GreensKeeper ASSET MANAGEMENT

a division of LIGHTWATER PARTNERS LTD

The Scorecard

Issue #2 – January 2012

"Analysts have recently been acting in Wall Street pretty much as they always have, that is to say, with one eye on the balance sheet and income account, and the other eye on the stock ticker.

Benjamin Graham

The Truly Important Things in Life (and Investing)

The Value Fund was successfully launched on November 1 and I have already settled in to the running of the business and dealing with regulatory compliance matters. Things are very busy but in short, I love my new job. What started out as an inexplicable desire to write an investing letter to a few dozen friends has led me to a new career and a growing distribution list that currently numbers in the hundreds. I believe that compared with my prior careers in law and investment banking, GreensKeeper will be my most rewarding.

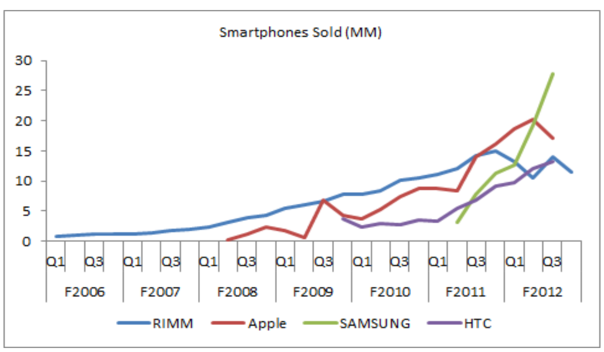
My time is largely focused on adding to the portfolio, broadening the universe of stocks that I follow and growing the business. On that front, if you are interested in receiving an investor package or know someone that would, I would love to hear from you.

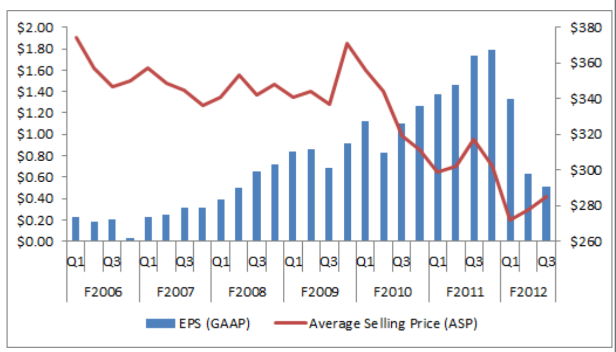
Accompanying this newsletter are the performance reports for the first two months of operations for the Value Fund. Beginning in the second-half of 2012 I will start to provide my investors with a full Statement of Investment Portfolio that will include a detailed listing of the stocks that I hold in the Value Fund. Like my investing hero Warren Buffett, I have historically been reluctant to discuss specific holdings. However based on feedback received from both current and prospective investors I have decided to provide greater transparency. It is time to follow my own path.

Research in Motion (TSX:RIM; NASDAQ:RIMM)

Not a day goes by without someone asking me for my view on RIM. The past year will clearly go down as *annus horribilus* for Canada's former tech darling. For those living in a cave during the past year the following all transpired during 2011: (i) a share price decline of 75%; (ii) RIM's North American market share of smartphone sales fell over 60%; (iii) two of its employees forced a plane to be diverted to Vancouver due to their drunken antics; (iv) the company once again delayed the launch of its new Blackberry 10 operating system; (v) RIM has repeatedly lowered its earnings guidance; and (vi) the shares are currently trading below the company's book value of $19.77 and close to their tangible book value of $13.70. Not good.

The rapid pace of change in the smartphone and tablet markets are usually enough to keep me away from the sector in general. However, the massive price decline caused me to take a closer look to see if I was missing something. RIM makes the bulk of its profits from selling new devices each quarter so the following trends are worrying:





One of the key factors for me when investing in a company is the quality of management. Specifically, I look at their success in execution, whether or not they are shareholder-friendly and their level of candour with the owners of the business. The current management team owns 10% of the company so interests should be aligned. However, both co-CEOs have been made enormously wealthy by virtue of their past success and may no longer have the laser-like focus that is required to stay on top. Steve Jobs was notoriously obsessive about Apple and wasn't distracted by things like purchasing an NHL sports franchise.

A distracted management team could explain some of the problems identified above, but I have an even bigger concern about the company. I believe that RIM has already started to lose their dominant position with the business market – a market that has traditionally been their core strength. Exhibit A – the Playbook tablet was launched without standalone email and calendar functions, critical tools for business users. Exhibit B – RIM recently announced that their Blackberry Enterprise Server secure solution will allow IT departments to support competing devices such as the iPhone. In the consumer market, smartphones have become status symbols and RIM's devices have clearly lost some of their lustre. Business executives are buying iPhones and insisting that their IT departments support them. In short, RIM is currently losing both the smartphone battle and the enterprise war.

