GreensKeeper ASSET MANAGEMENT
a division of LIGHTWATER PARTNERS LTD

# The Scorecard

**Issue #1 - October 2011**

## My Painting

One of the things that attracted me to mathematics in my university days and now investments in my middle years is the rationality and objectivity of both pursuits. You are either right or wrong in both disciplines. The difference is that with investments, the proper course of action is only proven out over longer periods of time. As Benjamin Graham - the father of value investing - wrote in his seminal work *The Intelligent Investor:* in the short run the stock market is a voting machine, in the long run it is a weighing machine.

The Scorecard will be my platform to communicate the GreensKeeper Value Fund's performance to investors and to keep score against my preselected benchmarks. I aim to deliver absolute returns to my clients (net of all fees) in excess of both the S&P/TSX Index and the S&P500 Index (measured in Canadian dollars) over the long term.

I encourage readers to start with my previous newsletters (McValue Portfolio Newsletters) which are available on the website. I started writing them for a few friends and they introduce some key concepts like *Owner Earnings, Circle of Competence* and *Intrinsic Value* that I will not repeat here.

## The Inner Scorecard

My investment idol Warren Buffett has often talked about the concept of an Inner Scorecard. An Inner Scorecard is the set of criteria and standards by which a person judges himself/herself. In contrast stands the Outer Scorecard, which is a picture of self-worth predicated upon the judgments of others.

***" The big question about how people behave is whether they've got an Inner Scorecard or an Outer Scorecard. It helps if you can be satisfied with an Inner Scorecard. "***

**Warren Buffett**

As applied to investing, my interpretation of this concept is being able to think for yourself. I often listen to the opinions of others and have occasionally changed my views on certain stocks when another person's arguments were valid and improved on my thinking. However, I have never had a hard time ignoring the short term irrationality of the stock market or the views of people that I like and respect if I disagreed with their conclusions (including many management teams). The Inner Scorecard is really about being yourself – something that I am quite good at. Fortunately for me my quirks magically become "eccentricities" as I grow older.

## Starbucks (Nasdaq:SBUX)

I can remember the last conversation that I had about Starbucks before buying the stock. It was at a dinner on Friday, October 24, 2008 celebrating my brother's birthday and I had just completed my analysis of the stock. I asked a few people seated around the table what they thought about the company. Recall that in October 2008 the world economy was grinding to a halt, the commercial paper market was frozen and global stock markets had just crashed 30% in the past month and as much as 10% earlier that day.

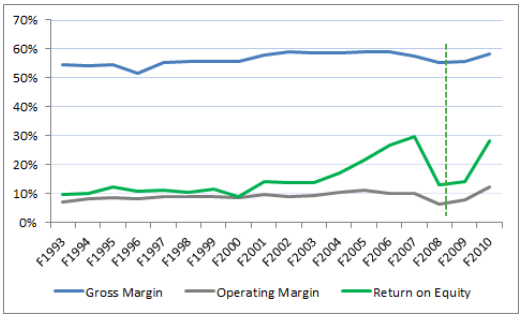
The general consensus around the table was that the company was unlikely to do well in the current environment and that I should avoid the stock. People were cutting back on spending and were unlikely to pay $4+ for a cup of coffee. As a discretionary item many people were likely to give it up or find a cheaper alternative, etc. I bought the stock on Monday morning.

What was I thinking? Despite the state of panic that existed in the world at the time I figured that people would continue to drink coffee. It is warm, makes you feel good and caffeine is mildly

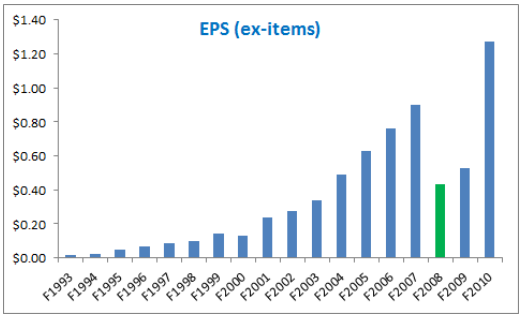
addictive. In tough times people still need small rewards to boost their spirits. Also, humans are creatures of habit and a daily trip to a Starbucks is a ritual for many people. Starbucks is the largest coffeehouse company in the world. I concluded that their ubiquity and their premium brand would mitigate migration to other lower priced alternatives. Starbucks had expanded too rapidly in recent years but the founding superstar CEO Howard Schultz was now back at the helm. Most importantly it was the numbers that spoke to me – they literally jumped off the page.

At the time of my investment the company was clearly going through a tough patch given the economic environment and their overexpansion. Stores were being closed and earnings were taking a hit. However the fact remained that Starbucks was and is an incredible cash flow machine. They sell cups of coffee for $4 – a pretty good business model. During the prior 12 months the company had generated $1.4 billion of cash from operations and spent about $1.1 billion on capital expenditures leaving $300 million in free cash flow. I estimated that $600 million of the capex was required to maintain the existing infrastructure and the rest was for expansion (new stores).

The balance sheet at the time was fine with only $740 million of net debt which existed primarily due to $3 billion of questionable share buybacks by the former CEO over the prior three years. There was $300 million of additional availability under their existing credit facilities. Even considering their off-balance sheet liabilities (leases) they were clearly going to be just fine. In a pinch they could simply slow their store growth. The numbers spoke volumes:

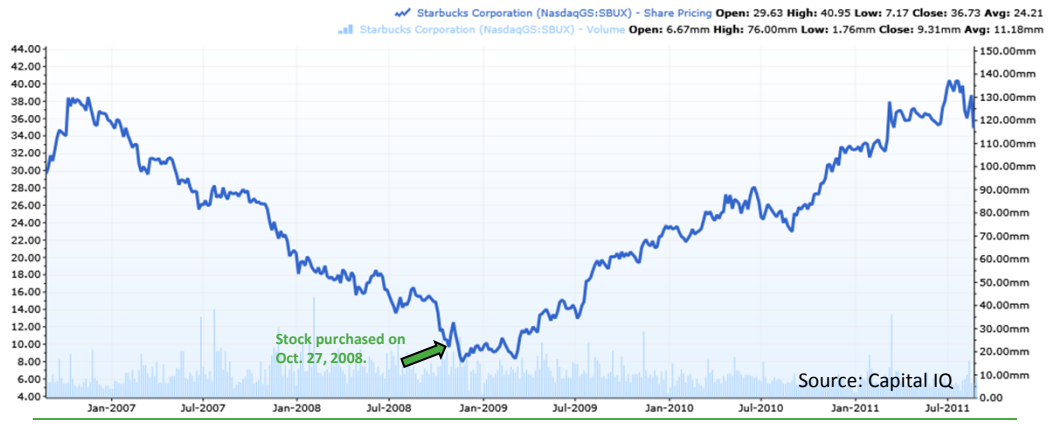



Source: Capital IQ




Source: Capital IQ

To me, despite the negatives and the potential risks the numbers spoke for themselves and the stock was practically being given away at what I calculated were 11 times normal owner earnings for a growing business with the market leading position. The business wasn't broken, it was just operating in a tough environment and working through some poor capital allocation decisions that had been made. I figured that Schultz would be able to fix that given his prior track record at the company. The result may not have been *Inevitable* but it was highly probable:




Source: Capital IQ

*" Companies such as Coca-Cola and Gillette might well be labeled "The Inevitables." Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in ten or twenty years… In the end, however, no sensible observer - not even these companies' most vigorous competitors, assuming they are assessing the matter honestly - questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. "*

**Warren Buffett**

As any good Canadian must ask, what about Tim Hortons (TSX:THI)? There is no question that Tim Hortons is another great company with very attractive economic characteristics. Unfortunately its stock has never traded at a price at which I would consider buying it. At least not yet. Remember that even a fantastic company can be a poor investment if you overpay for its stock.

I calculated that I have made enough on my investment in Starbucks to buy a cup of coffee a day there until I am 115 years old. Let's hope that I live long enough to enjoy them all.

## The Value Fund

Despite my mother's protestations to the contrary, I was never any good at art. It just wasn't my thing. But I did find my passion and talent when it came to investing.

Warren Buffett gave a speech in his native Omaha in 2003 and spoke about why he continued to work despite his enormous wealth. His answer was simple – he loved managing money and running Berkshire Hathaway:

> *"I mean, I feel like I'm on my back, and there's the Sistine Chapel, and I'm painting away; it's my painting, and somebody says, 'Why don't you use more red instead of blue?' Goodbye. It's my painting. And I don't care what they sell it for. That's not part of it. The painting itself will never be finished. That's one of the great things about it."*
>
> Warren Buffett
> Speech at the Oquirrh Club, "An Evening with Warren Buffett", October 2003.

The GreensKeeper Value Fund is my painting. I will have the bulk of my family's capital invested alongside my clients. I am truly blessed to be able to wake up in the morning and do what I love to do for a living. I will do my very best to deliver the returns that you deserve on your hard earned savings. Thank you for your trust and support.

Michael

***" Obviously many companies in high-tech businesses or embryonic industries will grow much faster in percentage terms than will The Inevitables. But I would rather be certain of a good result than hopeful of a great one. "***

**Warren Buffett**

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# 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.

