The Osler Fund: 2020 Annual Letter to Unitholders

The Osler Fund ("The Fund")

The Osler Fund is a RRSP/TFSA/RESP/Pension eligible fund. The Fund was formed on February 5, 2019 with the following principles in mind:

1. Satisfactory longer-term performance can be achieved by buying high quality businesses that are trading at substantially discounted prices and then allowing that value to compound over many years.

2. We view stock ownership as a partnership with the people who operate the company. As such, we want those people to be honest, talented and motivated (through substantial ownership of equity in their employer).

3. Downside protection is more important than trying to hit it out of the park. We like our companies to have strong balance sheets, thoughtful capital allocation and competitive advantages.

4. In order to create long-term value, one must be prepared to do the research to justify a contrarian opinion and then act accordingly. One must then have the patience to hold unpopular securities for long periods before other investors understand your variant perception of value.

Further information is available at our website: www.theoslerfunds.com

Our friendly lawyers remind us to always start off with some mandatory disclaimers:

- *Our Annual Report contains forward looking information. We will not update this report even if our opinion changes.*
- *While we believe our comments and facts are accurate, you should not rely on them without verification.*
- *Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. The indicated rates of return are the historical annual compounded total return including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional changes or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated.*
- *The Fund is governed by the terms of a trust agreement made as of February 5, 2019 between McElvaine Investment Management Ltd., in its capacity as manager of the Fund, and McElvaine Investment Management Ltd., in its capacity as trustee of the Fund.*
- *Further information is available on our website: www.theoslerfunds.com.*

2020: Annus Incrēdibilis

Introduction

Dear Friends, Family and Fellow Unitholders,

Imagine if we were to enter a time machine and go back to September 2019 (when the Fund started investing). If we told all of you what was about to happen in 2020, we suspect you might have questioned our mental health. I (LP) don't think it's overly dramatic to invoke the four horsemen: flood, fire, famine and pestilence rode with wild abandon through 2020 in terms of extreme weather, extreme politics[1], distressed health care infrastructure and capital markets deeply dislocated from fundamentals. The social and economic implications are staggering and unfortunately, the worst seems likely still to come.

We were fortunately able to take advantage of the dramatic sell down through March, although it surprised all of us how ephemeral the opportunity was. The SPY ETF (which is the most convenient way to acquire the entire S&P 500 index constituents) hit it's annual nadir of $222/unit on March 23/20, only to immediately go up in nearly a straight line to exceed its all-time high of $353 on September 1st! That's not much time to get greedy…[2]

What is even more remarkable is that most of that recovery was driven by a half dozen technology focused equities and this happened on a backdrop of double digit unemployment, an unprecedented drop in Q2 US GDP (-32.9% worse than any quarter during the Great Depression) and widespread shuttering of small businesses.

Bullish investors believe that this kind of market performance is actually justified because of rock bottom interest rates, massive and unprecedented Central Bank monetary

[1] We have never found any profit in trying to analyze and forecast political/macroeconomic outcomes. For this reason, we won't discuss the upcoming US election and its impact. These topics definitely belong in the "too hard" pile.

[2] This is a reference to Mr. Buffett's famous quote: *"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful".*

stimulus, an imminent vaccine-stimulated 'V' shaped economic recovery and the fact that many severe recessions in the past have been associated with booming stock markets.

We do not find these explanations very convincing or reassuring. Interest rates can go up without warning, stimulus must end, safe and effective vaccines are not a given and the past isn't necessarily a reliable guide to the future. Caution and preparedness are particularly justified now, in our opinion.

Performance

As of August 31, 2020, TOF's 1-year rate of return was -4.74%.

Over the same time period, positive contributors to the return include Abiomed, Tourmaline, Amazon and Berkshire Hathaway. Negative contributors were Simon Property Group, Suncor, Fairfax Financial and Fairfax India. Although there is no perfect comparison index, the iShares Canadian Value Index ETF probably comes the closest: it returned -6% in the past 12 months. By comparison, a broader index such as the Dow Jones Global Total Return Index (C$) returned 13.7% during this period.

Our job is to produce positive absolute compound annual growth; we take little stock in relative comparisons and will never use them as an excuse for a poor absolute return.

Obviously, we are not happy with the first year result. Despite this, we strongly believe our investment process is robust and that our portfolio is positioned well for the future.