Even if I ignore the past stock option backdating scandal and the above-noted execution blunders, the final straw for me came in the company's third quarter conference call on December 15, 2011. In addition to confirming an inventory write-down of $485 million related to the Playbook, the company's co-founder and co-CEO had the following to say in his prepared remarks on the call:

> *"While we remain solidly profitable … we recognize our shareholders may feel we've fallen short in terms of product execution, market share and financial performance." Jim Balsillie*

Did you catch that? He didn't say that *he* was disappointed, but rather that he understood that shareholders might be. The comment reminded me immediately of something that my investing hero once said that always stuck with me (see quote at left). In my opinion, RIM's co-CEOs are not being totally honest with themselves about their recent mistakes or their own ability to turn things around. They continue to overpromise and under-deliver.

"The CEO who misleads others in public may eventually mislead himself in private."

Warren Buffett

Major change at the top is unlikely at RIM despite lobbying by activist shareholders. The board is largely deferential to the founders given their history of success and the fact that like most companies, the directors were appointed to their posts by the current management team. Jim Balsillie and Mike Lazaridis may yet turn things around with their next-gen devices but I am not highly confident of that result. Equally as likely is the prospect of the co-founders continuing with their recent track record of poor execution to the point that the company starts to lose money and destroy book value (anybody remember Palm, Inc.?). I have long felt that RIM had outgrown the managerial talents of the co-founders of the company. This is not uncommon with many successful technology companies but it can be fatal if not dealt with in time. With RIM my concern is that it may already be too late for a change at the top to turn things around.

As a proud Canadian I wanted to like RIM and I wish them all the success in the world. I hope that Jim and Mike can right the ship. But when investing my own capital and that of my clients I am not willing to assume odds that I calculate are no better than those offered in Vegas. I will continue to take a pass on RIM and look elsewhere for attractive investment opportunities.

"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or grass grow. If you want excitement, take $800 and go to Las Vegas."

Paul Samuelson
US Economist (1915 – 2009)

Not So Wonderful

Over the holidays I was channel surfing when I stumbled upon that James Stewart Christmas classic – *It's a Wonderful Life*. The film usually leaves me with a warm feeling but given what has been happening in Europe what caught my attention this year was the scene where the customers of the Bailey Building and Loan make a run on the bank. As I wrote back in April 2010 (McValue Newsletter #3) one of my concerns about the market's rapid advance were the PIIGS – that unflattering and ultimately prophetic acronym that refers to Europe's most profligate countries – Portugal, Ireland, Italy, Greece and Spain. In order to understand what is really happening in Europe it is instructive to look at how the banking industry operates.

"…I intend to manage the hell out of [risk-weighted assets]."

Jamie Dimon
CEO of JP Morgan Chase
Financial Times, Oct. 25, 2011

Banking 101

At its heart, banking should be a fairly simple business. Banks accept depositors' savings and recycle them into loans for credit-worthy borrowers. In this way banks serve a useful capital allocation function like the equity markets. Banks borrow from depositors at a rate below their lending rate and pocket the difference (referred to as a bank's 'net interest margin'). Banks repeat this process many times and by growing their assets and adding leverage to their equity base they can earn attractive returns for shareholders.

One prominent feature of this arrangement is that depositors can withdraw their money on demand (hence the term demand deposits) yet banks make loan commitments for much longer periods of time. Banks borrow short (and cheap) and lend long. In order to avoid bank runs like the one that befell our protagonist George Bailey and to maintain stability, governments around the world invented deposit insurance to assure retail depositors that their money was safe.

Given this arrangement, bank runs and panics are things that governments prefer to avoid as they end up holding the bag. Hence they regulate banking activity through several means including limits on a bank's ability to use leverage. The Basel Accord (1988) introduced the concept of the categorization of a bank's assets according to their perceived riskiness (known as 'risk-weighting'). The riskier the asset, the greater the capital that a bank would need to set aside. All very logical.

But there was an interesting category of assets that were classified with a 0% risk weighting, namely AAA and AA rated sovereign debt. In other words, banks were permitted to buy as much of these assets as they wished without setting aside *any* capital. Incentives are powerful things so banks levered-up on these "risk-free" assets in order to maximize their returns on equity. Governments didn't mind as they were running large deficits and needed people to buy their bonds – so why not their own banks? Only it turns out that these risk-free assets weren't so risk-free. Euro government bonds started to decline in value and were downgraded by the credit-rating agencies and banks are now reluctant to buy them. The problem with leverage is that it magnifies not only gains but losses as well. Small mistakes in a leveraged environment can be fatal. At a leverage ratio of 30 to 1, a small 3.3% decline in the value of a bank's asset portfolio will eliminate its *entire* equity base (it will be bankrupt).[1]

