LEWIN CAPITAL MANAGEMENT LTD.

January 16, 2023

Dear clients and friends,

Re: LCM Annual Letter December 31, 2022

In LCM's fifteenth annual letter I will discuss the markets in 2022, review our results and discuss why "fear of missing out" has no place in an investment strategy.

Year in Review

Risk came back into focus this year, as central banks around the world tightened monetary policy to quell post-pandemic inflation. US inflation hit 9.1% in June, a level not seen since 1981. To combat inflation, the US Federal Reserve raised interest rates more aggressively than it had in 40 years, with the federal funds rate rising 4.25% over 2022 from near zero levels in March. Similarly, in Canada the prime lending rate rose 4% to 6.45% during the year. As interest rates act as financial gravity on asset prices, stock, bond and real estate prices were all under pressure in 2022. Geopolitical issues added to the uncertainty, with Russia invading the Ukraine and concerns rising about potential conflict between China and Taiwan.

After such an historic rise in interest rates and inflation, it is tempting to conclude a crystal ball is needed to navigate the current market. Indeed, there are presently a number of big questions about the economy[i] that investors do not know the answers to – and in fact, the central bank governors don't know the answers either.[ii] How does one invest with this overhanging macroeconomic uncertainty? This was the exact topic we dealt with in our 2009 letter, "The Role of Economic Forecasting in LCM's Investment Process." What is required to make money in these markets are the same skills needed in any economic environment – they are the ability to value a business and the ability to identify business quality. As the potential risks of rising interest rates and rising inflation have been present for some time,[iii] LCM has incorporated a wider range of assumptions for the economy, interest rates and inflation in its calculations of intrinsic value of businesses. If an investment thesis does not stand up to this analysis, we will sell it as we have in the past.

In terms of research and portfolio activity, last year I interviewed 23 management teams (including a welcome return to eleven in-person interviews) and attended 4 virtual investment conferences. With respect to portfolio activity, LCM sold one position in its entirety on the back of what looked like an expensive acquisition, and we trimmed two positions by roughly one third each due to concerns about position size and maturation of the investment thesis underlying each position. We bought more of one company that we had sold most of in 2017; this is now our 4th largest holding and is priced to generate compelling returns. At year end, our portfolio was invested in nine companies across eight industries, and we held 35% in cash. Our holdings remain priced to generate attractive returns for the portfolio over a multi-year investment horizon.

Results[iv]

Last year we earned a total portfolio return of 8.7%. These positive results were earned against a somewhat ugly backdrop of market declines. The Canadian stock market declined by 5.8% and the US market was down 18.1% (down 12.4% in Canadian dollars). LCM's results beat a simple average of the Canadian and US stock markets by 17.8% in 2022.[v]

Over the past 3 years, LCM has earned 20.7% per year, beating a simple average of the Canadian and US stock markets by 12.3% per year. The Canadian stock market gained 7.5% per year, and the US market was up 7.7% per year (9.2% in Canadian dollars) over the same 3-year period.

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 576.1%, or 14.1% 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 5.4% 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 process.

FOMO has No Place in an Investment Strategy

Last year offered up numerous examples of why FOMO (fear of missing out) should never be part of an investment strategy. The decline in interest rates in recent years had the effect of lulling investors into a false sense of security. And in the several years prior to 2022, an environment of rapidly rising prices created all sorts of justification for throwing caution to the wind, abandoning a disciplined approach, and following the crowd.

