LEWIN CAPITAL MANAGEMENT LTD.

January 20, 2025

Dear clients and friends,

Re: LCM Annual Letter December 31, 2024

In LCM's seventeenth annual letter I will discuss the markets in 2024, review our results and discuss some topics that arose from a talk I gave earlier in the year.

Year in Review

Interest rates and speculation about the future rate of inflation continued to dominate the headlines in financial media in 2024. After pausing rate increases in October of 2023, the US Federal Reserve cut short-term interest rates 3 times starting in September of 2024, from an upper limit of 5.5% to 4.5% currently. Although monetary policy is an imprecise tool that is said to affect the economy with “long and variable lags”, the stock market behaved like Fed policy was the only thing that mattered, thus small changes in Fed posturing had big impacts on market sentiment. Stock prices started rising after tightening stopped in late 2023 and continued rising through last year, especially the largest and most expensive stocks. Despite the optimism in the stock market, an indicator that the Fed might not have inflation under control are the rates on long-term bonds – US 10-year treasury yields have risen from 3.7% when the Fed paused rate increases in 2023 to 4.8% currently. Higher long-term interest rates act like an anchor on all asset prices, whether stocks, bonds, real estate or private businesses so this is worth monitoring.

Aside from subtle shifts in monetary policy many of the issues facing the market look similar to last year. There is no shortage of conflict in the world. China is still seeking to find new engines of growth after a real estate bust, the US is assessing protectionism and tariffs with renewed vigor, and depending on the source, artificial intelligence will either enable a quantum leap in efficiency or put us all out of work.

The ‘narrowness’ we discussed in last year’s letter continued, with the strong performance of the largest (and most expensive) companies in the market dominating the index returns. The S&P 500 Index returned 25.0% in USD last year, with over half the returns driven by the largest 7 stocks[1]. These stocks are expensive, trading at a weighted average trailing PE multiple of 46X.[2] From these high levels of valuation, not much has to go wrong before index investors are incurring permanent capital losses. The Equal Weighted S&P 1500 Index[3] gives us a look at how the *average* stock performed, combining large, mid and small cap stocks, and removing the heavy influence of the largest stocks from a market cap weighted index (like the S&P 500), and this index was up 9.8% in USD last year.

There are many concerning signs of overenthusiasm in capital markets: high levels of index valuations, rising levels of corporate and government debt, and a general disdain for liquidity with massive amounts of capital tied up in private equity and private debt. There also seems to be a gambling mentality among retail investors with high volumes of option trading. All of this argues for caution. LCM’s portfolio continues to be conservatively positioned. Our top 3 positions representing 44% of the LCM portfolio, are attractively valued at a multiple of just under 15X PE on trailing earnings. In addition, our fundamental analysis gives us high confidence that the earnings of these businesses will be considerably higher 3 to 5 years from now. Last year some trimming of smaller positions and adding to larger positions was warranted. LCM's cash position remains high at 33%, which gives us plenty of room for opportunity. Incidentally, LCM is not alone with its high cash position. Warren Buffett has 29% in cash today, and it is not lost on us that he might be practicing what he preaches "to be fearful when others are greedy" which in the past has been a very lucrative strategy.

Results[4]
Last year we earned a total portfolio return of 18.7%. These were decent results given our conservative position. These results lagged the markets which continue to be driven by the largest and most expensive stocks in the market as discussed above.

Since the start of the pandemic five years ago, LCM has earned 17.3% per year, beating a simple average of the Canadian and US stock markets by 3.3% per year. It is worth remembering that a period of fear or chaos such as a pandemic, while unnerving and detrimental to short term returns, set LCM up for a period of higher than historical returns as LCM was able to deploy capital at attractive valuations. In this context, a bear market or return of fear might be viewed as an opportunity to be taken advantage of rather than a problem to be worried about. The Canadian stock market gained 11.0% per year, and the US market was up 14.5% per year (16.9% in Canadian dollars) over the same five-year period.

LCM was founded before the financial crisis in 2008, and since inception has earned a cumulative total return of 754.5%, or 13.9% 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 3.5% 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.

Q&A on Value Investing at LCM
In March I spoke at the Ben Graham Centre for Value Investing which is part of the Ivey School of Business in London, Ontario. I gave a talk about LCM's investment philosophy to a keen group of students in Dr. George Athanassakos's Value Investing course. During the Q & A, I received several great questions which I've continued to reflect upon since the talk. I thought I would use this year's letter to share my answers to a few of the questions and elaborate on LCM's idea generation process.