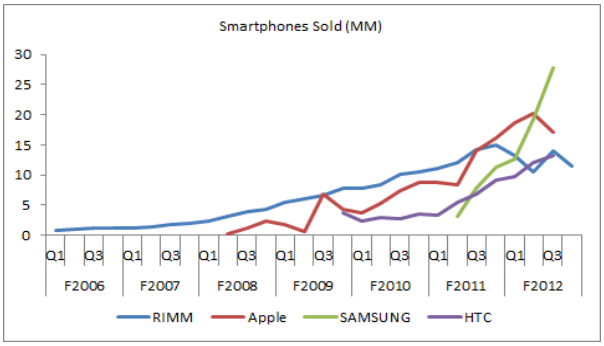
My time is largely focused on adding to the portfolio, broadening the universe of stocks that I follow and growing the business. On that front, if you are interested in receiving an investor package or know someone that would, I would love to hear from you.

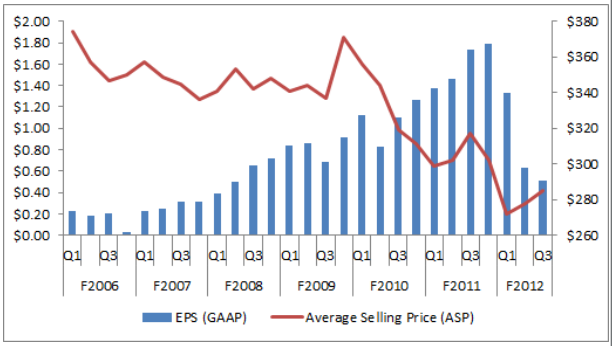
Accompanying this newsletter are the performance reports for the first two months of operations for the Value Fund. Beginning in the second-half of 2012 I will start to provide my investors with a full Statement of Investment Portfolio that will include a detailed listing of the stocks that I hold in 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.

*"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)**

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.

## 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.

## 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.

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

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

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:

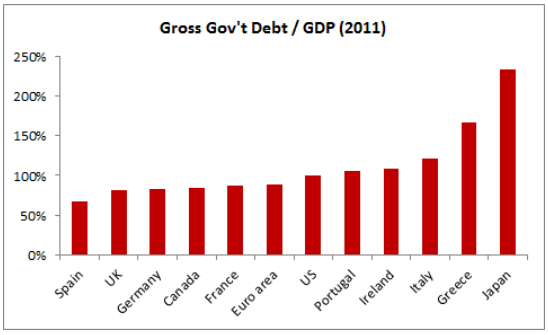
*[1] A prudent supplement to RWA is to limit banks' total leverage multiple (assets to equity) regardless of the type of assets held. Canada was one of only two major countries that had this system in place all along (the United States being the other). While our banks were better at managing credit 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.*

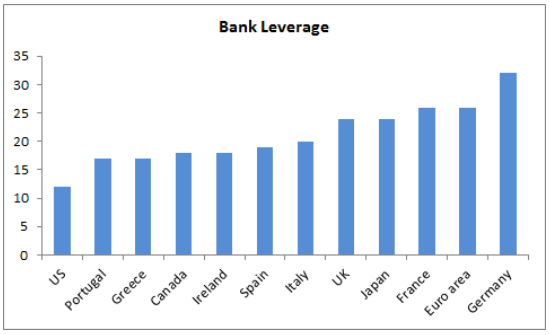
*[2] For an entertaining and insightful read on the financial crisis in Ireland, Iceland and Germany I highly recommend the book 'Boomerang' by Michael Lewis.*

*"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**




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**

*[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 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.

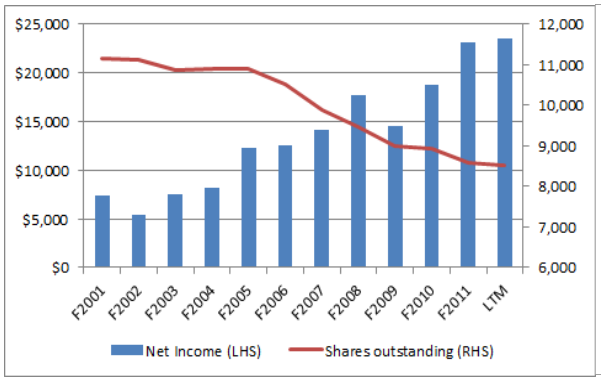
The most consistent criticism of the company's stock is that it "hasn't done anything in ten years". That is quite right as you can see for yourself in the chart below. MSFT (the stock) has largely been dead money:

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

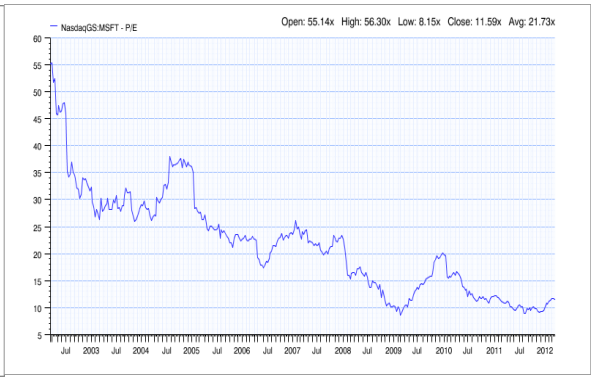
**Benjamin Graham**

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**

## 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 Scorecard

**Issue #4 – July 2012**

## PIIGS and Merde

The Value Fund is up 1.7% year-to-date and 1.1% 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. More importantly, I am excited by what we currently own and believe that our portfolio of stocks are worth significantly more than what Mr. Market is currently valuing them at. Despite the tough economic climate, these businesses should thrive in the coming years and grow their earnings accordingly. Time will tell. In the meantime I am continuing to reduce our cash balance as I acquire additional stocks that meet my unwavering criteria.

As mentioned previously, I have decided to start disclosing the holdings of the Value Fund in order to provide investors with greater transparency. A full list of the Value Fund's current holdings is provided on page 3. Additional details on the positions (cost basis, position size, etc.) will be provided to clients directly when they receive our June 30 financial statements.

*"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or grass grow."*

**Paul Samuelson**

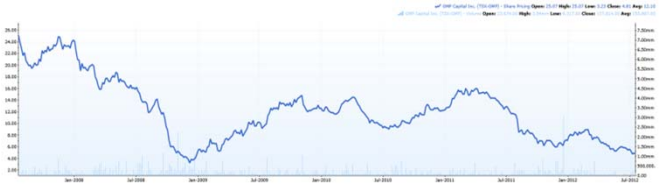
**Nobel Prize-winning Economist**

## GMP Capital Inc. (TSX:GMP)

One of the keys to being successful at investing over the long term is to stick to businesses and industries within your *circle of competence*. Put another way, you should invest only in businesses that you know and understand. During my investment banking days at Cormark Securities, our primary competitors were the Canadian bank-owned dealers and then GMP Capital Inc. (GMP). They were, and still are, a formidable competitor.

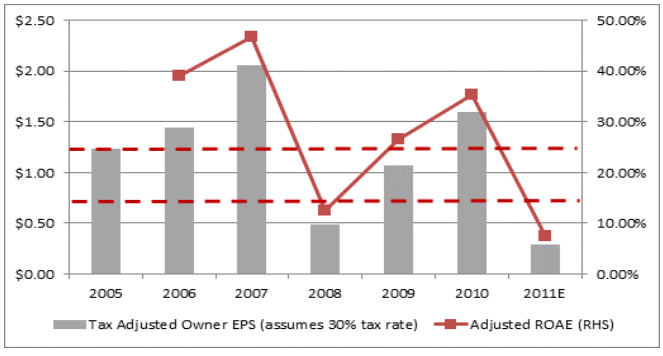
GMP at its core is an institutional investment bank - it acts as agent/underwriter on equity financings and provides advisory services on merger and acquisition (M&A) transactions for Canadian companies. It also facilitates trades for its institutional clients by matching buyers and sellers for blocks of securities. Most of the firm's revenues come from two very cyclical sectors: Energy (Oil & Gas) and Mining. This is a regulated business that is difficult to get right but once you do, it is a license to make money. The business generates a lot of free cash flow and requires very little capital (desks, computers, office space) other than working capital to facilitate its trading and underwriting activities. The real assets of the business are its talented employees.

As illustrated in the charts at right, GMP is a cyclical business with the ability to earn returns on equity of 15-25% and easily earn over $1.00 in earnings per share in good markets.[1]



Source: S&P CapitalIQ.

GMP's business franchise reminds me of a Canadian version of Goldman Sachs *prior* to its initial public offering (IPO) in 1999. Post-IPO, Goldman has become much more reliant on its proprietary trading business which requires significant leverage and is a much riskier (and hence less valuable) business.




Source: Company Reports, GreensKeeper Estimates.

[1] Historical earnings have been adjusted to take into account a number of one-time items and to adjust for GMP's conversion from an income trust to a corporation in 2009.

*"Our sustained heavy overweight in quality stocks in 2009 was painful, intellectually and otherwise. Our pain in 2010 was more "business as usual," waiting for the virtues of value to be revealed. The saving grace is that, although value is a weak force in any single year, it becomes a monster over several years. Like gravity, it slowly wears down the opposition,"*

**Jeremy Grantham,**
**GMO LLC Quarterly Letter**
**Q1 2011**

Going public provides investment banks with a permanent form of capital and access to more if needed. But the downside is that management is tempted to take greater risks once they have access to capital other than their own. I don't believe that Goldman Sachs would have taken the risks that they did in 2008 (leverage of 23 to 1) had the firm been capitalized like they were historically with just the partners' capital on the line.[2] Despite the fact that both are public companies, GMP is a very different business than the Goldman Sachs of today. GMP has largely stuck to its knitting after its IPO and the employees and directors of the firm still own about 25% of the business. They have done a lot of things right and have had a few hiccups along the way.

