LEWIN CAPITAL MANAGEMENT LTD.

January 14, 2021

Dear clients and friends,

Re: LCM Annual Letter December 31, 2020

In LCM's thirteenth annual letter I will discuss the markets in 2020, review our results and share some thoughts on mentorship.

Year in Review

There was really only one issue facing markets last year, but it was a big one. After commenting on the absence of fear in last year's letter, a few months into 2020 a global pandemic led every market participant to fear their own mortality culminating in a vigorous market sell off. At the worst, by March 23rd, the Canadian and US stock markets had declined 33 to 34%. Policy makers had to weigh the potential for millions of human deaths against the economic collapse that would result from shutting the economy down to fight the virus. Several CEOs described their order books as dropping to zero in a matter of weeks which no one had ever experienced. With the narrative of the 2008-9 financial crisis in mind, governments around the world stepped in with a huge stimulus response, this time more rapidly and more generously. The investing public, perhaps having missed out on the great buys of 2009, heard the bell ringing this time when the stimulus was announced and the rebound was as vigorous as the sell off.

As the year progressed, markets looked beyond the pandemic and one could observe many signs of a return to greed and general absence of fear. For instance, in addition to stretched market valuations (covered in last year's letter), insiders cashed out in record numbers with $167 billion of IPOs, eclipsing the previous high of $108 billion set in 1999.[i] Many of these newly public companies do not even make money, instead promising tremendous future growth. Analysts are expected to understand and predict the future benefits from network effects and scale economics that in some cases have not kicked in yet, despite the companies being already quite large. Uber provides a great example. It went public in 2019 and produces over $10 billion in annual revenue, but somehow has still never generated positive operating cash flow. Compare this to Starbucks. At the time of its IPO in 1992, Starbucks was 100X smaller, with 'only' $100 million in revenue, yet it was already generating positive earnings and cash flow. Investors are so keen to not miss out on the next big thing, they are willing to look out a lot farther into the future. The IPO statistics this year include record issuance from SPACs or "blank check" companies where the buyer is not aware of what business they are buying at the time of issue. Retail brokerage volumes, typically a contrary indicator, reached record levels through platforms like Robin Hood; levels of debt used to purchase stocks on margin also hit a high.

In terms of research and portfolio activity, 2020 was a busy year. I interviewed 52 management teams across a variety of industries mostly through one-on-one video conferencing. This is more than double the number of meetings I took in 2019, both reflecting more opportunity in the market and increased availability of executives as no one was travelling. I took an interesting course on interview techniques for investors put on by two veterans of the CIA. With respect to portfolio activity, beginning the year with a lot of cash was helpful. We invested 17.5% of the portfolio in ten buy transactions. Fear in February, March and April allowed us to increase our positions in three of our existing holdings by 3X, 2X and 30%. We also identified opportunities in 2 companies, both well managed, quality businesses that we have studied for several years and were able to buy at very attractive valuations. We did not sell any stocks in 2020, thus it was a tax efficient year with no realized capital gains. At year end, 72% of the portfolio was invested in ten companies across eight industries and we held 28% in cash. Overall, despite the high valuations of the market averages, our holdings remain priced to generate attractive returns for the portfolio over the next several years.

Results [ii]

Last year we earned a total portfolio return of 14.1% or 15.9% measured in US$. Absolute returns are the primary goal at LCM but these results also beat a simple average of the Canadian and US stock markets by 3.0%. Some of the buys we made this spring contributed to returns already in 2020. For instance, our best purchase was the existing holding we tripled in March. By December 31, this stock had risen 265% from the average price we paid in 2020.

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 338.7%, or 12.6% 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, particularly as they are a product of our patient and disciplined approach.

Mentorship – stories from both sides of the desk

One advantage of less travel and fewer in-person meetings has been more time for reflection. This year, I have thought a lot about mentorship. Throughout my career, I have had the benefit of working with great mentors who have built my confidence and taught me the importance of independent thinking. I have also had the privilege of mentoring finance students for roughly the past twenty years. And, in a year where human interaction has been limited, I thought I would share some stories of what I’ve learned.

On Confidence

Sometimes having the right mentor in your corner can push you to achieve more than you thought you could on your own. My first job out of university was managing money at a firm run by a pair of value investors. My boss was Murray Leith Sr.- he was passionate about business, curious about everything and not afraid to challenge conventional wisdom. In the mid-1990s our firm had several defined benefit pension clients that were making the decision to switch from a balanced portfolio and ‘immunize’ to lock in current interest rates and cap their liabilities. As the most recent graduate in the firm, with the most up-to-date math skills, the task fell on me to learn about immunized bond portfolio management, buy a software package to help manage the process and then restructure the portfolios. Two of these pension plans had a famously difficult pension consultant advising the plans, and it was my job (at 25 years old) to present my recommendations from the results of this process to the pension committee. I was nervous, and just before Murray and I went into the meeting, Murray took me aside and said, “Just remember Dan, nobody in that room knows this better than you do.” At that moment this was just what I needed to hear, and I delivered the presentation, answered the tough questions from the consultant and we successfully implemented my plan and kept the client.