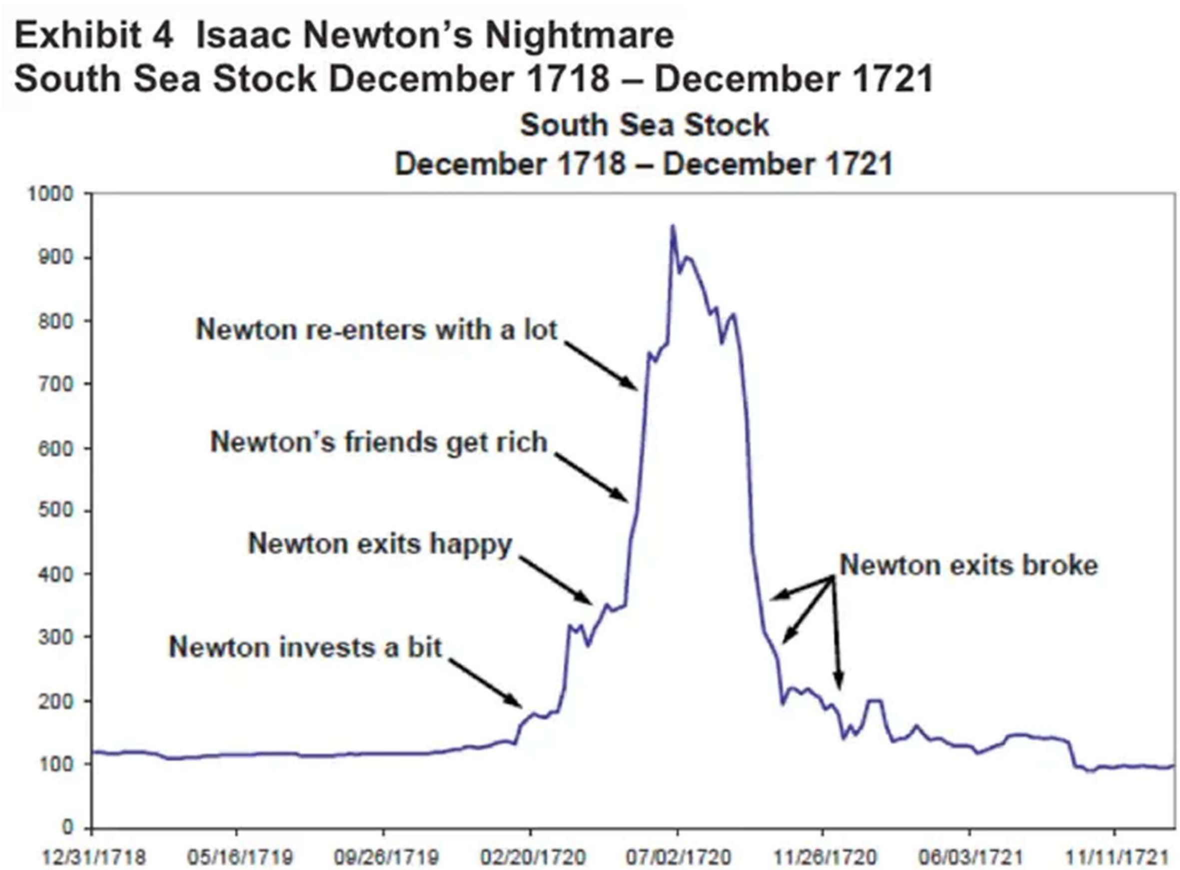
As savings accounts and government bonds provided little to no income, many risky purchases were justified by TINA or a “there is no alternative” mindset. With near zero discount rates, distant future cashflows became very valuable, thus companies that had the potential for growth, particularly in the technology sector, were bid up to very expensive levels. Speculation flourished in assets that paid no interest such as bitcoin and direct investments in commodities. The magic combination of past price appreciation and FOMO drove investors to buy what’s “hot” rather than follow a disciplined process of investing with a margin of safety. However, the rise in interest rates in 2022 has caused a wholesale re-think about the wisdom of this behavior. FAANG[vi] stocks, the five leading technology companies, were down on average 46%. Tesla, the electric vehicle manufacturer with a cult-like following amongst retail investors, declined 65%. Bitcoin also finished the year down 65%.

Retail investors weren’t the only investors influenced by fear of missing out. Institutional investors, seeking to emulate the higher returns that the Yale Endowment earned in its early move to alternative assets decades ago, deployed trillions of dollars into the illiquid private equity industry. Should interest rates remain elevated, many deals done by private equity firms will face a reckoning in the years ahead, as the economics of those deals are often dependent on heavy borrowing and low rates. FOMO and a rising tape can be hard to resist, even for the smartest amongst us, as the next example will illustrate.

A history lesson on the perils of FOMO from Isaac Newton

Jeremy Grantham, an expert on financial bubbles at GMO Investments, has presented an excellent example of how even the brightest people can lose their sense in the market using Isaac Newton’s investments in the South Sea Company in the year 1720. The South Sea Bubble is often mentioned in collections of historic financial bubbles and manias, and I’ve always liked Grantham’s chart for its vivid depiction of how Isaac Newton experienced FOMO.

Mr. Grantham presented the following chart in a letter in 2011. The chart depicts Isaac Newton's investments in the South Sea Stock over a three-year period.



Marc Faber, Editor and Publisher of "The Gloom, Boom & Doom Report."

In Grantham's words, this is what happened:

> Newton had the great good luck to get into the South Sea Bubble early. He made a really decent investment and a very quick killing, which mattered to him. It was enough to count. He then got out, and suffered the most painful experience that can happen in investing: he watched all his friends getting disgustingly rich. He lost his cool and got back in, but to make up for lost time, he got back in with a whole lot more (some of it borrowed), nicely caught the decline, and was totally wiped out. And he is reported to have said something like, "I can calculate the movement of heavenly bodies but not the madness of men." [vii]

I cannot think of a better example of FOMO. Isaac Newton, a brilliant mathematician, scientist, discoverer of the laws of motion and gravity, and inventor of the first reflecting telescope, among many other achievements, was driven by FOMO to risk it all. One might think that Newton's capacity for logic would protect him from the pressure of the crowd, but rising prices and envy caused him to lose his sense, borrow money and buy back shares at prices above the price he had already sold, and he lost everything. If it can happen to someone as smart as Newton, then surely we all need to keep our wits about us and be careful to not abandon our discipline in hot markets.

