GreensKeeper ASSET MANAGEMENT

a division of LIGHTWATER PARTNERS LTD

# The Scorecard

**Issue #3 – April 2012**

## Mr. Market and The Path Less Traveled

The Value Fund is up 3.9% year-to-date and 3.3% since inception (after all fees and expenses). To date the Value Fund is ahead of the S&P/TSX total return index but lags the S&P500($CAD) – our two primary benchmarks. Our cash balance has been steadily declining since my last newsletter as I have found a number of suitable stocks worth purchasing at current levels.

In order to outperform the market over time, you must be different than the market. While this less than brilliant observation seems obvious, it is often lost on money managers. Our approach entails ignoring the constant siren song of performance benchmarks and running the risk of lagging the market at times. When working for a large financial institution, business pressures lead many to worry more about their careers than their long term performance. Naturally, this leads to the safe choice of closet-indexing (mind you a full management fee is still applied). My desire to outperform the market over time is the primary reason that I founded GreensKeeper. When managing my own money and that of my clients, I wanted to ensure that I created an environment that allows me the freedom to invest for the long-term. By eliminating the institutional pressures that lead to sub-optimal, short-term decision making, we are positioned to do so.

*"I would rather lose half our clients … than lose half of our clients' money."*

**Jean-Marie Eveillard**

**First Eagle Funds**

As an adult, I have been blessed with the temperament to be different than others and not care what the crowd is thinking when I disagree with it. I like the stocks that we currently own in the Value Fund and take my time before reducing our cash balance by adding any new stock to the portfolio. This inactivity can be psychologically painful to many when the markets rally sharply. However I recognize that I tend to own stocks for a very long time and only buy them when I believe them to be mispriced. You should not be surprised to learn that I haven't sold anything that I have purchased for the Value Fund to date. This approach necessarily implies that I need to be very picky when committing capital. I think that the words of famed French value investor Jean-Marie Eveillard (at left) express my views better than I ever could. Experience has taught me that in the long run, we win.

## Microsoft Corporation (NASDAQ:MSFT)

I started buying Microsoft for the Value Fund in November shortly after the launch and have added slightly to the position as new investors have joined. Our average cost base is US$26.58. I have heard a few main criticisms of the stock and by addressing them, will share a few lessons that I have learned over the years.

Microsoft has three divisions that actually matter financially: (i) its Window's operating system, (ii) the Office suite of productivity products and (iii) its server software business. These three core businesses accounted for over 100% of Microsoft's operating income for fiscal 2011. The Entertainment Division (Xbox, Kinect) makes a modest profit and the Online Services Division (Bing search engine, MSN portal) actually loses money.

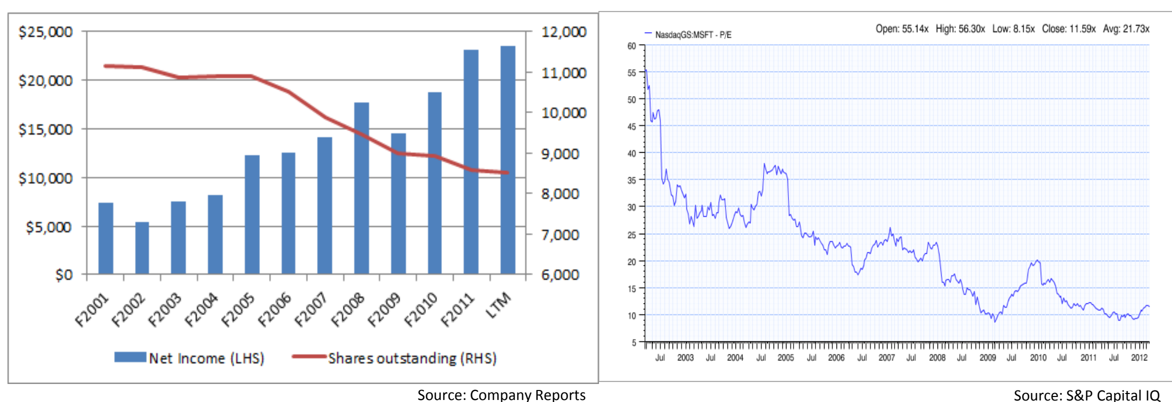
The most consistent criticism of the company's stock is that it "hasn't done anything in ten years". That is quite right as you can see for yourself in the chart below. MSFT (the stock) has largely been dead money:

*"Mr. Market is there to serve you, not to guide you."*

**Benjamin Graham**

I learned something a long time ago from reading about Ben Graham whose words were as obviously true to me then as they are now (see quote at left).