Top 5 positions:

1. Cash: 35.6% of Assets

As of August 31, 2020, we had 36% of assets in cash and if one includes the TAIL position as a source of cash, it would be 44.7%. In terms of foreign exchange exposure, 56.7% of assets are denominated in US greenbacks and 43.3% are in loonies; adjusted for the mostly Canadian cash position, we are roughly 50% exposed to each country's dollar. As we are

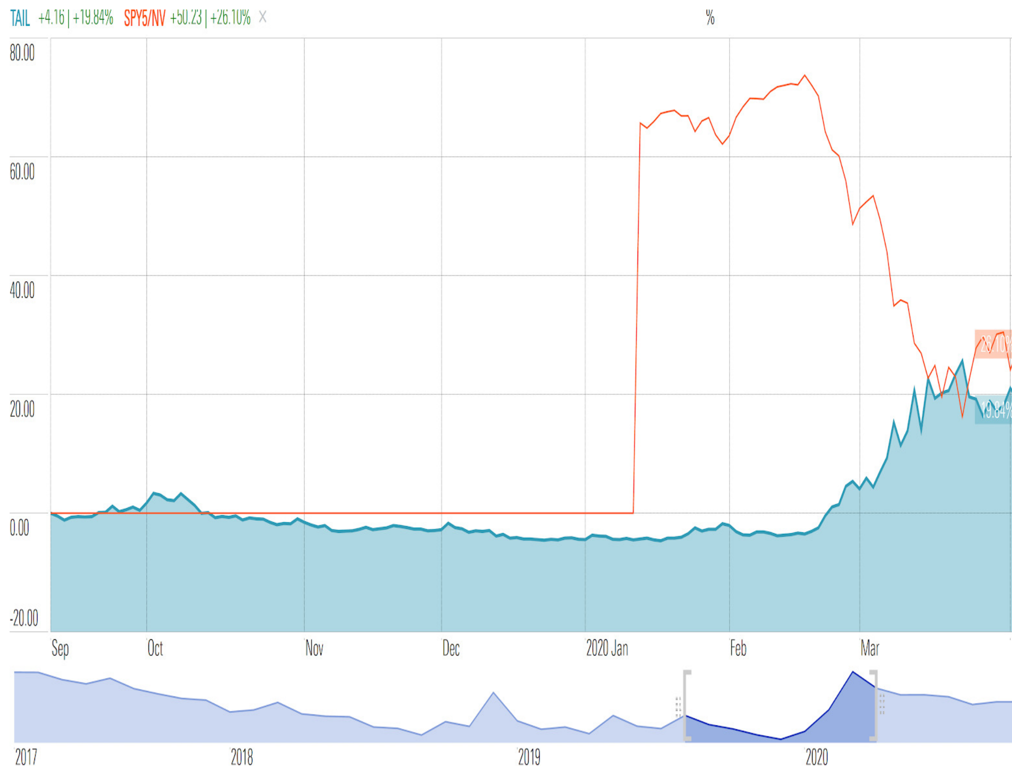
agnostic concerning future forex price movements, we are satisfied with the 50:50 situation.

Is cash king or is cash 'trash'? We think it depends on the context. Clearly, cash or cash equivalents are earning next to nothing (when we last checked some 10-year T-bills were yielding 0.6%, implying a negative real rate of return) and dilute our portfolio returns. For most of the past 12 months, our cash position was over 50% of the portfolio and probably would still be if it wasn't for the opportunities created by March's drawdown. On the other hand, cash provides optionality, particularly during times of uncertainty. One of the lessons learned from March is that the markets will not wait until you are ready to act. You must be prepared. Cash gives us that.

2. Cambria Tail Risk ETF (TAIL): 9.1%

In the Fall of 2019, we started our first trading very tentatively because markets seemed ebullient and we are contrarians at heart. Other than highly distressed energy and retail concerns, security prices reflected a very rosy outlook indeed. We noticed that the VIX, an index reflecting equity price volatility, was near all-time lows, so we decided to start buying the TAIL exchange traded fund managed by Meb Faber.[3] The intent of the position was risk mitigation and to act as a source of cash for deployment during an expected large market drawdown. The ETF is mostly made up of intermediate duration US T-bills, a security favoured by many investors during times of uncertainty. There is also a small allocation to a rolling portfolio of S&P 500 puts in the ETF that appreciate in value when the S&P drops. The T-bill yield partially offsets the MER of 60 bps. Eventually we invested just under 10% of our assets in TAIL.[4] As you can see from the graph below, TAIL served its purpose reasonably well when March's pandemic panic roiled the global markets. We intend to adjust our TAIL position according to prevailing volatility; buying when low and selling when high, which is convenient as opportunities arise just when the cash becomes available. One current concern is that the generationally low yield for the T-bill portion of the ETF might limit its capacity to partially hedge our portfolio (although it is possible that T-bill yields may turn negative like they have in Europe and Japan).

[3] Mr. Faber is famous/notorious for his generally bearish views on the markets.
[4] Per our Trust Indenture, a 10% initial position is the maximum permitted.