An update on unprofitable disruptors
A final reminder on the benefit of keeping one's head in frothy markets comes by way of an update on the 'disruptor' business models which we cautioned against in our letter last year. The rising prices of these stocks were irresistible to many, culminating in what was probably the worst example of overvaluation in the market since the tech bubble in 2000. What a difference a year makes. The 40 largest, newly-public companies that had never earned any EBITDA in their lifetimes were valued at a collective C$2.859 *trillion* when we made the calculations in December of 2021. One year later, the value of these same 40 businesses is C$1.468 trillion, for a one-year decline of roughly 49%. While most of these businesses are still losing money, 4 of them reached positive EBITDA during the year. Interestingly, even those 4 stocks declined on average 24% last year. A logical question might be, "At what price do these businesses look interesting?" My cynical answer is that after falling 49%, for most of these companies there is only another 100% of losses left to go. The hard truth about markets is that a business that doesn't make money is very likely to be worthless – apart from possibly having some unique strategic value to a profitable incumbent. This is not where LCM will spend a lot of time sifting through the ashes to find value, especially when there are plenty of proven business models to study that already make money most of the time.

How to stay the course
Nothing can suspend the human capacity for critical thinking faster than watching other people make money quickly and easily. And, under the influence of FOMO, people often mistake the fear of not keeping up with one's neighbors as "risk", when in fact that fear is actually envy. Risk in investing is losing money, or permanent loss of capital. Envy has been a powerful driver of human behavior since the beginning of time, and in an investment context, envy often leads people to take their eye off the ball of the real "risk" of losing money, ultimately with disastrous results.

As Phil Fisher and Charlie Munger have opined, all you need is a handful of decent businesses purchased at attractive prices to protect and grow your capital. Demanding a margin of safety on one's investments is a vital component to this process, but it will not protect you from losses from time to time, and you may miss out on many of the raging booms that occur periodically in markets. Importantly, however, you will have a much better chance of sidestepping most of the capital destroying busts that follow every boom. With your hard-earned capital invested in a select group of decent quality businesses, purchased with a margin of safety, you can achieve the ultimate goal of earning *more attractive returns on your capital* over the long term, having not taken as much risk as your peers. And if you find yourself getting impatient, remember Isaac Newton.

<u>T-bills</u>
As interest rates offered on risk-free treasury bills backed directly by the Government of Canada have increased, we have started buying them for clients in the cash portion of the portfolio again. At lower interest rates they weren't worth the hassle because if rates rose and we needed to sell the bill to fund a new investment, it was possible to incur a small loss instead of earning a small amount of interest. Now that the rates are satisfactory, it is a modest but worthwhile benefit to our returns. T-bills are very liquid so they can be sold immediately as we identify new investments. Expect to see more of these in the cash portion of our portfolio should rates remain attractive.

What can clients expect going forward?
It is important to remember that LCM does not own the market and 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 2023. If you have any questions, please call me at 604-558-0070.

Sincerely,

Daniel Lewin CFA
President

P.S. We are grateful for referrals with whom our approach might resonate. Due to our segregated model we have a minimum of $10 million for new clients and we ask that all clients only allocate capital to us that has a time horizon of five years or more.

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[i] Such as: how high will interest rates go, and for how long will they stay high? Will there be a recession, and if so how long and deep of a recession will result from the Fed's tightening actions? What will it take to rein in inflation? What will be the rate of inflation 5 or 10 years from now?

[ii] Although I read the autobiography of Paul Volcker, Keeping At It by Paul A. Volcker with Christine Harper, and I am pretty sure every Central Bank governor around the world read it too. Volcker was the Chairman of the Federal Reserve that conquered inflation forty years ago, and his story cautions against concluding an early win against inflation as it can come back worse and be much more challenging to fight as it was in 1982.

[iii] In our annual letters we first mentioned rising interest rates and inflation as risks to consider as far back as 2013. And we highlighted the risk of rising rates again in 2018 and inflation risks again in our 2018 and 2020 letters.

[iv] 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 5.1% per year over the fourteen and a half years ended December 31, 2022. 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 12.3% per year in Canadian dollar terms over this same period. In US dollars the S&P 500 has risen 10.1% per year. Thus LCM's total portfolio return of 14.1% per year has beaten a simple average of the Canadian and U.S. Stock Markets by 5.4% per year since inception. "Since inception" refers to the fourteen and a half year period from June 30, 2008 to December 31, 2022.

[v] Not a lot of equity investors earned a positive return last year. From a WSJ Article on January 9, 2023 "The Best Stock-Fund Managers of 2022" of 1,410 actively managed funds only 40 earned a positive return last year. The average loss for the whole year according to Morningstar Direct was -18.2% in US dollars.

[vi] FAANG stands for the stock prices of Facebook, Apple, Amazon, Netflix and Google.

[vii] GMO Special Topic, January 2011. Titled "Letters to the Investment Committee XVII" authored by Jeremy Grantham.