January 24, 2022

Dear clients and friends,

Re: LCM Annual Letter December 31, 2021

In LCM's fourteenth annual letter I will provide a brief snapshot of the markets in 2021, review our results and make a few observations about investing.

Year in Review

The market brushed off all concerns and rose with optimism in 2021. Indicators of euphoric sentiment typically seen at market tops are everywhere: index valuations are near record levels meaning high stock prices relative to underlying earnings; margin debt is at record highs; retail participation is high; the notional value of options traded has hit a record high and the number of IPOs in the United States reached an all-time high this year with over a thousand companies selling out to go public. While some businesses remain impacted directly by the pandemic, the big issues affecting markets remain the same - inflation and interest rates. Measures of inflation such as CPI are rising at a pace not seen since the early 1980s, and the general consensus on interest rates is that the Fed will raise short term rates several times in 2022 to keep inflation in check. Whether the current increase in inflation, brought on by pandemic related stimulus and supply chain issues, is transitory or permanent is the subject of great debate and there is no clear answer. Likewise, it is unclear if interest rates will rise to levels that threaten the economy. What is clear is that it is prudent to ensure that security-level calculations of prospective returns still look attractive using higher assumptions for inflation and interest rates.[i]

Despite all the froth in the markets, there are still pockets of value. Current market conditions are reminiscent of the late 1990s when any company not related to the internet or technology was widely and incorrectly viewed as obsolete. At that time, contrary to the popular view, I was able to make money for my clients by buying breweries, railroads and steel mills at compelling values. Today, the market has discarded businesses that do not fit the popular *compounder* narrative (a growing company with low volatility in results, perceived competitive 'moat', high historic returns on capital, significant index weight and perhaps long history of share buybacks), or the *disruptor* narrative which I will discuss later in this letter. In 2019, we identified an opportunity that had none of the compounder or disrupter characteristics currently desired by the market. Indeed, when we made our initial investment the industry consensus was so uniformly negative the highest quality assets in this industry were available for 30 cents on the dollar. Three years later, our initial contrarian investment thesis is unfolding as expected, and after a nice gain in share prices last year (which was a key contributor to LCM's returns in 2021) the businesses we own are still priced very attractively: selling for double-digit free cash flow yields using conservative assumptions.

In terms of research and portfolio activity, in 2021 I interviewed 33 management teams and attended 4 conferences, all virtually. With respect to portfolio activity, LCM only bought stocks in 2020 but in

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2021 some selling was warranted where price rose faster than our estimate of intrinsic value. We also shifted some capital between holdings to increase returns. At year end our portfolio was invested in ten companies across eight industries and we held 32% in cash. Overall, despite 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 41.8% or 42.9% measured in US$. These results beat a simple average of the Canadian and US stock markets by 15.4%. The Canadian stock market rose 25.1% and the US market was up 28.7% (up 27.7% in Canadian dollars).

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 521.9%, or 14.5% 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 4.3% 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 investment approach.

A Few Observations About Investing And Markets

Each year I spend some time in my annual letter discussing an aspect of LCM's approach or an observation about the market. This year I will discuss why it is important to consider how returns are earned, as well as provide a cautionary note on unprofitable *disruptor* business models.

How returns are earned

The giant marketing machine of the investment industry inundates the public with much fanfare about the returns of the top funds each year, but rarely mentions how the returns were earned. In my opinion, how returns are earned is as important as the level of returns from year to year. Why is this important? It is important because it is meaningless to evaluate the returns of any investor without considering the risk taken to achieve them. Suppose, for example, we interviewed a winning race car driver, and discovered that the champion won by cutting out the seat belts and removing the brakes thereby creating the lightest and fastest winning car. What matters is not that the driver won this race, but for the next ten races, because of the risk they take, nine times out of ten they won't finish. How the returns are earned is important because it influences future performance.

