LEWIN CAPITAL MANAGEMENT LTD.

January 22, 2024

Dear clients and friends,

Re: LCM Annual Letter December 31, 2023

In LCM's sixteenth annual letter I will discuss the markets in 2023, review our results and share some thoughts on narrow markets and interest rates.

Year in Review

Rising interest rates caused by continued central bank tightening were a big stress on the economy in 2023, and signs of cracks at the margins made for jittery capital markets. Higher rates meant lower asset values, which sparked runs from concerned depositors at a few banks. In March, three small to mid-sized US banks failed, and liquidity concerns at the global brokerage firm Credit Suisse resulted in its forced sale to a competitor. By October, the US 10-year treasury bond yield had risen to 4.9%, a level not seen since 2007. Because monetary policy acts with "long and variable lags,"[1] many businesses were holding their breath, waiting to see how much the economy was going to slow. Consumer Price Inflation, the key target of central bank tightening, appeared to ease somewhat with US Core CPI decelerating to 4% by the end of the year. This gave the US Federal Reserve cover for a pause in tightening, and talks shifted to the potential for some interest rate cuts next year. While the bankers adjusted their models, geopolitical concerns worsened, with a war continuing in the Ukraine, a war breaking out in Gaza, ongoing unease between Taiwan and China, and tension surfacing between Guyana and Venezuela.

After facing a reckoning in 2022, the largest stocks in the market bounced back in 2023. The seven largest companies in the S&P 500 (dubbed the Magnificent Seven) had an average gain of 111% in 2023. Keep in mind these same seven companies had an average loss of 46% in 2022.[2] Since the Mag 7 now account for over 30% of the US market, gains in these few stocks largely drove the returns of the entire market index. This phenomenon is known as a "narrow" market, and I will share some thoughts on the ramifications of narrow markets later in the letter. Outside of the Mag 7, the stock market had a return of roughly zero for the first ten months of 2023. In November, after the Fed hinted that rate hikes were potentially on pause, all of the businesses that had been hit hard by interest rate increases jumped up in the final two months of 2023.

In terms of research and portfolio activity, last year I conducted 34 management interviews, and attended 4 investment conferences. Some of our investments faced fundamental challenges in 2023, including increased costs to deliver products or services due to inflationary pressures, and uneven demand as customer buying patterns reverted to 'normal' after elevated purchasing and supply chain problems through the pandemic. Last year required a fair amount of analytical effort to ensure that the competitive position of our companies was still advantageous given the significant changes in the economic environment. We sold a portion of three of our holdings where the consensus was rosy, but the fundamental outlook appeared less solid, and we added to one existing holding at compelling valuations. At year end, our portfolio looked only modestly different than last year, with investments in nine companies across eight industries, and 36% in cash. Our cash was invested in Canada and US government treasury bills at rates from 4.9% to 5.4%, and these bills can be sold easily as we identify new ideas. LCM's top four holdings are projected to earn annual total returns in the high teens on average over the next three to five years using assumptions that appear conservative, and collectively these businesses represent roughly 43% of our portfolio.

Results[3]

Last year we earned a return of 6.5%. This result was below our long-term target and lagged the markets which were heavily influenced by the rise in US mega caps. In addition, because our core holdings have strong balance sheets and low financial leverage, the potential drop in rates at the end of the year did not benefit these stock prices much.

Looking back to the start of the pandemic, over the past four years, LCM has earned 17.0% per year, beating a simple average of the Canadian and US stock markets by 6.4% per year. These returns were a function of good stock selection along with having cash to deploy during the pandemic at bargain prices. The Canadian stock market gained 8.6% per year, and the US market was up 12.0% per year (12.6% in Canadian dollars) over the same four-year period.

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 620.1%, or 13.6% 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 4.3% per year relative to a simple average of the Canadian and US stock markets since inception. We are pleased with these long-term results, particularly as they are a product of our patient and disciplined investment process.

Some Thoughts on Narrow Markets

Over the past few years, the US market returns have been largely driven by a handful of stocks, making for a narrow market. Narrow markets occur when a small group of stocks determine the performance of the market as a whole. This typically drags on for several years making it appear that a new investment paradigm has set in. The Tech Bubble of the 1990s is a common example. In that instance, the arrival of the internet led investors to become so enthralled with technology stocks that the stock prices rocketed well beyond what their fundamentals could justify, and “old economy” stocks were jettisoned. The tendency for rising prices to limit critical thought took hold, begetting further rising prices, overvaluations, and eventually permanent loss of capital.[4]