**The Good**

One of the keys to success in the investment banking business is the quality of the players on the team. It is hard to retain talent over time as competitors try to poach them or they become wealthy enough to pursue other activities. GMP has dealt with the retirement of a number of its early partners and has successfully managed to attract new talent to the firm and to keep them financially motivated.

GMP has also been successful in starting an asset management division from scratch in 2008. The asset management business is a natural extension of their core franchise and requires very little regulatory capital. It is a good business and GMP has capitalized on this opportunity. The division is currently profitable and already has assets under management of $582 million which should continue to grow.

GMP has also extended its core franchise to new geographies, namely the U.S., the U.K. and Australia. Expanding its core business to places where it can leverage its expertise in commodities is a smart and relatively low risk strategy. In early 2011 the firm also raised $115 million of permanent capital via a preferred share issue on what I believe are attractive terms. It should allow them to avoid having to do another dilutive equity issue like the one they did in the depths of the market collapse in 2008. I give them full marks for both of theses initiatives.

**The Not So Good**

Management teams of great businesses that generate a lot of free cash flow are often tempted to use it to expand their business empire. It is simply human nature. Unfortunately this often this leads to *unforced errors* when management takes the cash generated by the great business and invests it in a less attractive one. It is somewhat ironic that a firm whose primary function is to allocate capital efficiently has been less than stellar when it comes to its own capital allocation. A few examples will demonstrate.

In 2005 GMP decided to start up a wealth management division with financial advisors who would provide advice to retail clients in exchange for advisory fees. In my opinion, the wealth management business is a mediocre one at best. The business requires large scale to operate at a profit and even at scale, the investment advisors often consume most of the business' economics leaving little for the shareholders. In addition, the business brings with it huge regulatory and compliance risks. Unfortunately, to date this division has lived up to my expectations: growth in assets under administration but few profits for the shareholders. It consumes management time and capital that I believe is better used elsewhere.

In 2006 GMP purchased a private equity business (Edgestone) for approximately $152 million. Over the ensuing years, the business was essentially written off *entirely*. This is a significant amount of money for a company that is currently valued by the market at about $340 million.

[2] For an excellent book on the history of Goldman Sachs as a private partnership, I recommend "The Partnership: The Making of Goldman Sachs" by Charles D. Ellis.

*"Of one thing be certain: if a CEO is enthused about a particularly foolish acquisition, both his internal staff and his outside advisors will come up with whatever projections are needed to justify his stance. Only in fairy tales are emperors told that they are naked."*

**Warren Buffett**

**Value Fund – Current Holdings**

Berkshire Hathaway

Cash (US$)

Cash (CAD$)

Cisco

GMP Capital Inc.

Home Capital Group Inc.

Microsoft

Sanofi

Tempur-Pedic

Wells Fargo

GMP recently acquired a New York investment brokerage that focuses on institutional sales and secondary trading of high yield and distressed debt. It is a natural extension of GMP's institutional equity franchise. However, the debt capital markets business operates on much thinner margins and I believe is a less attractive business than GMP's core equity-focused franchise. More troubling, GMP paid $48 million (plus a possible future earn-out) for a business with a book value of about $2.1 million that was modestly profitable in 2011 and is unlikely to earn much profit this year.

Finally, GMP's dividend history has been all over the map. The company has increased its dividend, decreased it and paid several special dividends over the past five years. Having been in this business, I know that it is a cyclical one. The key is to keep your costs in check (including employee count and compensation) when things are slow, maintain a fortress-like balance sheet and distribute capital to shareholders in an efficient manner if and when it is available. The idea of a steady common share dividend isn't consistent with the cyclical nature of the business. I applaud GMP's management and board for distributing the excess capital to shareholders. I would just encourage them to do so via special dividends when excess capital is in hand. This strategy has the added benefit of reducing the pressure of earning enough to cover a fixed quarterly amount.

**Investment Thesis**

In short, I have to give GMP poor marks for its historical capital allocation decisions. My preference would be for the firm to stick to their core institutional equity investment banking franchise and grow their asset management business. That's it. I believe that these two divisions account for 95% of GMP's entire business value. Any excess cash should be returned to shareholders via special dividends and/or share repurchases if and when the shares are significantly undervalued (like now).

Being significant shareholders in the company as well, I suspect that there are many GMP employees that would agree with my conclusions. In this regard, our interests are completely aligned. I am hopeful that management and the board have reflected on the past and will make future capital allocation decisions that will maximize value for all shareholders.

Despite the risks, I believe that the stock is attractive at current levels ($4.90) and I own a position in the Value Fund. The business should continue to generate significant free cash flow and the book value per share of $3.47 (tangible book value - $2.80) should provide some support for the stock. The investment has not been a good one to date as the stock continues to hit new 52-week lows and is trading below my average cost. Obviously I bought too early. However, I am long-term bullish on the Canadian Energy and Mining sectors despite the market's current pessimism. These sectors will turn as they have always done – I just can't tell you exactly when. And when they do, GMP should absolutely mint it as they have done in the past.

## Meanwhile, Over in Euroland

Politics makes for strange bedfellows and the political partnership of France and Germany over the past few years has been interesting to watch. Alas the duo better known as "Merkozy" (Merkel and Sarkozy) is no more after the latter lost the French presidential election in May to Francois Hollande. The new celebrity "couple" of Merkel and Hollande has not yet been ceremoniously christened by the European press with a suitable handle. In light of all of Europe's trouble with the PIIGS I think that "Merde" (Merkel and Hollande) seems quite apt. It's catchy n'est-ce pas?

**Michael McCloskey**
Founder & President

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# The Scorecard

**Issue #5 – October 2012**

*"If I'm pretty sure I won't lose money, all the other possibilities are good ones."*

**Joel Greenblatt**
**Gotham Capital**

## Birdy Num Nums

The Value Fund was up 2.8% in Q3 and 4.5% year-to-date (after all fees and expenses). Since inception the Value Fund is ahead of the S&P/TSX total return index but lags the S&P500($CAD) – our two primary benchmarks. The biggest movers in the quarter were Tempur-Pedic (+39%), Sanofi (+14%) and Home Capital (+14%). Our poorest performer was a recent addition – Joy Global (-7.9%). The 3.5% appreciation of the Canadian dollar during Q3 was also a headwind given our large holdings of US dollar denominated assets. I do not hedge our US dollar exposure as I do not believe the cost is worth it, and I am comfortable being long US dollar assets at current exchange rates.

I had planned to write about the latest addition to the portfolio (Joy Global - NYSE:JOY) but several recent events changed my mind. First, the actor Herbert Lom, best known as Chief Inspector Dreyfus to Peter Sellers' Inspector Clouseau in the brilliant *Pink Panther* movies, passed away. Next, Tempur-Pedic (a former Value Fund holding) traded strangely and subsequently announced a significant acquisition. Finally, a lot of ink was spilled critiquing Facebook's "successful" IPO which turned out to be anything but. The first event may seem difficult to reconcile with an investing newsletter but bear with me for a few moments and all will become clear.

Peter Sellers is one of my favourite character actors of all times and I must have watched each of his Pink Panther movies dozens of times. The recent passing of Herbert Lom made me reminisce about their collective comedic genius. It also made me think of one of Sellers' lesser-known films - a 1968 oddity called *The Party*. The movie consists of a series of skits involving Sellers buffoonish lead character Hrundi Bakshi being mistakenly invited to an exclusive Hollywood party. In one scene Hrundi picks up a bowl of bird seed labelled Birdy Num Nums and "feeds" them to a parrot in a large cage by hurling the entire bowl's contents at the bird. Good stuff! (YouTube: http://bit.ly/5GYarP). The investing lesson in all this… please bear with me a little longer.

## Tempur-Pedic (NYSE:TPX)

My investment thesis for Tempur-Pedic (TPX) was very straightforward. In brief, I believed that: (i) people would continue to purchase mattresses, premium mattresses in particular, (ii) TPX would retain its premium brand and pricing power while tweaking its business model to respond to increased competition, and (iii) the company would continue to grow its sales and earnings over the long-term along with the growth in the premium segment. A longer version of my investment thesis on TPX is available from a recent BNN appearance (BNN video: http://bit.ly/PMvUe1).

Source: S&P CapitalIQ.

Since the date of purchase, TPX's stock price action was as follows:

The stock generally increased in price since purchase until it peaked at about $35 in mid-September and then made a sharp reversal until an acquisition was announced on Sept. 27. So what happened to the company and/or the industry during this period to justify the price action? Was the stock worth $22 or $35? The reality is that there was no material announcement that would justify the market valuing the business as much as 60% higher over that short period of time. The S&P500 was up about 11% during that time, so that only explains a small portion of the major move. The reality is that Mr. Market started to view the business more favourably and the stock as underpriced.

In my mind, the critical question that an investor must always ask is: "what is the stock worth"? If my investment thesis was correct, I believed the stock to be worth well in excess of $40. If TPX delivered the results that I expected going forward, in the long-run I trusted that Mr. Market would value the stock accordingly. By buying at less than half of what I believed it to be worth, I de-risked the purchase for my clients. Modern portfolio theory suggests that TPX is a very risky stock given that the volatility of its stock price relative to the market (Beta of 2.0) is quite high. Without putting too fine a point on it, this measure of risk is idiotic. The risk of owning a stock isn't its price volatility, it is the price that you pay relative to its intrinsic value. An intrinsic value is difficult to calculate with pinpoint accuracy, so it is important to buy cheap enough that you leave yourself plenty of cushion or *margin of safety*.

