<u>The Osler Funds April 2020 Blog Post:</u> Leaving the Door Ajar

> *"I can live with doubt and uncertainty and not knowing. I think it is much more interesting to live not knowing than to have answers that might be wrong. If we will only allow that, as we progress, we remain unsure, we will leave opportunities for alternatives. We will not become enthusiastic for the fact, the knowledge, the absolute truth of the day, but remain always uncertain ... In order to make progress, one must leave the door to the unknown ajar."*

— Richard P. Feynman 

A day doesn't pass by without at least one of my friends and colleagues asking me the question, "What are you doing in your portfolio now?"

Generally, I'm relieved to talk about any topic other than COVID-19, as it has utterly consumed my life, both inside and outside the hospital. I'd like to use this blog post as an opportunity to explain my answer to this question, which reminds me so much of Dr. Feynman's "...leave the door to the unknown ajar" quote.

On the highest level, an investment portfolio is much like a farm. There are both times of plenty and famine. If not tended to in a thoughtful manner by the farmer/portfolio manager, the fields tend to fall into ruin. It is clear, at least to me, that we are in a historic famine right now.

Our fund[1] is fortunate in that we were prepared, in no small part due to luck and in part due to our value-driven investing process. In other words, we had trouble finding cheap and safe securities to buy and so we sat on a portfolio of mostly cash. Our largest position (other than cash) by some margin was <u>Cambria's TAIL ETF</u>[2], which serves as a convenient source of cash at an awfully opportune time.

This isn't to say that we haven't suffered a bit. All of the equities we held prior to the end of February drew down and our energy holdings were truly taken out to the back of the shed. A combination of biologic contagion and a desperate oil price war between Saudi and the Russian Federation truly created a perfect storm. In aggregate, the portfolio dropped by just under 16% year to date and we are down about 12% since our inception September 2019.

So much for how we were positioned before the market rout. How did we respond?[3]

First, as with all things, we did a lot of research. No one knows how the pandemic/oil price war will play out but we can do a bit of semi-quantitative scenario analysis and probabilistic decision-making.

For example, 3 different outcomes could be considered and a probability assigned to them:

A. "V" shaped recovery: the pandemic abruptly stops in the next few months (or sooner) due to a treatment, mass vaccination or a spontaneous biologic phenomenon (mutation, seasonality etc) and Russia/Saudi agree to be rational. US has a moderate recession and recovers by mid 2021, China and SE Asia fare similarly. Europe muddles through somehow. Let's assign an 80% chance of this becoming reality, entirely based on historic precedents.[4]

B. An "L" shaped (non) recovery: COVID gains momentum after pausing briefly in the summer months (much like Spanish 'flu in 1918 summer), decimating the world's population, health care systems and economies. A global depression ensues for many years. This dystopian-type outcome would be 10% likely.

C. Something between A and B; sort of a long grind. 10% likely.

Our first priority is safety. We systematically went through each security we owned and 'stress tested' them with an 'upside/downside' analysis. For each scenario, we use the probability weighting in both directions. Two of our sixteen holdings, Playa Hotels and Resorts[5] and Cenovus[6], looked vulnerable due to financial leverage. With the upside/downside ratio not being obviously favourable, we took a loss and redeployed the cash to positions with better risk:reward situations.

Our next priority is exploiting opportunity. This is where a contrarian mindset comes in handy. For example, a first order line of thinking might be "Retail is dead. All the malls are going to close permanently. Amazon will eat their lunch." A second order thought might be "It's not likely they will all close. If so, who can survive and take advantage of a dramatically improved competitive landscape?"

Great capital allocators, strong balance sheets, network effects and economies of scale all play into creating a kind of 'winner-takes-all' dynamic in such financially stressful times. In scenario A, picking the winner can be extremely rewarding. In scenario C, one can expect a decent return that would probably eclipse most fixed income portfolios. Scenario B would be a disaster for almost any kind of portfolio composition other than cash and perhaps gold.[7]

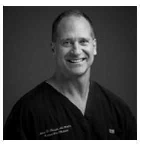
A similar line of reasoning could be applied to airlines and energy, both incredibly unpopular industrial sectors these days. I will leave it up to you to decide if there are safe ways to invest there...

In conclusion, even though we have no special insight into what the future holds for us, we are excited about the opportunities this volatile market is creating for our fund. We are indeed peeking our heads through the door to the unknown.

Although preservation of capital is our top priority, we think that judiciously and incrementally deploying our large cash position into our strongest and most undervalued businesses may reap attractive returns for our unit holders. I believe that during crises like we are in now, active management pays off. When you own the entire market, you will own many businesses that will fail. If you can own the winners and have more than a modicum of patience, you are more likely to have a satisfactory result.

Tim, David and I wish your families will be safe, healthy and (eventually) prosperous through the remainder of 2020 and beyond.

Sincerely,

Lorne 

P.s. I am putting more money into my pension right now and believe that this may be one of the best times to invest in a generation. If you would like to join me you can do so easily through this Wealthbar link:

https://join.wealthbar.com/3p-financial/

Wealthbar accepts pension accounts, cash personal accounts, corporate, RRSP, TFSA and RESPs. Minimum investment is only $1000. You can do all the registration in the comfort of your home with no paperwork and no phone calls needed![8]

Endnotes

1. 3P Financial is a division of McElvaine Investment Management Ltd.

2. This exchange traded fund is meant to be used as a hedging instrument against high volatility. It holds intermediate duration US T-bills and some S&P500 put options. It has appreciated about 24% YTD and outperformed the TSX by about 46%.

3. It is in the best interest of the fund that I only discuss securities that we either have sold or have full positions in. Considering the current market environment, I hope the reader understands why I don't mention many in this post!

4. There is no doubt that there are many unique features about this crisis; however, there is also no reason to believe that they should be different than any of the other ones. With no additional information you should assume the base rate. For example, both the Spanish flu and the Avian Flu pandemics were followed by protracted economic booms. Other important periods of austerity like WW2 were followed by long eras of prosperity. This is why I have assigned a high probability to scenario A. My colleague, David, is a bit more pessimistic and would assign a 20% chance. He believes that COVID19 will impact society and economy over multiple years. We will both continue to use Bayesian thinking to update our investment decision processes.

5. PLYA trades on the NASDAQ

6. CVE trades on the TSX

7. I am not convinced gold is a reliable 'disaster hedge' other than the fact that many people believe it to be so. For a historical perspective please check out: https://awealthofcommonsense.com/2015/07/a-history-of-gold-returns/

8. Commissions, training commissions, management fees and expenses all may be associated with investment funds. Please read the offering memorandum before investing. Investment funds are not guaranteed, their values change frequently, and past performance may not be repeated.