The Nifty Fifty is another great example of a narrow market. In the late 1960s, a couple of brokerage firms came up with the idea that an institutional investor only need own the 50 best companies; because they were of such high quality, and their prospects so bright, their valuation was irrelevant.[5] Nifty Fifty stocks were promoted as “one decision stocks” meaning an investor just needed to decide whether or not to buy them, and then never had to sell.[6] The funneling of institutional buying into a short list of companies had predictable results – it created a self-fulfilling prophecy of rising stock prices and ever-increasing valuations for the Nifty Fifty. In 1972, at the peak, a dollar of earnings from the Nifty Fifty was valued at an average P/E of 43X; this was more than double the 18X multiple of the S&P 500 at the time. Companies on the Nifty Fifty list included heavyweights such as Johnson and Johnson, Procter and Gamble, Xerox and Avon. It’s not hard to imagine investors owning these stocks and thinking their capital was totally safe, after all they used these companies’ products everyday, not unlike investors in the Magnificent Seven today taking comfort each time they order something from Amazon, scroll through Instagram, or drive in a Tesla. However, the strength of the business models and the ubiquity of the products did nothing to save investors in the Nifty Fifty. These favored stocks dropped over 50% in the bear market of 1973-74, faring worse than the market. Moreover, the damage from overpaying for the stocks persisted. From the peak in 1972, these stocks on average lost money for the next five years. If you held on to them for 29 years, you would have ended up with half as much money as you would have if you had invested in the S& P 500 instead.[7] While a large proportion of companies that comprised the Tech Bubble ultimately proved to be worthless, that was not the case in the Nifty Fifty; however, despite the high quality of the businesses, the consequences of overpaying prevailed.

Returning to the present day, the outperformance of US mega-caps over the last few years has been driven by a perception that these large businesses are not susceptible to a slowing economy, and a yet-to-be proven narrative that artificial intelligence is going to disproportionately benefit these companies. While these notions may prove true, it appears equally likely that we are in a period of overvaluation, with the Mag 7 trading at 45X trailing earnings,[8] which is roughly double the valuation of the market and similar to the premiums of the Nifty Fifty at the peak in 1972. In fact, three of the Mag 7 companies have multiples over 65X, which strikes us as dangerous given what we know from the past.

What can we take away from the history of narrow markets? Danger occurs when a narrow part of the market rises too much, creating an overvalued situation where stocks trade well above their underlying intrinsic value, leading to conditions ripe for permanent loss of capital. Even though the initial idea from which a narrow market is born is often a good one, it can be taken too far. In Warren Buffett's words "what the wise do in the beginning, fools do in the end." We see red flags when investors get so enamored with certain stocks that talk of selling them becomes viewed as foolish and unnecessary (cue the Nifty Fifty). This is made ever more frustrating because the sentiment can drag on for several years. However, history has shown that the sentiment supporting high valuations can disappear in an instant; when a margin of safety cannot be identified it is prudent to look elsewhere for opportunity. Heeding the lessons of the past, and remaining patient and disciplined, will allow us to protect and grow our capital over the long run.

The Price of Time – Low Interest Rates and Financial Bubbles

I selected The Price of Time by Edward Chancellor as LCM's holiday book this year because it is packed with interesting information about interest rates, a subject at the forefront of everyone's mind in 2023. Particularly noteworthy are Chancellor's comments on Walter Bagehot, an English banker from the 1850s:

> As a banker and financial journalist, Bagehot observed that outbreaks of financial recklessness did not occur at random. Rather they tended to appear at times when money was easy and interest rates low.[9]

Chancellor links the most speculative financial episodes of history to periods of easy money, including the Dutch Tulip mania in the 1600s, the Mississippi Company bubble in France and Britain's South Sea Bubble[10] in the 1700s, the British railway mania of the 1800s, and the dramatic growth in credit preceding the crash of 1929.

The past fifteen years have provided a dramatic example of easy money in North America. After the Great Financial Crisis of 2008/9, the Fed dropped rates to zero, kept them there for 7 years, and supported the bond market via a $6+ trillion expansion of the Fed's balance sheet.[11] The instances of capital misallocation that flowed from this policy are numerous and global in scale. Consider China's massive property boom that fueled a huge consumption of global resources, the 18 trillion dollars of bonds across the globe that traded at negative yields in 2020, the proliferation of $1 billion+ unicorns in private equity, or the C$2.8 trillion value for the 40 largest newly-public unprofitable disruptors we discussed in the 2021 letter. These bold acts of monetary stimulus are without precedent and the result of this “easy money” approach has yet to be fully tallied.