Whenever a stock that I own makes a large move (in either direction) without any noticeable change in the underlying business or its industry it usually elicits a strong involuntary emotional reaction. I can't control it - it's simply part of the human condition. My response is to try and picture the imaginary Mr. Market as one of Peter Sellers' zany characters. Should I be asking Inspector Clouseau or Hrundi Bakshi for investment advice? Of course not! This little mental trick may seem silly to you. But it is my own way of internalizing Benjamin Graham's Mr. Market allegory and a golden rule of investing: You can't value a stock by just looking at the movement in its share price.

Yes portfolio managers can be a little eccentric. But it is mental tricks like this that keep me from making rash judgments and giving in to my fight or flight responses when markets move sharply. The most important thing about investing is temperament, not intelligence.

After peaking at $35 in mid-September, TPX's share price retreated rather aggressively. Again there didn't appear to be any rationale for the change in sentiment. However, this time I suspect that there was something behind the move. On September 27, TPX announced a $1.3 billion acquisition of Sealy (NYSE:ZZ). Mr. Market was quite excited by the deal and TPX's stock was up 14.4% on the day. I didn't like the transaction and sold our entire position at $30.52. I will take our 39% three-month return and find somewhere else to deploy the capital. For those that are inclined, I published a more detailed article on the reasons that I disliked the transaction on *Seeking Alpha* which can be found here: http://ow.ly/e4lsv.

*"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."*

**Benjamin Graham**
**The Intelligent Investor**

*"Success in investing doesn't correlate with I.Q. once you're above the level of 125. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing"*

**Warren Buffett,**
**Berkshire Hathaway**

## Facebook Fail

Andrew Ross Sorkin wrote an interesting article in the *New York Times* on subject of the Facebook IPO "debacle" and came to the conclusion that it was the company's CFO – David Ebersman – who was to blame. It didn't take long for the online comments to pile up with opinions all over the map. Having participated in many IPOs as an investment banker and in my former life as a securities lawyer, several people have asked me for my views on the matter. No surprise, I have strong opinions on the topic.

The reality of the Facebook IPO is that this was a bubble in search of a sharp object. Facebook may be an amazing social utility but it is too early to tell if it will evolve into a cash generating machine like Google. Facebook is approaching 1 billion users, a truly astonishing feat. However, its business model is still evolving as the company struggles to find ways to monetize this traffic.

So how do you value a business like Facebook? I would argue that it can't be done. In my opinion, you cannot predict with any degree of certainty how much money the company will make in the coming years or whether or not they will be displaced by a newer technology. In other words, prudent investors should stay away. Unfortunately this approach isn't as exciting as jumping on board of a stock that seems to go higher and higher every time that it is traded in the private market prior to the IPO. In my mind, looking around at the major parties involved, there was plenty of blame to go around.

**The Company:** Mark Zuckerberg is probably a genius and has created something that has changed the world and will probably continue to do so. I applaud his vision. However, he is young and inexperienced when it comes to the financial markets. Everyone has a blind spot and it is important to surround yourself with people you trust and respect that can make up for your shortcomings. If the goal of the Facebook IPO was to sell as little stock as possible for the maximum valuation achievable, then the Facebook IPO was a huge success for the company. But I don't believe that was the goal. Mr. Zuckerberg is a billionaire many times over and his other actions don't lead me to believe that he had any intention of overpricing the IPO. He was just out of his league. The entire executive team (including the CFO) would have been involved in the final pricing decision and the board would have been involved at one stage as well. They all had their opportunity to take a more cautious approach by pricing less aggressively, accepting a little more dilution and leaving more on the table for new investors. In my view, that is the primary mistake that the company made. The IPO "debacle" has been an unnecessary distraction to the company, its employees and their morale. People that congratulate the company for getting the best price possible fail to recognize that the IPO created lasting damage to the company's reputation and their momentum.

**The Underwriters:** In an IPO, the key role of the underwriters, and the lead bookrunner (Morgan Stanley) in particular, is to assess demand and recommend an initial pricing range and a final IPO price and size. They do this based on the valuations of other similar companies that are publicly traded and indications received during the IPO roadshow. The underwriters are often faced with conflicting demands – sellers that want the highest possible price and buyers that want to buy cheap. A large "pop" in the stock means that the issue was priced too low. If the stock trades down, it was priced too dear. The right balance is to have the stock trade up slightly to balance these competing interests. When in doubt, my instinct was always to err on the side of leaving more upside for new investors. To be fair, I wasn't in the room and don't know the discussions that took place. Nevertheless, the fact remains that the demand that was perceived to be there dried up very quickly. The Nasdaq's technology snafu didn't help matters. However, Morgan Stanley could have recommended pricing lower and sizing less aggressively. Recall that the IPO pricing range and size of the offering were both increased shortly prior to the launch. The reality is that they misread the market.

*"If you want to find the true culprit behind the Facebook IPO 'debacle', take a look in the mirror."*

**GreensKeeper**

*"We have met the enemy and he is us."*

**Pogo**

*"If making money right away is important to you, please take your money out."*

**Seth Klarman**
**Baupost Group**

**Value Fund Former and Current Holdings**

AÉROPOSTALE
BERKSHIRE HATHAWAY
Cash (US$)
Cash (CAD$)
CISCO
GMP Capital Inc.
HOME CAPITAL GROUP INC.
JOYGLOBAL
Microsoft
SANOFI
TEMPUR-PEDIC
WELLS FARGO

**The Investors:** You may not be surprised to learn that this is where I believe most of the blame ultimately rests. At the end of the day, people were lining up to buy Facebook's stock at any price. Most buyers were likely looking for a quick flip and panicked when that didn't happen. There were even certain so-called "value" funds that bought stock in the IPO. If I ever buy a stock for the Value Fund at a valuation of 100x trailing earnings (65x forward earnings), feel free to physically knock some sense back into me. As a joke I told one of my investors (with a straight face no less) that we had bought into the Facebook IPO. His astonished reaction was priceless but he quickly figured out that I was joking. Priceless.

## Valuation Matters

Markets will forever continue to oscillate between the extremes of panic and greed. The common thread is that at both extremes, most people ignore valuations to their peril and become transfixed with stock price movements. It has happened for centuries and will continue to as it is simply in our nature.[1]

I would encourage you to honestly ask yourself the following question (be honest):

> *How many times have I invested in a company after only looking at its stock chart or reading a news article without ever looking at the company's financial statements?*

Whenever you find yourself doing this, try and imagine that you are taking investment advice from Inspector Clouseau or Hrundi Bakshi. Remind yourself that he is a temperamental imbecile. Take advantage of his temporary bouts of stupidity. If, on the other hand, you can't avoid internalizing the "wisdom" that his stock quotations are imparting on you, just accept the fact that you are speculating, not investing.

My goal in building the Value Fund's portfolio (My Painting – Scorecard #1) is to assemble 15-18 stocks in exceptional businesses that I understand and at prices that I feel are very attractive. The valuation requirement means that they are often unloved by the market at present for varying reasons. On occasion things work quickly like they did in the case of Tempur-Pedic. More often, the market takes longer to agree with my view of the stocks that I have selected.

It is important that you understand my investment philosophy as I want to attract the right kind of investors to the Value Fund. My value investing philosophy and methodology will inevitably lead to some volatility in our monthly performance. My own focus is to measure the Value Fund's returns over years, through both good and bad markets. If my grasp of the facts and my reasoning are right, I am confident that we will have protected our downside and be rewarded handsomely over the long-run.

**Michael McCloskey**
Founder & President

[1] For an excellent book on the history of stock bubbles and human folly throughout the ages, I recommend *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay, first published in 1841.

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# The Scorecard

**Issue #6 – January 2013**

## Apples and Oranges

The Value Fund was up 7.7% in 2012 after all fees and expenses. Our biggest winners for the year were Tempur-Pedic (+38.8%), Sanofi (+29.7%) and Home Capital (+23%). Our only losing positions were GMP Capital (-17.4%) and one small position that I recently initiated but prefer not to discuss at the moment as I am still accumulating shares. So how did the Value Fund stack up against the major indices?

| | 30-Dec-11 | 31-Dec-12 | Change |
|---|---|---|---|
| S&P 500 Total Return Index ($CAD) | 2,195.64 | 2,491.67 | 13.5% |
| DJIA Total Return Index ($CAD) | 23,052.21 | 24,987.40 | 8.4% |
| GreensKeeper Class A | $9.9433 | $10.7047 | 7.7% |
| S&P/TSX Total Return Index | 33,302.95 | 35,696.72 | 7.2% |

| | 30-Dec-11 | 31-Dec-12 | Change |
|---|---|---|---|
| S&P 500 Price Return Index ($CAD) | 1,278.98 | 1,418.92 | 10.9% |
| GreensKeeper Class A | $9.9433 | $10.7047 | 7.7% |
| DJIA Price Return Index ($CAD) | 12,425.26 | 13,037.31 | 4.9% |
| S&P/TSX Price Return Index | 11,955.10 | 12,433.53 | 4.0% |

I want you to compare the two performance tables above. Did you catch the sleight of hand in the table on the right? Some mutual funds compare their results against benchmarks based on *price* return indices instead of *total* return indices. What's the difference? Price return indices only track the capital appreciation of a portfolio but ignore income generated by the assets such as dividends and interest. Total return indices, on the other hand, include this income in the return calculation. Our portfolio, like most equity portfolios, earns interest and/or dividends on many of its holdings. While using the price return benchmarks may be tempting to some (it makes a mutual fund's relative performance look better), I believe that by doing so, an equity manager is making a misleading comparison. I don't ever intend to join that club. Aim high and let the chips fall where they may is more my style. The proper benchmarks for the Value Fund are the total return indices reproduced in the first table above left.