How LCM earns returns has not changed over the past fourteen years and is a function of our patient and disciplined approach. We spend a lot of effort trying to minimize permanent losses of capital by conducting rigorous due diligence, ensuring a margin of safety at the time of purchase for each position, and focusing on the balance sheet of our holdings. Today, for example, of our ten current positions, six have (or will have inside the next twelve months) zero debt net of the cash on their balance sheets. We also limit the total exposure to any one company or industry as a percent of the portfolio at the time of purchase. All of the businesses we have owned are decent quality, and instead of lowering our standards and buying lower quality securities with no margin of safety we hold cash. While nothing can insulate a portfolio from periodic annual losses, following a patient and disciplined approach should reduce the chance of permanent loss of capital over the long term.

Caution: unprofitable disruptors ahead
One area of the market that is receiving a lot of attention these days are newly public companies that seek to disrupt various existing industries and change how business is conducted. Let's call these companies *disruptors*. What they tend to have in common, besides having recently gone public, is fast growing revenues, some technology or platform that will help them capture a significant share of a large total addressable market for their products or services at some point in the future, and unfortunately, many of them have a money-losing bottom line.[iii]

If you canvassed the globe for the 40 largest, newly-public companies that have never earned any EBITDA[iv] in their lifetimes, you'd find many disruptors in e-commerce, ride-sharing, food delivery, cloud computing, and electric cars. These businesses seem to me to be incredibly richly valued. Collectively these 40 companies are trading for C$2.8 *trillion* in total, or an average of C$71 billion per company. These new disruptors have growing revenues, but otherwise lack current fundamentals and have little in the way of hard assets. These attributes make it difficult to estimate an intrinsic value for the business, and therefore establish a margin of safety – despite much upside potential, they have no downside protection and thus are unlikely investments for LCM.[v] In bear markets, businesses with no fundamentals (such as EBITDA, cashflow, operating profit, net income, or free cash flow) or no hard assets (such as real estate, factories, or established brands) tend to get hit the worst. No doubt amongst this list of hopeful world-changers, there will be some startling successes.[vi] However, many will surely fail.[vii]

Incidentally, while the stock market is generally good at correctly pricing small bits of incremental news - a quarterly earnings release, or a tuck-in acquisition - it often makes big mistakes (over and undervaluing) when major changes to industries are underway. After rewarding the founders of these 40 disruptors with over $2 trillion in paper gains, one may wonder whether the founders might be tempted to sell some of their shares for a few billion and move on to the next challenge rather than sticking around and doing the heavy lifting required to eke an operating profit out of these emerging businesses. If you are interested in making money from these disruptive new ventures, perhaps the best path is to found one yourself rather than buying shares in the company post an IPO.

<u>What can clients expect going forward?</u>
Demanding a margin of safety can minimize losses over the long term, but periodic losses are unavoidable for all investors in the stock market. The fact that other people buying and selling each day determines the price of the stocks you own is a unique feature of the stock market and what makes stocks unlike any other asset class. Top real estate investors do not have to suffer the indignity of marking down their most esteemed properties because someone mailed in a stink bid at 40 cents on the dollar. Private equity owners can pretend their investments are whole even during a global financial crisis. [viii] For stocks, even if the majority of shares in Public Company XYZ are owned by reputable institutions, at any moment the price of the whole company on the stock exchange could be determined by a single hot-headed lunatic [ix] with 100 shares they are desperate to buy or sell quickly. As such, holders of common stocks need to be comfortable with occasional dramatic declines in price.

Of course, the availability of daily price and liquidity in stocks can be turned from a nuisance or inconvenience into a tremendous advantage that we can profit from if we have some cash and the right mindset. Few real estate or private business owners get a chance to add to their best assets at a

60% discount. 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 2022. 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.] There are a few things to consider when contemplating the impact of higher interest rates and/or inflation on different businesses. Both rising inflation and rising interest rates are bad for high multiple stocks, as the discount rate rises, distant cashflows are worth less and multiples drop. Inflation can be problematic for very capital intensive businesses, as it takes more profit to maintain the property, plant and equipment. Also the premium one pays for companies with pricing power might drop if every company is able to raise prices in an inflationary environment. And of course, higher rates are bad for businesses with a lot of debt to the extent that a higher percentage of cashflow has to go towards financing or repaying the debt.