In considering alternatives to the easy money policy adopted in North America, Chancellor highlights a fascinating counterexample, recounting what occurred in Iceland.[12] The 2008 Global Financial Crisis impacted Iceland too, but authorities there took a decidedly different approach to address the issue. Several of the offending bankers were jailed, three of the worst banks were privatized, interest rates *rose* and unemployment jumped considerably. What is perhaps most interesting is that 6 or 7 years after the crisis the level of unemployment returned to normal, and the citizens of Iceland were left with a healthy respect for maintaining a prudent balance sheet.[13]

So where does this leave us? Today, even the central bankers cannot say with certainty what will happen to interest rates, and there is some debate about whether the Fed’s policies can ever be unwound. While this could be a cause for trepidation, one refreshing thought is that LCM’s strategy has never relied on a perfect forecast of interest rates. Monetary policy has been aggressively stimulative for most of LCM’s existence, boosting asset values and rewarding leverage, but LCM has still managed to earn an attractive level of risk-adjusted return on our capital by focusing on decent-quality businesses and demanding a margin of safety. My personal hope is that central bankers end their experiment with zero rates, and rates settle at some normal level that benefits savers again. While we don’t expect it to be easy, LCM’s focused mandate and long-term perspective best position us to be able continue to protect and grow our capital whatever the future holds.

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 2024. 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 out 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.

1 The concept that monetary policy acts with a lag is generally attributed to Nobel Prize winning economist Milton Friedman in the 1950s but the quote here "Monetary policy operates with what they refer to as 'long and variable lags'" is made by Thomas Hoenig, in the excellent book The Lords of Easy Money by Christopher Leonard. Mr. Hoenig is the former President of the Federal Reserve Bank of Kansas City, and his dissenting opinion against Federal Reserve Chairman Bernanke's aggressively easy policies after the financial crisis is laid out in the book.

2 The Magnificent Seven are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. Recall that investment returns are multiplicative not additive, so the two year return of the Mag 7 is -46% x 111% or (1-.46)x(1+1.11) -1 = 13.9% or 6.7% per year over the two years.

3 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 5.6% per year over the fifteen and a half years ended December 31, 2023. 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 12.9% per year in Canadian dollar terms over this same period. In US dollars the S&P 500 has risen 11.1% per year. Thus LCM's total portfolio return of 13.6% 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 fifteen and a half year period from June 30, 2008 to December 31, 2023.

4 The NASDAQ Composite Index of technology companies peaked in March 2000 at a Price/Earnings Ratio of 200X only to fall 78% from its peak by October 2002, erasing all of the gains since the bubble started in 1996. Incidentally, the stock market is generally efficient at pricing in incremental news to a business such as a quarterly earnings report, or a tuck-in acquisition, but it often makes mistakes when a substantial change is underway like the introduction of the internet, or artificial intelligence for instance.

5 In fact Morgan Guaranty and Kidder Peabody came up with their own lists and 24 stocks overlapped, appearing on both lists. The academic study in footnote 8 uses these 24 stocks for its calculations.

6 This is similar to a widely accepted narrative amongst prominent value investors today that one should fill their portfolio only with 'compounders' and ideally hold them forever. While I would not likely sell a business with a durable competitive advantage and an attractive long term fundamental trajectory if it trades temporarily at a 25% or 50% premium to my best estimate of intrinsic value, the future is never certain, and at a 200% or 300% premium surely it may make better sense to sell and buy something else, or sell and just wait in cash rather than expose your capital to significant loss.

7 This data is from Jeff Fesenmaier and Gary Smith "The Nifty-Fifty Re-Revisited" Journal of Investing, Fall 2002, Volume 11, Issue 3. The 29 year period referenced is from the end of 1972 to the end of 2001, roughly an investment lifetime.

8 Actually the average P/E multiple for the Mag 7 was 51X trailing earnings at year end, and weighted by market capitalization it is 45X. It's overly simplistic to think that investment analysis boils down just to a P/E multiple, but it's a good place to start. To obtain a margin of safety as the valuation rises, one must have increasing confidence in a superior fundamental outlook. It is easier to find a margin of safety when valuations and expectations for future profits are both low, requiring the companies you own to step over smaller hurdles to attract new buying.

9 The Price of Time Edward Chancellor, 2022. Page 67.

10 We discussed Isaac Newton's problems with FOMO during the South Sea Bubble in last year's letter.

11 This data is taken from The Lords of Easy Money by Christopher Leonard.

12 The Price of Time Edward Chancellor, 2022. Pages 300-301.

13 "Chapter 6 Ten Years Later – Iceland's Crisis and Recovery" Oct. 6, 2018 publication from the Central Bank of Iceland.

Suite 211 – 2150 Western Parkway, Vancouver, B.C. V6T 1V6 Phone: 604.558.0070 Email: info@lewincapital.com