So what did Microsoft's *business* do in those intervening ten years? Well, the company's net income went from $7.3 billion to $23.2 billion and the company's share count was reduced 23% as Microsoft bought back a lot of its stock. The result of the stagnant share price over that same time period was a massive multiple contraction (see chart at right below). At the time of purchase for the Value Fund, Microsoft was being offered to us at less than 10x trailing earnings vs. over 50x a decade earlier.




Source: Company Reports

Source: S&P Capital IQ

Another common criticism of Microsoft is that the world is heading towards a post-PC era which will hurt them. In the personal computer (PC) world, Microsoft has long dominated as the operating system of choice - Windows has a 90% market share. I agree that Apple is a great company and that smartphones, iPads and other tablets are here to stay. They will certainly cut into PC growth rates going forward. But smartphones and tablets are not PCs and are excellent at certain tasks (reading, email, web surfing) and not at others. I laugh to myself when I see someone with a tablet tethered to a keyboard trying to work on a complex document or spreadsheet. For certain tasks, I believe that PCs will remain the device of choice. And with their near-monopoly in operating systems, Microsoft's pricing power gives them the ability to make incredible profits even with modest unit growth.

If Microsoft manages to gain some traction as a viable operating system in the smartphone and tablet world via its Windows 8 launch this fall, then great. That's upside that I am not counting on. In my opinion, the real risk that the proliferation of smartphones and tablets pose to MSFT is that people expect Office "apps" to be priced like apps instead of the hundreds of dollars that they currently command. I don't expect that to happen – but it could. It is one of the things that I am watching closely.

*"A ham sandwich could run Coca-Cola"*

**Warren Buffett**

Microsoft is also dominant in productivity software and enterprise server software and tools. Without boring you with the details, let's just say that Microsoft is the dominant player in business/enterprise software.

As I mentioned last quarter when discussing Research in Motion (Scorecard #2), technology is usually a challenging area to invest in as things change so rapidly. In other words, the predictability of the business' future path is difficult, if not impossible, to determine with any degree of certainty. However I feel comfortable that Microsoft's core business franchises will continue to prosper for the foreseeable future.

Warren Buffett has joked that he searches for businesses whose economics and competitive position are so wonderful, that they could be run by a ham sandwich. I believe that Microsoft's business franchise and its competitive "moat" meet this test. In fact, Microsoft's business is so good that what really worries me is that management will find dumb uses for the cash (paying $8.5 billion for a money-losing Skype comes to mind). As a matter of fact, I think that a ham sandwich could actually do a better job when compared with some of the acquisitions that Microsoft has made in the past.

*"Think about it a little bit more and you'll agree with me, because you're smart and I'm right"*

**Charlie Munger**
**Vice Chairman – Berkshire Hathaway**

*"You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right."*

**Warren Buffett**

After completing my lengthy analysis on a company I like to go back to first principles. I believe that before buying a stock, I should be able to articulate a simple investment thesis in just a few sentences. Microsoft has close to 80% gross margins and an unlevered return on equity in excess of 40%. The company is a cash flow machine – generating over $2 billion of free cash flow *per month*. I believe that Microsoft's dominant position in their key segments will continue for the foreseeable future. At our average cost of $26.58, I paid 9.7x trailing earnings (3% dividend yield) for one of the best software companies ever created. If I take into account the $45.5 billion in net cash that they had on their balance sheet at the time (I even applied a "repatriation tax" to the offshore component), the multiple was actually 8.2x. Microsoft also had another $8.6 billion or $1.00 per share in other investments (e.g. shares in Facebook, preferred shares) that I essentially ignored.