Q: How does LCM find new investment ideas?
Early in my career I used statistical screens to print out lists of the cheapest stocks in North America, or companies with the best balance sheets, or the most insider buying etc. Since LCM was founded, because our mandate is quite broad, an organic process for idea generation has worked better. I spend 90% of my time researching companies for investment. In a typical year I loosely keep track of a few hundred businesses, using services such as ValueLine, Capital IQ and Factset. In addition, I conduct more detailed analysis on a constantly evolving list of 60 to 80 companies. Included in this list are the nine companies LCM currently owns, several of those companies' key competitors, and a list of hopefuls where we seek to identify a buying opportunity. When an industry appears interesting, research might entail listening to conference calls and reading quarterly filings for a particular business and its competitors over a period of sometimes years until the best investment opportunity is identified. Some industries are complex, with a lot of industry-specific jargon, and it takes

considerable effort and time to analyze the companies and translate data into the metrics that matter. Other companies are easier to analyze, especially if LCM already has experience investing in a similar industry or business model. In these instances, it might only take a couple of weeks to thoroughly assess a new opportunity.

At the core of idea generation is a lot of reading. Company annual reports, quarterly financial reports, proxy statements, and regulatory filings,[5] are all required reading if you want to understand how a company makes money and what the key factors are for success in a business. Brokerage firms will sometimes have analysts who are experts in the industry they cover, and they host conferences and publish reports on industries or companies. Their reports are useful to read; however, they should be read last as they can be overly persuasive, and it can be tempting to simply follow their advice without first doing the necessary groundwork. Management interviews play a key role in idea generation. In some cases, after reading all the publicly available information, important questions remain, and the only way to obtain the knowledge needed is to interview the management team. Management interviews are a critical step in LCM's idea generation process, and I typically conduct between 20 and 40 interviews each year. On occasion, a field trip is warranted if we want to understand the operations side of a business better. For instance, in 2024 we visited a newly constructed plant that we see as integral to the growth of one of our companies.

Q: What is the most important thing you've learned about investing?
The most significant thing I've come to learn in my three decades investing in very different settings and in multiple capacities is how impactful a focused approach[6] can be on returns. The rationale behind a focused approach is that good investment ideas are rare and that it makes sense to structure the portfolio to capitalize on those ideas rather than dilute returns by owning the market. I founded LCM based on a strong belief in a focused approach and it has proven to be even more powerful than I expected. I've come to see that managing investment portfolios using a focused approach is a superior way to earn attractive risk-adjusted returns over the long run.[7]

The other notable thing I have learned in my years as an investor is that reading is key to expanding one's circle of competence and accordingly, one's capacity to generate new investment ideas. Aside from reading company filings and brokerage research, a considerable component of LCM's investment process involves reading books. In fact, to add to the previous question on idea generation, a handful of LCM's investment ideas have come directly from reading business biographies on a company and historical textbooks on an industry. Quickly scanning the bookshelf in my office, I can count 21 books that I have read on industrial/manufacturing companies, 11 books on energy, 9 books on retailing, 6 books on banking and insurance, and dozens more[8] interesting business books on single companies ranging from cosmetics to diamonds to chocolate. Charlie Munger, the billionaire investor and partner to Warren Buffett, often remarked that you could not become a good investor without doing a massive amount of reading on a broad range of subjects and I wholeheartedly agree with his opinion.[9]

Reading widely and historically is essential to investing. Indeed, some of the most useful books I've read are dusty old editions written in the 1950s and 1960s. I have read multiple books on different conditions that have occurred in the stock market over the past hundred years. These include hyperinflation in post WWI Germany, the Great Depression in the 1930s, inflation and bear markets in the 1970s, the crash of 1987, the tech bubble in the early 2000s, asset bubbles throughout time, the Great Financial Crisis, and more recently, money printing by central banks.

The adage, 'history doesn't repeat itself, but it rhymes,' explains the importance of analyzing markets with an eye to the past. Commentators often overlook the significance of historical events, touting current market conditions as unique and different, and leading people to believe that we are travelling into murky, unknown waters. However, many times parallels can be drawn with past events and insights gathered on how to respond. The stock market will never be predictable, but understanding history helps us to be better prepared when the future rhymes with the past.[10]

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 2025. 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.