[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 6.0% per year over the thirteen and a half years ended December 31, 2021. 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 14.3% per year in Canadian dollar terms over this same period. In US dollars the S&P 500 has risen 12.5% per year. Thus LCM's total portfolio return of 14.5% per year has beaten a simple average of the Canadian and U.S. Stock Markets by 4.3% per year since inception. "Since inception" refers to the thirteen-and-a-half-year period from June 30, 2008 to December 31, 2021.

[iii] Is it really necessary that a business makes money? Couldn't it be wise for a business to foresake all of its profits to accelerate future growth? The prevailing view amongst venture capitalists seems to be that businesses can endure a long period of not making money as long as they are growing quickly. Benjamin Graham's idea that stocks should be considered as fractional stakes in whole businesses is a helpful concept here. If you bought 100% of a business one year ago that lost $100 million last year, you would be $100 million poorer today. Bigger isn't better if it isn't more profitable. Running a business with no profit is a dangerous game, consider how the inventors of VHS video tapes might feel today, had they forgone profits for the first decade of their product rollout to ensure they captured the greatest share of the market.

[iv] On December 10, 2021 I did a quick screen on S&P Capital IQ for all the global public companies with over C$5 billion market cap, and currently negative EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Sorting from largest to smallest, I made a list of the 40 largest companies that have not recorded EBITDA for any year since they were created. I have been critical of EBITDA and it is a flawed metric to be sure, as Interest, Taxes and Depreciation are generally all real expenses. In this case we have used EBITDA as it is the most lax measure of profitability we could find to be charitable to these emerging disruptive businesses.

[v] Of course, just because a business hasn't made any money doesn't mean it has zero intrinsic value and thus cannot demonstrate a margin of safety – it is the discounted *future* cashflows from a business which determine its value today. Perhaps the business is on the cusp of achieving a critical economy of scale or network effect from broad adoption such that it will soon dominate its category and profitably get a large share of the total addressable market. Businesses that continue to lose money require funding: forecasting the future terms under which those funds may be raised is often a critical variable in assessing the per share intrinsic value today. This adds a great deal of uncertainty and complexity to forecasts, because current value is determined in part by what the future value will be. The difficulty for an investment analyst is establishing a high enough degree of confidence in your forecast to make a realistic appraisal of intrinsic value.

[vi] Amazon is probably the original and most successful *disruptor*, having changed the way books were sold, and then going on to transform publishing, retailing and cloud computing. Given the enormous wealth Amazon generated for its shareholders, it is no surprise that a number of businesses want to emulate their success. For the record, AMZN was unprofitable for its first few years of existence, but has earned positive EBITDA since 2001, and positive net income since 2003.

[vii] In 2020 I did a deep dive into a $6 billion IPO that was billed as a disruptive threat to one of LCM's investments in financial services. After reading all the filings, listening to three interviews with management and one quarterly earnings call I predicted an unending stream of future losses and calculated intrinsic value at zero. I admit it is anecdotal to give only this one example, however this IPO was one of the recent few that was squarely inside my circle of competence. If this IPO is in any way indicative of the average quality of disruptors being taken public it is a damning indictment of the investment bankers. This stock price is down 80% since I did the work, and down 89% from IPO price.

[viii] During the financial crisis in 2008-9, as the stock market collapsed private equity values held up comparatively well. This is surprising as private equity companies carry much more debt, and the high yield debt of some of the very same private enterprises collapsed in price. As debt ranks ahead of equity, if the debt is marked down then the equity of private companies should logically be worth even less.

[ix] In Chapter 8 of The Intelligent Investor, Benjamin Graham named this irrational lunatic Mr. Market and wisely instructed investors to not get bothered by his manic-depressive nature, but rather take advantage of it.