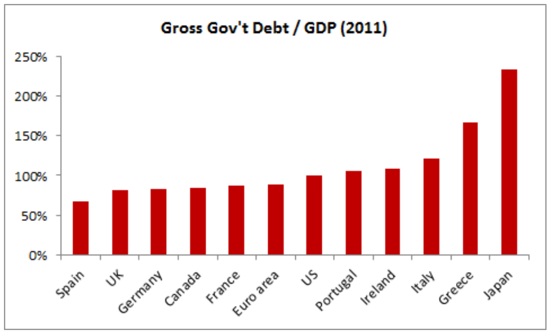
Back to Europe

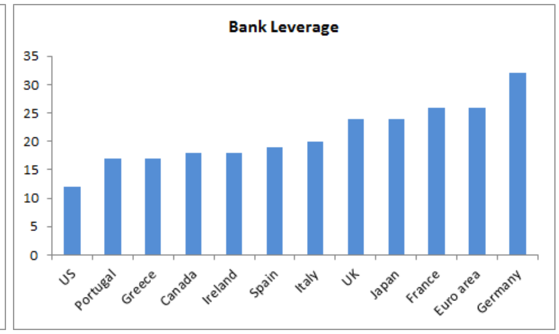
At the heart of Europe's woes is their banking sector. Ireland's government debt levels were actually quite low but they were pressured (I would argue duped) into standing behind their banks beyond their legal commitments to retail depositors.[2] Spain today has a debt to GDP ratio of 67% and Germany 83%, both lower than Canada's 84%. So why the fuss?

Germany has no desire to save Greece and the rest of the Euro zone out of the goodness of their hearts. Being a major exporter to the Euro zone is a concern but there is a bigger worry on their minds. The reality is that if they cut their southern European neighbours loose, the German banks have a problem that is too big for them to fix on their own. German banks own bonds of other Euro governments and will be forced to take a haircut. Add leverage and voila, you have a problem. Take a look at some of the current leverage ratios of the major banks in Europe and elsewhere:

[1] A prudent supplement to RWA is to limit banks' total leverage multiple (assets to equity) regardless of the type of assets held. Canada was one of only two major countries that had this system in place all along (the United States being the other). While our banks were better at managing credit quality during the downturn, this wasn't the only reason that they stayed out of trouble. The Canadian regulations prevented them from catering to their worst instincts. Give OSFI some credit for recognizing that banks need to be adequately regulated to protect them from themselves.

[2] For an entertaining and insightful read on the financial crisis in Ireland, Iceland and Germany I highly recommend the book 'Boomerang' by Michael Lewis.





Source: IMF Global Financial Stability Report, Sept. 2011

By rescuing their banks, overnight Ireland went from a debt/GDP ratio of less than 25% to over 100%. These bank leverage ratios may even *understate* the true leverage involved given bankers' creativity in using accounting gimmicks like Lehman's infamous Repo 105 or repo-to-maturity trades that keep debt hidden off of their balance sheets. All perfectly legal mind you.

One way or another, Europe's banks require additional capital and need to decrease their leverage multiples. Many find themselves presently shut out of the equity markets which leaves asset sales as an unattractive but necessary option. Lenders (both retail and wholesale) are also heading for the exits which leaves European banks with only two viable options: their own governments or the European Central Bank. The net result of all of this is that credit dries up for European borrowers and growth slows. It's that simple. And Europe, if not already in recession, is at risk of one.

What Really Matters

Given this macro environment, what do I do when deciding where, or if, to invest in the equity markets? The reality is that being aware of potential landmines like a Euro implosion is important in order to avoid direct or indirect exposures, but it doesn't otherwise impact my daily investment decisions. I believe that we are in for a period of slower growth as consumers, governments, businesses and banks continue to deleverage. At the risk of being flippant (and a bit of a Grinch), what's the difference between 2% GDP growth and a modest recession? I just assume below-average growth when valuing the companies that I look at. What *is* very important in this environment are strong balance sheets to weather the occasional storm that is likely to pass through.

One mistake that people often make is to assume that the stock markets will decline when the economy is in recession or one is forecasted. Being a math geek I went back and looked at the correlation between US GDP and US stock market returns over the past 80 years. The results will probably surprise you. Over this period only 17% of stock market movements could be explained by movements in GDP.[3] In other words, the stock market shows very little correlation with economic growth. There is however a much higher correlation between investment returns and buying quality stocks when they are cheap. I think that my investment hero said it best (see quote at left).

George Bailey taught me that having loving friends and family are the truly important things in life. But in the world of investing, it is the quality of the business and its valuation at the time of purchase that are truly important when it comes to long-term success. There are some great world-leading companies currently on sale while the public is worried about the economy, Europe, etc. I think that I will follow Warren's lead and put some more money to work in the New Year.

Michael

"A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful . . .

Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So, if you wait for the robins, spring will be over."

Warren Buffett
NY Times, October 16, 2008

[3] *For the mathematically inclined, I calculated a maximum correlation (r_{t+1}) of 0.413 when comparing the DJIA performance with the following year's GDP and accordingly a covariance (R-squared) of 0.17.*

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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, Long-term capital appreciation
Valuations	Monthly
Redemptions	Monthly on 30 days' notice
Management Fee	1.5% annual - (A series) 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:

> <u>Great Businesses</u>*:* We prefer to stick to investments in businesses that we understand, with attractive underlying economics and that possess durable competitive advantages.
>
> <u>Solid Management</u>: We seek investments in companies that are being run by competent and shareholder-friendly management teams.
>
> <u>Margin of Safety</u>: 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.