To date the investment has been a good one (last trade - $32.26 and we have also received dividends of $0.34 per share after the deduction of US withholding tax). But it is early yet. Only time will tell if my investment thesis is correct.

## Intelligent Investing

I believe that one of the keys to successful investing is approaching it with the proper mindset. By focusing on a company's long-term prospects you can avoid some of the common pitfalls that come with trying to predict what a business or the stock market will do in any given week/month/year (something that I do not believe is possible). This approach also implies that you don't need to be glued to the stock ticker every day or read every press release that a company puts out. I would have no problem not knowing what the market quote is on a particular stock that I own for months on end. If you buy the right type of business at the right price, monitoring its financial progress quarterly and any major changes are sufficient. Much of my time is actually spent on looking for new opportunities.

Another key success factor in investing is being able to come to your own conclusions based on thorough research, hard work and proper reasoning. Conventional wisdom is *often* but not *always* correct. The difference is important. I spend a lot of time looking at first-source materials (data, financial reports) and when my views differ from the crowd, that is usually where opportunity presents itself. Stocks that are out of favour due to misguided reasons are usually cheap and mispriced.

Before I head off to find some more diamonds in the rough I will leave you with something that had a profound effect on how I go about searching for investment ideas for the Value Fund and my overall approach to investing.

Any serious investor should do themselves a favour and pick up a copy of Ben Graham's classic – *The Intelligent Investor*. I agree wholeheartedly with Warren Buffett's comment that this book is the best book about investing ever written. I will even save you some time by suggesting that you only need to read Chapter 8 (Mr. Market allegory) and Chapter 20 (Margin of Safety). These two concepts, properly understood and embraced, will save you from a lifetime of investment grief. In fact, I will save you even more time. Reproduced on the next page are my favourite passages from Chapter 8. I hope that the words jump off the page for you as they did for me the first time that I read them many years ago.

**Michael McCloskey**

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## Mr. Market [1]

… Let us close this section with something in the nature of a parable. Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. *But the rest of the time you will be wiser to form your own ideas of the value of your holdings*, based on full reports from the company about its operations and financial position.

The true investor is in that very position when he owns a listed common stock. *He can take advantage of the daily market price or leave it alone, as dictated by his own judgment and inclination*. He must take cognizance of important price movements, for otherwise his judgment will have nothing to work on. Conceivably they may give him a warning signal which he will do well to heed—this in plain English means that he is to sell his shares because the price has gone down, foreboding worse things to come. In our view such signals are misleading at least as often as they are helpful. *Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.*

…

The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that *market quotations are there for his convenience, either to be taken advantage of or to be ignored*. He should never buy a stock *because* it has gone up or sell one *because* it has gone down.

…

The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book, and no more. Thus *the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment.*

1 *Graham, B., & Zweig, J. (2005). The intelligent investor: A book of practical counsel (4th Revised Edition). New York: HarperBusiness Essentials (emphasis added).*

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## The GreensKeeper Value Fund

| | |
|---|---|
| Minimum Initial Investment | $150,000 |
| Eligible for Registered Plans? | Yes (RRSPs, TFSAs, etc.) |
| Launch Date | November 1, 2011 |
| Type of Fund | Long equity,<br>Long-term capital appreciation |
| Valuations | Monthly |
| Redemptions | Monthly on 30 days' notice |
| Management Fee | 1.5% annual - (A series)<br>1.0% annual - (F series)* |
| Performance Fee | 20% over 3.0% annual hurdle |
| Loss Carry-forward? | Yes – One year |

## Service Providers

| | |
|---|---|
| Investment Manager | GreensKeeper Asset Management (a division of Lightwater Partners Ltd.) |
| Prime Broker and Custodian | CIBC World Markets |
| Auditor | KPMG LLP |
| Fund Administrator | SGGG Fund Services Inc. |
| Account Administrator | TD Waterhouse Institutional Services |

* F series issued generally to purchasers who participate in fee-based programs through eligible registered dealers.