Thinking for yourself
Another point I can recall Murray saying was: "Don't let the market do your thinking for you." [iii] What does this mean? Basically, a rising stock price should not be conflated with a great business or vice versa. You should always do your own work to establish an estimate of value for a company. If you start with the premise that not everything makes sense in the markets, you are more likely to find opportunity than someone who begins by assuming the market is rational and every investment is correctly priced. One of Benjamin Graham's famous contributions to investing is to consider the stock market a 'voting machine' in the short term, and a 'weighing machine' in the long term. The point is that opinions price the market in the short term, but facts determine the prices in the long run. If we look to the current price for guidance and don't think for ourselves, all we see is the votes or opinions which are ultimately meaningless. Patience is always important - for some companies it might seem like the scales have been thrown out, but eventually everything gets weighed. In the long run, price runs towards the weight of intrinsic value.

University of British Columbia Portfolio Management Foundation (UBCPMF)
I feel fortunate to have had a few great mentors to lean on when I needed to in my career, and I am delighted to try to pay some of that forward acting as a mentor/counsellor to the UBCPMF. The Foundation is a two-year program for half a dozen top finance students, which gives them legal accountability for the investment management of a real $10 million portfolio while they complete their finance degrees. Once a month a small group of students arrives in my board room[iv] with a list of challenging questions, usually centered on investment analysis of some company or industry. I try to foster a robust dialogue among the students, keeping my own opinions aside, so that the students learn they have the skills to work through most of these investment problems on their own. Building confidence and encouraging students to think for themselves are central objectives. As an alumnus of this program, I can attest that the lessons learned from making or losing real money are not easily forgotten.[v] I consider it a privilege to remain involved with the UBCPMF, and in fact I really enjoy it – the students bring so much energy and fresh perspective to every discussion that I feel energized after each meeting.

<u>Administrative change</u>
Since we opened in 2008, our objective has always been to be more transparent about fees charged and returns earned than the industry. In July 2016, the BCSC put in place new regulations called CRM2 which we have welcomed, mandating more uniform performance and fee reporting. To comply with CRM2, each year we send out the Investment Performance Report in early February and this includes a summary of fees paid. A few years of compiling this report has made us realize that our quarterly invoices have become redundant, so we will stop sending these starting with the current quarter.[vi] A straw poll I conducted indicated that nobody would miss the invoices, but if you can't find the information you need at tax time please let us know, we are always glad to help out.

<u>What can clients expect going forward?</u>
I left off last year's letter comparing current markets with the peak in 1999 and that is still appropriate. As I noted earlier, the enthusiasm in markets today is reminiscent of the tech bubble when everyone wanted to trade tips on dot com stocks. Today, there are signs of a bubble in electric vehicles. As Buffett says, be greedy when others are fearful, and vice versa. So perhaps now is a good time to be fearful or at least somewhat cautious. The lasting consequences of the pandemic are difficult to assess, but the idea of high inflation or loan losses from the accelerated adoption of

e-commerce are both risks worth contemplating. The prospect of increased taxation to finance the pandemic bailouts, along with a world in which owning the index is conflated with earning a risk-free return, also have potential ramifications for markets in the future.

Despite the caution we have when considering today's 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. 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 2021. 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 a minimum of $5 million in investable capital for new clients and we ask that prospective clients only allocate capital to us that has a time horizon of five years or more.

[i.] This information is from Dealogic, quoted in the December 30, 2020 edition of the Wall Street Journal. IPO is short for Initial Public Offering. Generally, the company knows more about its own business and industry than anyone else, and they are the ones that decide when to sell out to the public, hence an old joke among investors is that IPO stands for It's Probably Overpriced. This is ironic given the frenzied buying for most IPOs in the current environment.

[ii.] 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 4.6% per year over the twelve and a half years ended December 31, 2020. 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 13.3% per year in Canadian dollar terms over this same period. In US dollars the S&P 500 has risen 11.3% per year. Thus LCM's total portfolio return of 12.6% 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 twelve and a half year period from June 30, 2008 to December 31, 2020.

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[iii.] To give you an example of how deep this mindset ran in Murray, perhaps a story is in order. Early on, in addition to my duties as an equity analyst, I traded bonds to implement fixed income strategy for our clients. While we discussed bond strategy, I mentioned the duration of the ScotiaMcLeod Universe, which was the benchmark for bond portfolios composed of all issued securities. Murray said, “Now why would I care about that? Why would I let the financing decisions of a group of corporate and government treasury departments influence the duration of bonds we should own?” If there ever was a succinct explanation for anti-indexing there it is. Here is the stock market equivalent of that statement: Why would I assume that every company that goes public is worthy of investment?

[iv.] Of course our meetings have been virtual lately.

[v.] The portfolio was much smaller (around $700,000) when I was accepted into the program in 1991, but that didn’t take anything away from the experience. Our team sweated the decisions we made and every two months we were grilled by the Client Committee, comprised of leading members of the Vancouver business community. I still regard some of those meetings as the toughest I have had in the business.

[vi.] In addition to the fee disclosure in the Investment Performance Report, all fees will continue to be itemized in the January, April, July and October statements you receive directly from the custodian, and these fees are detailed again in the annual tax package you receive each spring. LCM will continue to send an invoice for annual profit share calculations if earned and will continue the practice of providing an Index of Performance for each client with every annual letter. The Index of Performance does a better job of describing overall performance for a family of accounts versus the CRM2 guidelines which stipulate that performance must be reported by individual account, for instance a CDN cash account, a USD cash account, an RRSP account etc.