Source: Morningstar

Key: Orange line is the SPY ETF (S&P500 index)
Turquoise figure is the TAIL ETF

3. Berkshire Hathaway Class B (BRK.B): 7.3%

Berkshire Hathaway (BRK) needs very little introduction for value investors. The main principles, Warren Buffett and Charlie Munger are both renowned value investors with multi-decades of proven performance. Berkshire Hathaway is a $520 billion conglomerate with ~38% market cap or ~$200 billion from external investments (of which 44% is an investment in Apple), and the other 62% in dozens of diverse fully or significantly owned private corporations (including GEICO and Burlington Northern Railway). The portfolio is made up of a wide variety of industries ranging from above average to excellent businesses.

We took the opportunity during the recent March market correction to enter our position in BRK-B. At the time, BRK was trading at 1 times book value[5] while maintaining a $130 billion investment float. Historically, BRK has stated that it would repurchase its own shares when book value was below 1.3 times. The $130 billion investment float was both a safety feature in BRK and a potential fund for opportunistic investments. Warren Buffett, through BRK, has been the go-to investment partner in times of distress. We believe that BRK has formed and trained a solid 'next generation' management team to replace the nonagenarian tandem of Warren and Charlie.

4. Tourmaline Oil Corp (TSE:TOU): 5.3%

In spite of its name, Tourmaline is one of Canada's largest natural gas producers. Mike Rose and his team have kept costs low and continued to build their presence both in the Montney and Deep Basin with several small acquisitions over the last 6 months. In other words, while some producers were forced to raise cash by selling assets, we are partnered with a firm which has the financial capacity to take advantage of others' difficulty. In addition, the outlook for the price of natural gas is improving. Both insiders and the company have been buyers of shares.

5. Jefferies Financial Group (JEF): 4.8%

A NYC based investment bank. In a twisted way, Covid may be a tailwind for the investment banks. There is no shortage of companies requiring assistance in capital raising and restructuring. The result is 2021 is shaping up to be a good year for Jefferies financially. In addition, Jefferies has a relatively strong balance sheet and significant extra assets which are being slowly liquidated. Insiders own some 15% of Jefferies (worth about C$1 billion) and Jefferies has been repurchasing its shares.

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[5] Like Mr. Buffett frequently states in his annual letters, Berkshire's intrinsic value is far above GAAP book value.

Since this is our inaugural annual report, we thought it may be appropriate to answer some questions we frequently get from existing and interested unitholders.

Does Value investing still work?

We agree with Charlie Munger that all true investing is value investing: after all, the point is to buy something for less than it is worth and then sell it later for a higher price. Traditional value investors focused on the balance sheet and tried to buy tangible assets (like factories or inventory) for pennies on the dollar. As our industries evolve with technology, more and more of businesses intrinsic value is derived from intangible assets such as brand strength or platform value. For example, the network effect of increasing subscribers and merchants to Amazon's platform is not linear.[6]

The tricky thing is that it's very difficult to assign a dollars and cents figure to intangible assets and if you do, the range of error is quite large. This would be in stark contrast to say, valuing a used car lot where you could look up each vehicle's salvage value and the lowest similar real estate valuation for the lot itself and come up with a worst case value for the whole thing. If you could buy the lot for less than the sum of the parts, you were pretty likely to make money in the end. For companies like Apple, Facebook, Amazon and Alphabet, the spectrum of outcomes is much wider. As such, we need a larger margin of safety for these 'growth' investments.

To address the original question, yes, we think value investing works, as long as the process is rigorous, patient and applied with a sufficient margin of safety.

Is Active or Passive Investing Better?

We get asked this question all the time and clearly, yes, being active managers, we have horses in this race. On the other hand, substantially all of our retirement savings is

[6] If you're interested, read about Metcalfe's law: https://en.wikipedia.org/wiki/Metcalfe%27s_law

invested in our actively managed funds[7], so we are eating our own cooking at the same time.

One of us (LP) likes to answer this question simply by saying, "Yes". As a rule of thumb, index funds/ETF's are a great way to get exposure to an asset class that you have no particular investment edge in. For example, our CI Direct portfolios use ETF's for fixed income, cash equivalents and some international exposure: these are difficult or expensive (or both) to invest in directly, so we find the passive vehicles convenient and cost effective to use.

There are drawbacks that are often overlooked by passive investing advocates:

1. Lack of diversification: 5 stocks drove most of the performance of the S&P 500 over the past decade, for example.
2. Difficult to maintain conviction during market downturns.
3. Passive investing is essentially a 100% momentum strategy: this inevitably causes distortion of the underlying portfolio: ie. the bigger components in the fund get bigger and the smaller ones become smaller which may magnify risk.
4. Poor liquidity in some cases (particularly fixed income funds).
5. Tracking error.[8]
6. The choice of fund and the timing of entering/exiting/rebalancing are all active decisions in themselves and are subject to the same foibles as a fully active fund.
7. You are guaranteed to underperform the reference index 100% of time.