Observant readers will have also noticed that all returns are reported in Canadian dollars. Over 60% of the Value Fund's current holdings are U.S. dollar denominated assets. That percentage will likely increase over time as most of the world's great companies are publicly listed in the U.S. When we calculate the gain or loss on any position, we measure it in Canadian dollars. Accordingly the U.S. indices should be reported in Canadian dollars as well. The Canadian dollar appreciated by 2.2% in 2012 against the greenback which had the effect of reducing the reported returns on our U.S. assets.

One last point about benchmarks is worth thinking about as you open your year-end mutual fund statements that arrive in the mail. The Value Fund, like any mutual fund, is at a disadvantage when it comes to total return benchmarks. The reason is that mutual funds incur operating fees (legal, accounting, trading commissions), foreign dividend withholding taxes and management fees, all of which reduce stated returns. That said, if a fund manager cannot beat the indices, after all fees and expenses, *over the long run*, they are not earning their keep. You always have the option of purchasing a low-cost exchange-traded fund (ETF) that will only slightly reduce the returns on the total return indices.

The Value Fund's performance in 2012 fell a little short primarily due to carrying a large average cash position during the year. The stocks that we owned performed well (better than well, actually) but I didn't hold enough of them. My conservatism cost us some performance during 2012. However, I prefer waiting for severely mispriced situations that let me sleep at night knowing that with the stocks that we own, the odds are strongly in our favour. The portfolio's cash position is now at an all-time low and I expect the Value Fund to be fully invested very shortly.

## Lifelong Learning

One of the things that I love best about my job is that I get to read and think all day long. I will never get tired of learning. Investors typically get better with age as experience and knowledge are both cumulative. The daily journey is a joy and full of surprises.

*"Well, some of our success we predicted and some of it was fortuitous. Like most human beings, we took a bow."*

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

GreensKeeper ASSET MANAGEMENT
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# The Scorecard

**Issue #6 – January 2013**

At the time that I was starting GreensKeeper, I came across an advertisement in the newspaper for a liquidation auction of high-end office furniture. A major Bay Street law firm was changing buildings and decided to upgrade to the latest and greatest. I invested $5 for a copy of the auction catalogue and wandered over to the TD Bank Tower during the inspection period to have a look for myself. There were some fantastic solid mahogany office suites on offer. Not having secured GreensKeeper's office space yet, I figured I could store the furniture for a few months until I signed a lease.

On auction day I registered along with about 70 other people, many of whom were clearly professional buyers who purchase office furniture to resell. Once the bidding started I sat back and watched things unfold in order to get my bearings. The first few hundred lots were well bid and I quickly caught the hang of things and turned my attention to some reading material I had brought with me (unlike my Amex card, I don't leave home without it).

A few hours later something caught my attention and I looked up. It was the sound of silence. 'Crickets' as they say. I checked the lot number against my handwritten notes and sure enough it was one of the mahogany desks that I had inspected earlier and in excellent condition. There were probably 15 identical desks on sale that day and many of the earlier ones had gone for $600 (they retail new for about $2,600).

The auctioneer asked again if there were any bids. Silence. Just before he moved on to the next lot I put up my bid number and said '$25'. Sold! I probably could have paid less but would have been embarrassed to offer anything less. I took the desk home and stored it until I secured my office space. Wouldn't you know it, my office came fully furnished with a desk even better than the one that I purchased. Not needing two desks, I put the one I had purchased at the auction up for sale on a free online auction site. Within a few weeks I had someone interested in buying it. The buyer showed up, inspected it and didn't even negotiate my $1,100 asking price. He knew that he was getting a good deal and more than happy to pay it.

*"It takes character to sit there with all that cash and do nothing. I didn't get to where I am by going after mediocre opportunities."*

**Charlie Munger**

The hardest part about value investing is having the discipline to be extremely patient. Attractive opportunities to buy shares of excellent companies on the cheap don't come along very often. Market panics are a good source but far too infrequent. More often they come in the form of companies that are encountering a temporary problem and the market overreacts. A few stocks that I purchased for the Value Fund in 2012 were examples of this. For instance, below is the one-year stock chart for Western Union:

The use of leverage is another form of impatience. I'm not referring to a company's use of a modest amount as part of an appropriate capital structure. Nor am I referring to minimal use of leverage in an equity portfolio (although my bias is to avoid it altogether). What I am referring to is the use of significant leverage in order to attempt to enhance returns. Leverage amplifies gains but also does so with losses. And they are often called at the most inopportune time.

In both my legal and investment banking careers I have witnessed situations where people that I knew have had brokers sell their margined stock holdings due to margin calls. The consequences are severe as margin loans force a sale at the worst time to sell - when stocks are plunging. Mortgage debt is another example. Used prudently, it allows the immediate use of an asset at a reasonable cost. Too much of it provides an even larger house but at the risk of losing it altogether if something goes wrong. I have always preferred something more modest knowing that I wouldn't be out on the street when life threw me a curveball.

*"Learn from the mistakes of others. You can't live long enough to make them all yourself."*

**Former First Lady**
**Eleanor Roosevelt**

We all make mistakes. I do and can guarantee that I will continue to. However, time has taught me that I prefer to follow the advice of Eleanor Roosevelt and learn from mistakes the easy way - by studying the mistakes of others and avoiding the painful first-hand experience.

Patience has always guided me in the investing world. Avoiding the use of leverage and waiting for obvious stock opportunities are both dependent on maintaining the discipline of being extremely patient. It is difficult as I am driven and extremely competitive. Fortunately my fear of loss has always been stronger than my desire to compound invested capital quickly. Mathematics taught me that the magic of compounding works the same way in reverse as it does when stocks are rising. I prefer to wait for favourable situations and to avoid giving up any meaningful ground. I am fortunate in that my conservatism comes naturally. It is just how I am and have always been – in other words it is simply my temperament. That said, I have never had a problem buying a stock when it is universally hated provided that I view it to be materially mispriced and misunderstood.

My conservatism may cost the portfolio a few percentage points of performance from time-to-time, however I am convinced that it is the long-term path to success. I am currently GreensKeeper's biggest client (although I would be pleased to be displaced by any whales that you would be kind enough to send my way). Given that my investment dollars are right beside my clients (as they should be), you should know that I manage the portfolio no differently than I would were it mine alone.

## Moats

*"In business, I look for economic castles protected by unbreachable 'moats'."*

**Warren Buffett**

A good friend of mine read my recent *Globe and Mail* article on owner earnings (**link**) but it left him with a unanswered question. Over the holidays he asked me what I meant when I referred to a company's 'moat'. He is a very well educated, intelligent and successful businessman so his question led me to a realization. Namely, investing terminology that I use daily and often take for granted may not be clear to those that don't manage investments for a living.

An "economic moat" is a *sustainable* competitive advantage that is possessed by certain very special companies. The term was coined by Warren Buffett in his 2007 Annual Letter to Berkshire Hathaway's shareholders. One of the Oracle of Omaha's many gifts is his ability to explain complicated concepts in a simple manner using metaphors that tend to stick in the mind:

> *" A truly great business must have an enduring 'moat' that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business 'castle' that is earning high returns. … Our criterion of 'enduring' causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's 'creative destruction' is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all."*
>
> **Warren Buffett**

Moats come in several forms and Morningstar has done a good job of categorizing them in an easily understood format. A few specific examples that I came up with should help you to understand them better:

| Types of Moats | Examples |
|---|---|
| **Intangible Assets** *(Patents, Brands, Licenses)* | AstraZeneca, Coke, Home Capital |
| **Switching Costs** | Joy Global, Microsoft |
| **Network Effects** | American Express, Google |
| **Scale / Cost Advantages** | GEICO, Exxon, Western Union |

On occasion you will discover a great business that possesses several of these economic moats (e.g. Coke – strong brand, trade secrets, economies of scale). When multiple moats are combined, the company that possess them can often keep its competitors at bay and maintain its abnormally high profits for many, many years.

Why do moats matter and why does Buffett focus so much time and effort trying to identify and understand them? The answer is: the *w i d e r* a company's economic moat, the more confident you can be about its future financial results. And when you can predict a business' future with reasonable certainty, you can value it. Knowing what a business is worth allows you to purchase its shares when the stock market does not recognize what you do.

## GreensKeeper Annual Meeting – March 23, 2013

My goal in building the Value Fund's portfolio (My Painting – Scorecard #1: **link)** is to assemble 15-18 stocks in exceptional businesses that I understand and at prices that are very attractive. I am nearly finished the first draft of 'my painting' and should be fully invested in Q1 2013. My painting is unfinished and always will be as I constantly strive to make it better.