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## Corporate Profile

GreensKeeper Asset Management, a division of Lightwater Partners Ltd. is an independent, owner-managed asset management company. We bring a unique offering to the Canadian marketplace based on a value-investing methodology. Our investment approach and our safeguards focus on the safety of our client's capital. We aim to deliver attractive absolute after-tax returns to our investors and invest our own money alongside our clients

GreensKeeper has been over 15 years in the making. After successful careers as a lawyer at a major Toronto law firm (M&A, Corporate Finance) and an investment banker with Cormark Securities, a leading independent investment bank, Michael McCloskey established GreensKeeper in 2010.

## Our Investment Philosophy

At GreensKeeper we practice bottom-up fundamental analysis combined with the value investing methodology taught by our investing heroes: Benjamin Graham, Philip Fisher, Warren Buffett and Charlie Munger. Value investing is all about buying an interest in a quality business for less than its *intrinsic value*. That discount provides us with our *margin of safety* to safeguard our clients' investments.

*What We Look For* - When selecting investments we scour our universe of stocks that possess the following characteristics:

> Great Businesses: We prefer to stick to investments in businesses that we understand, with attractive underlying economics and that possess durable competitive advantages.
>
> Solid Management: We seek investments in companies that are being run by competent and shareholder-friendly management teams.
>
> Margin of Safety: We patiently wait for the stock market to offer us a price that allows us to buy a stock for a sufficient discount to our estimate of its intrinsic value.

*Our Best Ideas* - The Value Fund will be managed as a concentrated or "conviction" portfolio. The benefits of broad diversification make sense for some but we prefer to make a few large bets on 15-25 situations that we understand well and where we like the risk/reward trade-off. In other words, *our best ideas*.

*Aversion to Leverage* - We prefer to avoid the use of leverage. We believe that doing so provides us with the benefit of never needing to sell when market conditions are difficult.

*Eating our Own Cooking* - Our founder has a significant percentage of his family's net worth invested alongside our clients.


This is intended for informational purposes and should not be construed as an offering or the solicitation of an offer to purchase an interest in the GreensKeeper Value Fund or any other Lightwater Funds (collectively, the "Funds"). Any such offer or solicitation will be made to qualified investors only by means of a final offering memorandum and only in those jurisdictions where permitted by law. Lightwater Partners Ltd is registered in Ontario, Canada under the categories of Portfolio Manager, Investment Fund Manager, and Exempt Market Dealer. An investment in the GreensKeeper Value Fund is speculative and involves a high degree of risk. Opportunities for withdrawal/redemption and transferability of interests are restricted, so investors may not have access to capital when it is needed. There is no secondary market for the interests and none is expected to develop.

The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits. There is no guarantee that the investment objective will be achieved. Moreover, the past performance of the investment team should not be construed as an indicator of future performance. In addition, the performance of the GreensKeeper Value Fund should not be mistaken for, and should not be construed as an indicator of future performance. The performance figures for the GreensKeeper Value Fund are unaudited, include actual or estimated performance or management fees and are presented for information purposes only.

Certain statements contained in this presentation are based on, *inter alia*, forward looking information that are subject to risks and uncertainties. All statements herein, other than statements of historical fact, are to be considered forward looking. Such forward-looking information and statements are based on current expectations, estimates and projections about global and regional economic conditions as well as industries that are major markets for Lightwater Partners Ltd. There can be no assurance that such statements will prove accurate and, therefore, readers are advised to rely on their own evaluation of such uncertainties. Further, to the best of management's knowledge the information throughout the presentation is current as of the date of the presentation, but management and the agents specifically disclaim any duty to update any forward looking information. The GreensKeeper Value Fund strategy in no way attempts to mirror the S&P/TSX or the S&P500. The S&P/TSX Composite Index and the S&P500 Index are provided for information purposes only as widely followed indices and have different compositions and risk profiles than the GreensKeeper Value Fund.