Although market momentum has favoured passive investing performance over the past decade, this has not always been the case over any given 5-year rolling period. The mathematics underpinning compound annual growth strongly overweight recent performance which doesn't reflect real life circumstances (ie. you may have retired 3 years ago or took some money out to buy a house).

Chris Davis, a renowned value investor, did some quantitative work on the active vs. passive investing question. The paper lives here:
https://selectedfunds.com/downloads/SFCaseActiveMgt.pdf

[7] Lorne, David and Tim have either all or the majority of their retirement savings invested in our Funds.
[8] This is the scenario where the ETF fails to replicate the index well.

In summary:

1. In several periods since 1975, even average active funds solidly outperformed indices on average;
2. Active managers tend to outperform in weaker markets;
3. Funds with lower than average fees and high insider ownership more often than not, beat their target index returns. For example, managers with lower than average fees and a high investment in their own funds have outperformed in 89% of all rolling 10 year periods.

How about ESG (Environmental, Social and Corporate Governance) factors?

We think the 3 issues in ESG can be encapsulated by the concept of having a sustainable business model. Companies with diversified and independent boards of directors tend to also be good stewards. They protect and cultivate all stakeholders (not just shareholders) and carefully manage their impact on environmental concerns.

Many investors believe that businesses that emphasize long-term sustainability will outperform those who do not; there is some moderate quality evidence supporting this view.[9] We tend to agree with this sentiment, but also think that a nuanced approach is required. Blindly following "ESG Scores" may not be optimal. For example, first order thinking might suggest that an ESG portfolio would have no fossil fuel exposure at all. We think this binary approach is a bit myopic and potentially may create undesirable and unintended consequences. For example, Tourmaline Oil is one of our largest positions. Its name is misleading because it almost entirely produces natural gas from the West Canadian Sedimentary Basin, which is by far the cleanest fossil fuel and has some of the most modern pipeline infrastructure in its geography, which is the safest way to distribute the gas. The company has reduced its C02 emission intensity by almost 50% since 2013, making it the lowest GHG emitter amongst peers, despite being the largest natural gas producer in Canada. The management is extremely transparent concerning all of its impact metrics. If investors shunned this company, it may not be able to raise capital

[9] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610&mod=article_inline

efficiently, preventing it from producing natural gas at levels sufficient to meet North American needs. The Canada Energy Research institute has modelled increasing natural gas demand growth all the way out to 2040; it's clear that renewables such as solar and wind generation facilities cannot replace the base demand and natural gas will be with us for decades.

The unintended consequences of shunning natural gas firms with good (and improving) environmental stewardship are that:

1. Canadian and US consumers of energy would need to obtain it from sources with more questionable and loosely regulated energy production practices.
2. The shareholder base left behind at corporations with poor ESG ratings may care less about these issues and be less likely to hold management accountable for governance, social issues and environmental impacts.
3. Some companies with poor stewardship records are marketing themselves as "ESG" using marketing strategies known as "window dressing'. A casual investor could easily be duped unless they dug a bit deeper.

In summary, ESG factors are an important consideration, but the devil is in the details and one needs to do the work to be effective.

Conclusion:

This annual report can be summarized by the following points:

1. The Fund underperformed in its first year due to some deep value positions remaining out-of-favour by market participants.
    - We believe these securities have potential for substantial upside but will need a few years for their underpinning theses to play out.
    - We continue to like our better performing holdings and will continue to monitor them closely.

2. We intend to maintain our cash position in order to be able to maximally exploit future (inevitable) market dislocations.

- Good ideas are uncommon, so we will prioritize our capital for higher quality, yet unappreciated businesses with strong balance sheets, run by management teams who are skillful and well incentivized owner-operators.
- We expect market volatility to continue and likely even increase in the intermediate-term.
  - With both the cash and TAIL positions available as a source of funds, we are well positioned to take advantage of opportunities.

3. All intelligent investing is value investing; high growth companies are more difficult to value precisely, but that fact doesn't preclude them from a value investor's portfolio.

4. Active and passive approaches both have their role, although the specific choice of vehicle, timing and allocation weight are all active choices by definition.

5. ESG factors are important considerations, although a thoughtful analysis of unintended downstream consequences and avoidance of 'window dressing' is necessary to achieve the desired results.

We are pleased to have you invest alongside us and appreciate your trust and support.

If your friends, family or colleagues are interested in joining us, please feel free to have them email us at info@theoslerfunds.com if they have any questions and pass on our URL at The Osler Funds. Alternatively, they can set up all sorts of accounts (cash, corporate, TFSA, RRSP, RRIF, RESP, pension) from the comfort of their living room using the following link: Join Us with CI Direct!

Sincerely,

The Osler Fund Team