leaner than normal. Why couldn't we find more ideas? Is our buy process working? At the root of these questions is whether it makes sense to have a disciplined approach,[vii] which is an obvious question to ask after a big gain in the market. Over the past several years, we have studied and passed on many businesses that are cheap, but also low quality – the sort of businesses you regret buying when the next recession comes along.

What about the higher-quality businesses today – why don't we just relax our discipline and pay a premium for one of these? In the investment business, the idea of buying high with the intention of selling higher has a name. It's called the "greater fool theory." The idea is that it is not foolish to overpay for something if an even "greater fool" will come along and pay more for it later. Keep in mind, however, that the person selling it to you thinks that *you* are the greater fool and they might be right. LCM is not a fan of this strategy due to the very real potential for permanent capital loss. Let me walk you through an example.

A high-quality business we do not currently own is Costco. A well-run business within the very competitive retail sector, Costco has a differentiated business model, charging a membership fee to customers for the benefit of uniquely low mark-ups which has insulated it from the threat of Amazon and a general weakness in bricks-and-mortar retail. Its early move into private label was smart, and while the company perhaps does not have as much growth potential as Aldi/Lidl (the privately held German hard discounters), its house brand Kirkland has done very well against branded products. Over roughly the past ten years since the lows of the financial crisis, sales have grown from $72 billion to $141 billion or 7% annually, and earnings per share (EPS) has grown 10.4% annually, including a 1% annual benefit from the recent reduction in the corporate tax rate. Although the company is growing from a larger base than a decade ago, the fundamental outlook for Costco is still good - barring a recession, EPS growth of 8% seems reasonable for the medium term. So, what is the market price for this company? For most of the last two decades, Costco has traded between 20X and 24X trailing earnings, as might be typical for a well-run company with some self-funded organic growth potential. It dipped to 14.1X during the worst of the financial crisis,[viii] and currently trades for 36X EPS. Three of the top five holders of Costco are passive or index funds, owning $24 billion in shares or 19.1% of the company. While the stock could rise on sentiment alone to its all-time peak in valuation of 45X, reached in the tech bubble of 1999, there is no margin of safety in the current valuation.[ix] A return to normal (not trough) valuation, say 22X, would cause a 39% drop in the stock price. If this were to occur, it would take six and a half years of earnings growth for the stock to climb back to break even. This assumes no recession, and 8% earnings growth through 2026. Zero capital gains over the next 6.5 years is not compelling.

As a point of contrast, compare Costco's 36X valuation and prospective earnings growth of 8% per year with LCM's top three holdings, which together represent a third of our portfolio. These companies each have a stronger competitive position in their respective industries, decent balance sheets, and on average are currently valued at roughly *half* Costco's valuation with a higher prospective earnings growth rate. For the new investment we identified this year, we paid 12.5X earnings and expect 29% annual earnings growth over the next five years. Looking back, consider the Exco Technologies example that we reviewed in our 2017 letter. Over the seven and a half years we owned it, Exco's earnings grew at 20.6% per year, its average valuation was 13X, and we sold some shares at 17X which was its cycle peak valuation. Exco is a small company, but the investment thesis was typical of LCM's investments. An investment thesis that is based on high prospective earnings growth rather than reliance on a large increase in the multiple is a more reliable way to make money in good *and* bad markets. These are the types of ideas at the core of LCM's approach. It is the essence of protecting and growing our capital at the same time. It does require patience and it isn't easy. Is there some reason that the bargains of the past will never occur again in the future? While we haven't seen much fear for a while, and the central bankers would have you believe they have banished the very possibility of fear from the human experience, I doubt it.