A list of selected current and former holdings of the Value Fund can be found in the margin at left. A few stocks that we currently hold are omitted as I am still building a position in them.

On completion of the annual audit of the Value Fund by KPMG, GreensKeeper clients will receive an Annual Report that will contain a more detailed discussion of the portfolio and the first full year of operations for the Value Fund. I also plan to host an Annual Meeting on Saturday, March 23 (invitation to follow) where I will make a very brief presentation and provide attendees with the opportunity to ask any and all questions about the Value Fund or investing in general. If you know of any friends that are growing tired of their current investment returns and interested in learning more about GreensKeeper and value investing, please bring them along.

If you have any questions or would just like to chat, I would be pleased to hear from you at any time.

**Michael McCloskey**
Founder & President

**Value Fund**
**Selected Former and Current Holdings**

Aeropostale (NYSE:ARO)

AstraZenica PLC (NYSE:AZN)

Berkshire Hathaway (NYSE:BRK.A)

Cash (US$ and CAD$)

Cisco Systems (Nasdaq: CSCO)

GMP Capital Inc. (TSX:GMP)

Home Capital Group Inc. (TSX:HCG)

Joy Global, Inc. (NYSE:JOY)

Microsoft Corporation (Nasdaq:MSFT)

Sanofi S.A. (NYSE:SNY)

Tempur-Pedic (NYSE:TPX)

Wells Fargo & Company (NYSE:WFC)

The Western Union Company (NYSE:WU)

GreensKeeper ASSET MANAGEMENT
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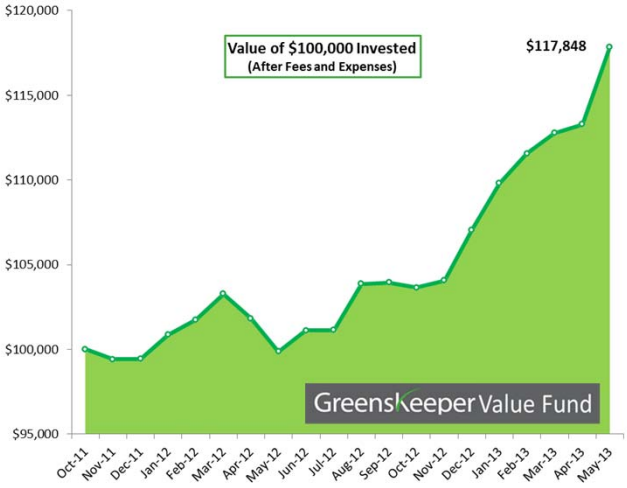
# The Scorecard

**Issue #7 – June 2013**

## Anchors Aweigh

The Value Fund is up 10.1% so far in 2013 and 18.0% over the past 12 months (both figures are after all fees and expenses). Our results have been held back somewhat by our sizable cash position which has been an anchor in this ever-upward market. Fortunately, our cash has now been almost entirely deployed and the portfolio is likely to remain fully-invested going forward.




| 2013 | YTD | 1-Year |
|---|---|---|
| **Value Fund** | **10.1%** | **18.0%** |
| S&P/TSX Total Return Index | 3.0% | 13.3% |
| S&P 500 Total Return Index ($CAD) | 19.9% | 27.2% |

**Statistical Analysis**

| | Value Fund | S&P/TSX | S&P500 (CAD$) |
|---|---|---|---|
| Standard Deviation [1] | 5.20% | 8.29% | 7.44% |
| Total Positive Months | 15 | 11 | 14 |
| Total Down Months | 4 | 8 | 5 |
| Median Market Capitalization | $34.7 Billion | | |
| 2012 Annual Turnover Rate | 18.6% | | |

[1] Annualized and based on monthly returns since inception on November 1, 2011.
[2] All figures as at May 31, 2013.

*" Charlie and I always knew that we would become incredibly wealthy. We were not in a hurry… If you're even a slightly above-average investor who spends less than they earn, over a lifetime you cannot help but get rich if you are patient."*

**Warren Buffett**
**Chairman**
**Berkshire Hathaway**

Building the initial portfolio in a prudent and disciplined manner has taken some time. Longer than initially expected to be frank. However, preservation of capital is one of our key tenets of investing at GreensKeeper. Whereas many investors start with the upside when focusing on investment opportunities, we start by focusing on the risks involved. We would rather wait for very attractive opportunities to invest in great companies at attractive entry-points rather than settling for mediocrity. And great companies rarely stumble badly so we wait patiently for opportunities to present themselves. Our purchases of shares in Western Union (NYSE:WU) and Coach, Inc. (NYSE:COH) are perfect examples:

Our preservation of capital mentality may cause us to miss out on some of the upside in the short-term, especially in bull markets like the present, but long-term our capital should be safe and continue to grow.

## GreensKeeper Inaugural Annual Meeting – May 28, 2013

GreensKeeper hosted its first-ever annual meeting several weeks ago and we had an excellent turnout. After a brief presentation on Value Investing and the Value Fund we opened up the floor to some Q&A. The quality of the questions coming from the audience was first-rate.

One of our goals at GreensKeeper is to pass along the value investing principles that we were taught by our investing heroes (Graham, Fisher, Buffett and Munger). It seems that our clients are returning the favour by

asking tough questions that keep us on our toes. Hopefully we held our own and we are already looking forward to next year's annual gathering.

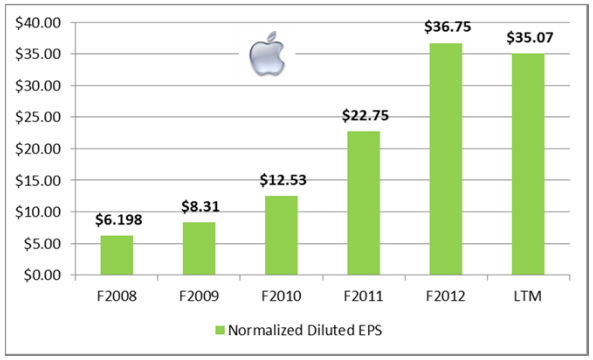
## Apple, Inc. (Nasdaq: AAPL) – In the "Too Hard" Pile

As a consumer I love Apple, Inc. What's not to like? They make fantastic products that are user-friendly and often leading-edge. At first glance the stock also appears attractive. The company has pricing power, market-leading margins, a cult-like legion of customers and a fortress-like balance sheet with $145 billion of cash and equivalents. And the shares appear cheap – trading at less than 12x earnings. A value-investor's dream, correct? Perhaps not.

*"The best way to predict the future is to invent it.."*

**Walter Isaacson,** *Steve Jobs*

We decided to pass on Apple for a very simple reason – our inability to predict what the company will look like in the coming years. Rapidly changing technology is fantastic for consumers but not so much for investors. Change is the enemy of business.



In fiscal 2012 Apple's flagship product – the iPhone – accounted for more than 60% of Apple's operating profit. My personal favourite – the iPad - represented another 10%-15% of Apple's operating profit for the year. In other words, three quarters of Apple's operating profit comes from two products. The iPhone did not exist seven years ago. The iPad only came into existence in 2010.

*"We're gambling on our vision, and we would rather do that than make 'me too' products."*

**Steve Jobs**

Apple's talented engineers and other employees notwithstanding, we believe that no one can tell what Apple will look like in five years. We know that we can not. Will competition cause fat profit margins to erode or lead to a loss of market share? Will the company go back to earning $6.20 per share as it did only five years ago or will earnings continue to grow from here? We simply don't know with any degree of conviction. The industry simply changes too fast and in ways that we find impossible to predict. As a result, we can't properly value the stock. In investing, there is no shame in saying that you don't know and moving on. However, failing to recognize your limitations is likely to bring future pain.

Some would argue that Apple's walled garden or "ecosystem" will keep the company's customers tied to its products and coming back for more. We believe that in time the quality of Apple's "moat" will reveal itself to be less secure than those who own the stock are assuming. A hot new smartphone (e.g. the Samsung Galaxy S4) may be all that it takes to lure away customers or at least put downward pressure on margins. Or maybe a competitor will invent a product that we haven't even dreamed of yet.

Perhaps we are being too harsh on Apple's future prospects and we acknowledge that the company may continue to be the market-leader in premium smartphones, tablets and whatever comes next. Or Apple's next products could be failures like the Apple Pippin and Newton. In either case, without a high degree of conviction about how things will evolve from here we choose to invest our money elsewhere. In a universe of investment opportunities there is no need to come to a definitive conclusion on the future direction of every stock. We simply choose to look for and invest in opportunities that are easier to predict.

GreensKeeper ASSET MANAGEMENT
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# The Scorecard

**Issue #7 – June 2013**

*"In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking."*

**Seth Klarman**
*Margin of Safety*

**Value Fund**
**Selected Former and Current Holdings**

Aeropostale (NYSE:ARO)

AstraZeneca PLC (NYSE:AZN)

Berkshire Hathaway (NYSE:BRK.A,BRK.B)

Cisco Systems (Nasdaq: CSCO)

Coach, Inc. (NYSE:COH)

DirecTV, Inc. (Nasdaq:DTV)

GMP Capital Inc. (TSX:GMP)

Home Capital Group Inc. (TSX:HCG)

Joy Global, Inc. (NYSE:JOY)

Microsoft Corporation (Nasdaq:MSFT)

National Oilwell Varco (NYSE:NOV)

Sanofi S.A. (NYSE:SNY)

Tempur-Pedic (NYSE:TPX)

Wells Fargo & Company (NYSE:WFC)

Western Union Company (NYSE:WU)

## Where To From Here?

Many (most?) investors are fascinated by the daily fluctuations of the stock market. CNBC, BNN and other business news programs fill countless hours of their programming days featuring "experts" that try and give meaning to recent market moves and predict the way forward. Investors are thus conditioned to search for meaning in Mr. Market's every twitch. It is a Pavlovian-like process.