1 Although this group of stocks has been called the Magnificent 7, a better name might be the Notoriously Expensive 7. At year end, Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla traded at an *average* Price/Earnings multiple of 49.5X trailing earnings, and a *weighted average* multiple of 46.0X trailing earnings. These valuations are above the 43X peak multiple the Nifty Fifty stocks traded at in 1972 which we outlined in last years letter. As I remarked previously, 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.

2 If you have been reading these letters over just the past few years, an obvious question might be, does valuation even matter? History shows that it is not *if* valuation matters, but *when*. In a hot stock market like we have seen, nothing matters - not valuation, nor quality of business model, nor soundness of balance sheet. When greed and optimism reign, sometimes the most expensive, least profitable, junkiest business models fly the highest. As sure as night follows day, periods of greed are interspersed with periods of fear in capital markets. That is because investors are human and human emotions have swung between greed and fear since the beginning of time. A drop in valuation due to fear or negative sentiment is one of the quickest and surest

paths to permanent capital loss, permanently erasing all the fancy gains that came before it. Thus, an emphasis on low or attractive valuations at the time of purchase remains a cornerstone of LCM's conservative investment approach.

3 The S&P 1500 Index is a combination of the 500 largest companies (the S&P 500), the next 400 medium sized companies (the S&P 400) and the smallest 600 (the S&P 600). Because the weights of the largest companies are so considerable, their performance tends to drown out the smaller companies performance in a market cap weighted index. For instance, in 2024 the market cap weighted S&P 1500 earned 23.9% - very close to the S&P 500 return of 25.0% because the largest stocks contribute so much to the totals. This compares with the aforementioned Equal Weighted S&P 1500 Index total return of 9.8%.

4 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 6.5% per year over the sixteen and a half years ended December 31, 2024. 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 14.2% per year in Canadian dollar terms over this same period. In US dollars the S&P 500 has risen 11.9% per year. Thus LCM's total portfolio return of 13.9% per year has beaten a simple average of the Canadian and U.S. Stock Markets by 3.5% per year since inception. "Since inception" refers to the sixteen-and-a-half-year period from June 30, 2008 to December 31, 2024.

5 In Canada, securities regulators require a public company to file an Annual Information Form or AIF, which discloses facts about the business in plain English; the US equivalent required by the SEC is called a 10K or 10Q form. Foreign companies with listed securities such as sponsored American Depositary Receipts generally file a 20F with similar information.

6 I first learned of the concept of focused investing in 1994 when I read Common Stocks, Uncommon Profits a terrific book written by Philip Fisher in 1958.

7 The essence of a focused approach is that one may achieve higher returns at possibly lower risk of loss by owning more of one's 1st, 2nd or 3rd best investment ideas, and not bothering to own one's 30th, 40th or 50th best idea. The alternative to a focused approach would be to follow the industry norms, and buy 100+ stocks you think will outperform over the next three months, being sure to include several companies from every industry no matter the opportunity set. This is akin to cooking a meal with every ingredient in the fridge and pantry, instead of using just the ones in season.

8 I have even read four books on gambling theory. This should not be a cause for concern - Las Vegas seems pointless to me as I cannot see the fun in playing any game where the odds are not in my favor.

9 The LCM holiday book this year was the new edition of Poor Charlie's Almanac, a collection of Munger's best speeches. If you did not receive a copy of this book and would like one please let us know and we will send one off.

10 While I have learned a lot from books, it still has not prevented me from making a number of investing mistakes. I wince when I think back to a number of excellent opportunities that were dangled right in front of my nose yet I managed to miss, I have sold too early more often that I'd like to publicly admit, and I have bought more than a few companies that generated losses over the past 32 years. In fact, despite our rigorous process and discipline, roughly one quarter (5 out of 19) of the investments LCM has made since inception in 2008 were exited at a loss or minimal profit. Over the years, we have gotten better at avoiding the losers, and selling early when the investment thesis is wrong. In addition, we have improved our position sizing, letting the winners run, and ensuring we buy enough when the opportunity is still excellent even if we missed the bottom. In the interest of publicly acknowledging my shortcomings so I can improve, before starting LCM I once bought more than 10% of the float of an auto parts manufacturer that cast automotive manifolds. It had a dominant market share, huge profit margins, and traded at low valuations with zero debt. Yet I managed to lose 60% of my investment after the founder died and new management took over. While I cannot think of a more interesting job, the investing business can be very humbling; the market likes to slam your fingers in a door every once in a while just to see if you are paying attention. This provides nearly endless opportunities for learning if one has the stomach to face the facts.