<u>What can clients expect going forward?</u>
This momentum in stocks could end tomorrow, but it also could go on for a few more years, as maddening as that sounds. The current environment reminds me a lot of the late 1990s – high valuations, huge impact from a few large companies, and general absence of fear[x]. It is interesting to recall what happened after the euphoria of the late 1990s ended, as all cycles eventually do. Virtually all of the managers who were fully invested in high multiple stocks suffered permanent impairments to their clients' capital. What followed was a fantastic period. After surviving the 2000 peak with our clients' capital intact, I was able to make a lot of money for clients by buying attractively priced businesses over the next several years such as railroads, steel companies and breweries with a good margin of safety and not much downside risk to capital.

Despite the caution we have for the market averages, it is important to remember that LCM does not own the market: generally, our holdings are not significant components of the index, the valuations of our holdings are attractive, the business models and balance sheets of our holdings are strong, and in lieu of buying investments with no margin of safety we hold a cash position. At the peak of valuations, the argument for holding cash for its option value i.e., to take advantage of future bargains, is at its strongest. Despite our current position being advantageous, in every letter we caution that losses on an annual basis are unavoidable from time to time. Given that owning shares in a company is analogous to being a part owner of a business, and just as no business owner can expect to increase their net worth in a straight upward line, neither can an investor in stocks. Taking a long-term perspective is the best advice to help maximize the long run returns for our capital.

I wish you all the best for 2020. 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.] This data is based on the latest twelve months normalized EPS from Capital IQ. There are many different multiples we could look to for the S&P 500. Based on unadjusted trailing EPS, the multiple is 24.5X, based on estimated earnings one year forward is 19.1X, and the Case-Shiller P/E using cyclically adjusted EPS is 31.5X – all say virtually the same thing. The stock market has not been this expensive since 2000, or 1929.

[ii.] From Wall Street Journal article on November 25,2019 which also pointed out how Apple and Microsoft combined, are larger than the smallest 2000 companies in the Russell 3000. The Russell 3000 index is made up of 3000 public companies that together account for 98% of the total market capitalization of all US public companies.

[iii.] 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 4.5% per year over the eleven and a half years ended December 31, 2019. 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 13.1% per year in Canadian dollar terms over this same period. Thus LCM's total portfolio return of 12.4% per year has beaten a simple average of the Canadian and U.S. Stock Markets by 3.6% per year since inception. "Since inception" refers to the eleven and a half year period from June 30, 2008 to December 31, 2019.

[iv] Sample questions 1. Why is the cash position so high? 2. How low has the cash position ever been? 3. How have you been able to earn the returns you have while holding so much cash? 4. What the hell are you up to over there? Answers: 1. In our 2014 letter we reviewed how LCM thinks of cash as a residual, the simple answer is there have been more sells than buys recently. 2. In 2012 our cash dropped below 16%. 3. LCM owns only it's best ideas, and the higher returns and lower downside of these investments has more than made up for any drag from holding cash over time. 4. Trying my best to manage risk and think logically about how to make the most money over the longest period of time.

[v] In these examples to keep it simple I have left out dividends. We include dividends in our analysis and focus on total return when making investment decisions, and in some of our investments the dividends have added considerably to our returns, however focusing just on the capital gain is straightforward and easier to calculate and it doesn't change the message.

[vi] If the cash five years ago was 26% of the portfolio, and the selling over five years added up to 48%, minus the buying of 12%, why does the cash today equal 48% instead of 26+48-12=62%? The answer is that our investments went up in value over the five years, so the weight of cash declines as a percentage of the whole portfolio.

[vii] For more on the topic of our disciplined approach, please see LCM's 2016 letter.

[viii] Astute readers might question why we did not buy Costco at the bottom of the financial crisis. While I did buy a number of businesses in the midst of that fear, I did not buy Costco and I should have. This was a stupid mistake I made.

[ix] Of course it isn't just Costco that looks expensive. On my screen I follow a selection of decent quality US companies, and these are currently valued between 26X and 48X trailing earnings, with on average similar earnings growth to Costco.

[x] Keep in mind, in spite of the absence of fear generally in the market, we were able to find one new idea this year with a good balance sheet at 3.5X normalized earnings.