As a result, it shouldn't surprise you to learn that we are asked countless times about our thoughts on the future direction of the markets and the basis for that opinion. What may surprise you is our answer. Judging from the long silence and puzzled look that usually follows our standard response it seems that it surprises others as well.

In the short-term (a day, a week, a month or even a few years) we believe that *the direction of the stock market is totally unpredictable*. In other words, it can not be predicted consistently by anyone. Accordingly, we don't spend *any* time trying to figure it out. It is simply a waste of time to try.

However, over the long-term the stock market is upward trending. Inflation alone will increase the level of the S&P500 Index over time as it is stated in nominal (as opposed to real) dollars. In addition, companies generally pay out annual dividends that are less than they make in annual profits. The retained earnings that they reinvest in their business generally result in higher future earnings.

Instead of trying to predict the future direction of the stock market, at GreensKeeper we spend our time studying individual companies that are unloved (and hence cheap). We try and determine if they are cheap for a valid reason, ever hopeful that on occasion we find a situation where the market has overreacted to a passing phenomenon. Provided that our work is first-rate, the company's business of high quality and its balance sheet in good shape, our results should be more than satisfactory in both up and down markets. In fact, many of the stocks that we own were purchased with plenty of bad news already priced in. Consequently, on a relative basis they should outperform more in down markets.

The more interesting question to ask us is whether we prefer bull vs. bear markets. Bull markets like the one we are currently experiencing make most investors feel good as their investment portfolio grows with each passing month. Unfortunately it also makes it increasingly difficult to find bargains.

At GreensKeeper we prefer sideways to down markets. The reason is quite simple. Bear markets and volatility create panic and the flight response that causes people to sell at exactly the wrong time (when stocks are cheap). Bear markets nurture *severe* stock mispricing. Provided that we are positioned to act (we are) and can do so with equanimity (we can), fear is our friend. That said, we are very comfortable operating in both bull and bear markets and are ready to exploit opportunities when they present themselves.

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT
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# The Scorecard

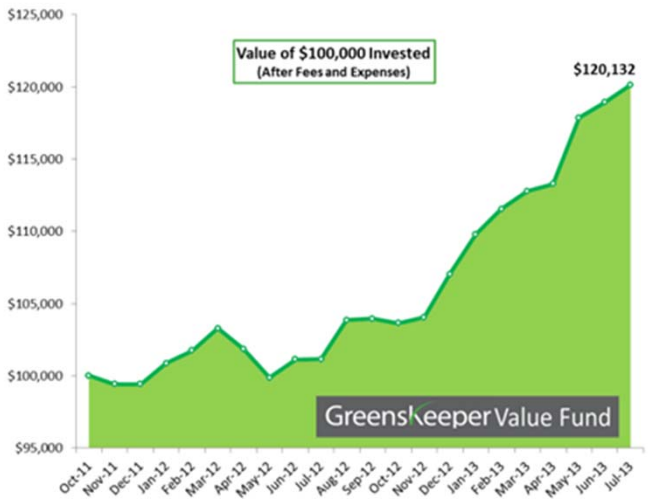
**Issue #8 – August 2013**

*"When there's nothing particularly clever to do, the mistake lies in insisting on being clever."*

**Howard Marks**
**Oaktree Capital Management**

## Unconventional Wisdom

The Value Fund is up 12.2% so far in 2013 and 18.8% over the past 12 months (both figures are after all fees and expenses). Since inception we have had 17 positive months and 4 down months. As reported in our last Scorecard, it took some time to deploy our cash holdings as attractive opportunities have a tendency of presenting themselves at their own pace. The continuing influx of new investors into the Value Fund makes this a constant challenge, but one that we welcome.




| 2013 | YTD | 1-Year |
|---|---|---|
| **Value Fund** | **12.2%** | **18.8%** |
| S&P/TSX Total Return Index | 2.3% | 10.5% |
| S&P 500 Total Return Index ($CAD) | 23.7% | 28.4% |

**Statistical Analysis**

| | Value Fund | S&P/TSX | S&P500 (CAD$) |
|---|---|---|---|
| Standard Deviation [1] | 4.93% | 8.77% | 7.20% |
| Total Positive Months | 17 | 12 | 16 |
| Total Down Months | 4 | 9 | 5 |
| Median Market Capitalization | $34.7 Billion | | |
| 2012 Annual Turnover Rate | 18.6% | | |

[1] Annualized and based on monthly returns since inception (Nov. 1, 2011).
[2] All figures as at July 31, 2013.

## Helen and Tom

A couple that I know recently approached me for a loan but their request was declined for reasons that will soon become clear. "Helen and Tom" are fantastic people. Kind, very charitable towards others and I enjoy their company. Unfortunately they have one negative quality. Helen and Tom consistently spend more than they earn, hence their request for a loan.

Now before you think that I am completely cold hearted, I did give them the opportunity to explain why they needed the money. There were lots of great things that they planned to do with it. Despite their bad habit of overspending, I was tempted to write a cheque and asked about their thoughts on repayment.

Helen and Tom were flexible on the repayment terms (I suspect that they would take what they could get). But their clear preference was for a longer term loan so that they didn't have a maturity date hanging over their heads. Ten years would be ideal but they would take five. That made me pause to say the least.

Believe it or not, I continued to hear them out because I have known the couple for a long time and know that their credit is good. They have fairly stable incomes and I was confident that they would pay me back. Even if that meant that they would likely have to borrow from others to do so.

When I asked them my final question about an appropriate interest rate their answer surprised me. They thought that "two or three percent a year" was sufficient. They knew that the risk of their defaulting on the loan was remote and they knew that I knew that too. Given the current level of inflation and the likelihood of higher inflation in the future, Helen and Tom were really asking me for a loan that wouldn't make me a reasonable return. In fact, in inflation-adjusted dollars I would probably be going backwards.

*"Neither a borrower nor a lender be."*

**Polonius,**
*Hamlet, Act I, Scene III*

*"Conventional wisdom is often, but not always, correct. Learn to think for yourself and when logic and reason lead you to a different conclusion, take advantage of it by reacting with equanimity."*

**The GreensKeeper**

Put yourself in my shoes and ask yourself if you would lend them the money on this basis. Take the charitable aspect of their request out of the equation and evaluate it on purely financial terms. Be honest about it. Would you lend them the money on these terms as a prudent financial investment? Like me, I suspect that your answer is "no".

Not to worry, Helen and Tom ended up finding someone else to lend them the money. In fact they found many millions lining up to do so. For my friends' real names aren't Helen and Tom. They are Canada, the United States, Germany and several other highly rated sovereign credits.

As this allegory demonstrates, lending your money to a credit-worthy borrower for a decade at two per cent or so makes little financial sense. Buyers of sovereigns pay a steep price for the owning these "risk free" assets at current prices.

Conventional wisdom holds that as we get older, we should blindly allocate a larger and larger percentage of our investment portfolio to bonds. One hundred minus your age invested in equities comes to mind. The problem with this rule of thumb is that it doesn't factor in the relative attractiveness of bonds to other investment alternatives at different points in time. Price always matters.

Safety doesn't come from an asset class. It comes from the price that you pay for an asset. An investment can be wise at one price and foolish at another.

Before allocating our investment dollars we always determine the relative attractiveness of the options available to us. There are plenty of choices: public equities, private businesses, real estate, commodities and cash equivalents. Based on current prices, we continue to favour equities for our own investment dollars.

Now, equities aren't for everyone. Some people can't stomach the inherent volatility that comes with the markets. Others have investment horizons that are too short. Investors should take the time to speak with their own financial planner about what makes sense for them.

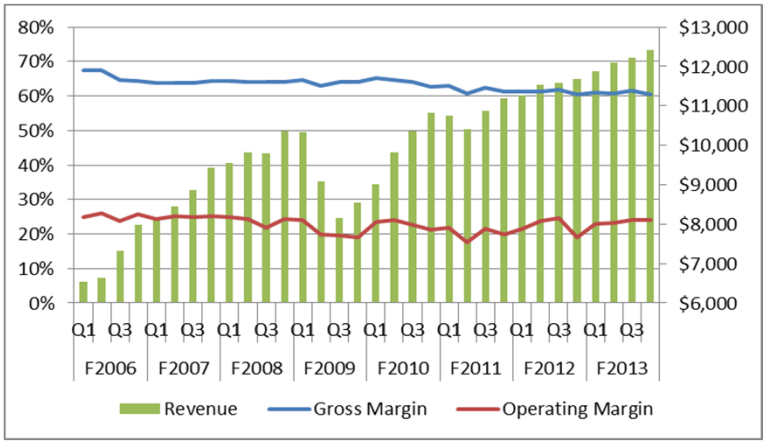
But for us, based on current prices, equities are the place to be. We will be investing our portfolio for many years to come and believe that the stock market will provide us with the best returns over the long term, despite the occasional bump in the road.

And if we can continue to find great companies to invest in at attractive prices, over time our results should not only provide us with a satisfactory result. They should turn out to be safer than investing in the broader market as well.

## Cisco Systems, Inc. (Nasdaq:CSCO)

Cisco Systems is the world leader in the design, manufacture and sale of high-performance networking equipment for the Internet. Their products are ubiquitous and most often the industry standard. In an era of increasing usage of smartphones, tablets, and connected devices (the "Internet of Everything") data transfer and consumption should continue to increase exponentially. As a result, telecommunications companies, governments and other organizations will continue to require faster routers, switches, etc. to keep up with the onslaught. In other words, Cisco should benefit from a tailwind as demand for its products and services is set to continue for years to come.

Financially speaking, Cisco is an excellent business. High, stable gross and operating margins and the company generates a tremendous amount of free cash flow. Cisco has managed to maintain a dominant market share in its core routing and switching products (>50% of revenue). For example, their share of the switch market has exceeded 60% in each of the past five years. Cisco's market share in the telephone carrier router market is about 50%.




Cisco is simply dominant and brutal to compete against. These attributes should continue going forward as high switching costs, intellectual property and scale combine to provide Cisco with what we perceive to be a wide economic moat.

On August 14 after the market close, Cisco reported its fiscal Q4 results. Revenues for the fiscal year were up 5.5% from the prior year and Q4 non-GAAP EPS of $0.52 was slightly ahead of expectations. The stock dropped 8% the next day due to management's conservative short-term revenue guidance (growth of "only" 3%-5% for the next quarter). Our take of the market's reaction is that expectations for the stock were simply too high. Cisco's quarter is a great example of what value investing is all about. We thought that the quarter was decent and the guidance conservative, prudent and very short-term. In a slow-growth world, providing aggressive guidance for a large company like Cisco is unwise. It is always better to manage expectations and try to outperform. Accordingly, our investment thesis on Cisco remains intact.

Cisco currently has over $50.6 billion of cash and equivalents on its balance sheet (or $34 billion, net of debt). This represents $6.42 per share of net cash sitting idle on its balance sheet. Even if we assume that the offshore cash is repatriated and taxed, this still leaves $4.16 in net cash per share. GAAP earnings of $1.86 over the past year actually understate the company's earnings power and our calculation of *owner earnings* for the year was $2.06.[1] The current share price of $24.07 implies that the stock is trading at less than 10 times trailing *owner earnings* (net of cash) for a world-class but slow growing business.

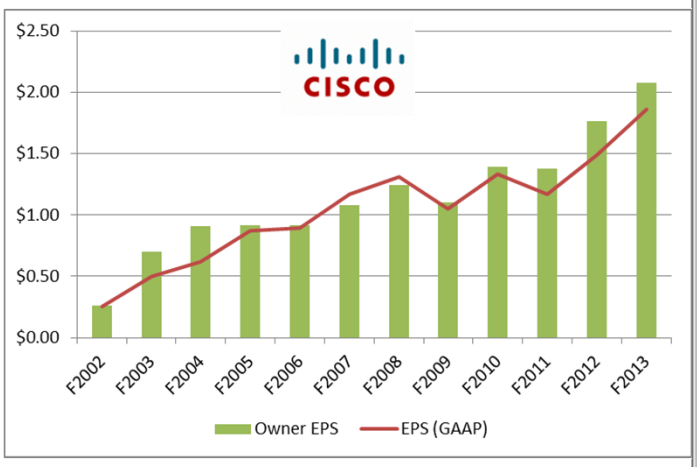
Most often, mispriced stocks are found in oddball corners of the market. However, when Mr. Market puts the best of breed on sale, all else being equal we would rather own quality. In rising markets everybody looks great but when the tide goes out, it is usually the strong that survive.

*"I would rather be certain of a good result than hopeful of a great one."*

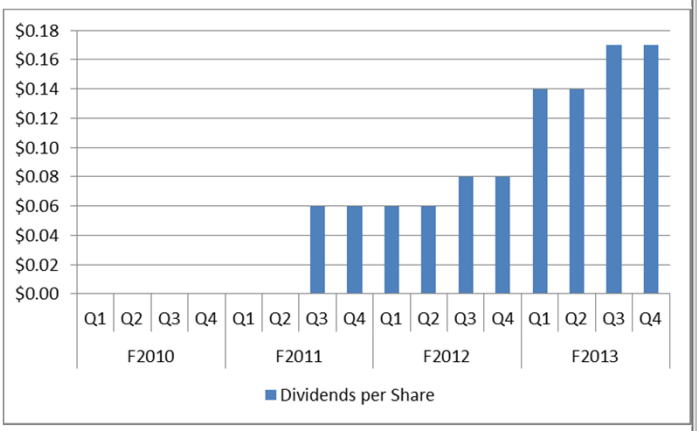
**Warren Buffett**
*1996 Annual Report*

[1] *Owner Earnings are our preferred measure of a business' earnings power. A detailed description of the concept can be found in our Dec. 20, 2012 Globe & Mail article available by clicking* ***here:*** *"Add 'owner earnings' to your toolbox of financial metrics".*

Cisco's management has historically been a poor capital allocator but this has started to change over the past few years. Share repurchases, the implementation of a dividend and steady dividend increases are all positive signs. Importantly, the company has publicly stated its commitment to returning at least 50% of annual free cash flow to shareholders.




The bears on Cisco cite the risks of increasing competition and technological changes such as Software Defined Networking (SDN) that are potential threats. Cisco spent $6 billion (12% of revenue) on R&D in its past fiscal year. This figure is larger than the *revenue* for some of the competitors that are described as potential threats.




We suspect that Cisco will stay on top of industry trends and continue to work with their customers to provide best in class networking solutions. When new technologies emerge and Cisco is late to the game, they will likely continue to make tuck-in acquisitions to maintain their industry leadership position. Even after returning $6 billion to shareholders, they still have almost $6 billion available to spend on acquisitions, if necessary.

Our take is that Mr. Market was eager to get euphoric on the back of Cisco's Q4 results. However, management's conservative (we would say prudent) guidance did not give him permission to do so. We still believe that the stock is worth at least $30.00 and are content to continue to hold it in the Value Fund. However, we are not adding to our position at the current price as we prefer a larger margin of safety (our adjusted cost base is $17.68).

Cisco may not be a "sexy" investment but it possesses the attributes that we look for at GreensKeeper (see the quote at left which was the inspiration for our company name). Cisco's balance sheet is rock solid and we know that our money is safe and should continue to grow at a satisfactory rate over time. If Cisco happens to deliver a blowout quarter along the way, Mr. Market may get another chance to get really excited about the stock as he happens to do from time to time. If and when that happens, we plan to take full advantage of it.

**Michael McCloskey**
Founder & President

*"Value stocks are about as exciting as watching grass grow. But have you noticed just how much your grass grows in a week?"*

**Christopher Browne**
***Tweedy, Browne & Co.***

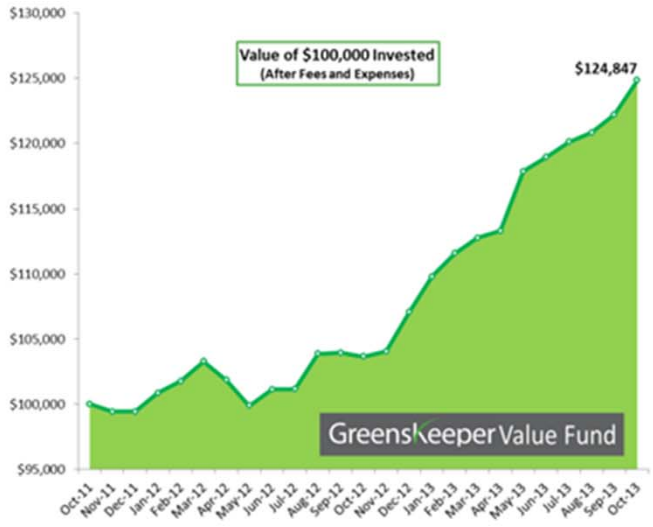
GreensKeeper ASSET MANAGEMENT
a division of LIGHTWATER PARTNERS LTD

# The Scorecard

**Issue #9 – November 2013**

## Taking Stock

As of October 31, the Value Fund was up 16.6% in 2013 and 20.5% over the past 12 months (both figures are after all fees and expenses). Since inception we have had 20 positive months and 4 down months. Given that GreensKeeper recently celebrated it second anniversary and with a new calendar year fast approaching, we thought that it was the perfect time to revisit a few of our portfolio holdings, discuss a stock that we recently sold and to take a look at current market valuations.




| 2013 | YTD | 1-Year |
|---|---|---|
| Value Fund | 16.6% | 20.5% |
| S&P/TSX Total Return Index | 10.3% | 11.0% |
| S&P 500 Total Return Index ($CAD) | 31.3% | 32.7% |

**Statistical Analysis**

| | Value Fund | S&P/TSX | S&P500 (CAD$) |
|---|---|---|---|
| Standard Deviation [1] | 4.69% | 8.78% | 7.61% |
| Total Positive Months | 20 | 15 | 18 |
| Total Down Months | 4 | 9 | 6 |
| Median Market Capitalization | $33.6 Billion | | |
| 2012 Annual Turnover Rate | 18.6% | | |

[1] Annualized and based on monthly returns since inception (Nov. 1, 2011).
[2] All figures as at October 31, 2013.

## Home Capital Group (TSX:HCG)

We first wrote about Home Capital in the *Globe & Mail* on August 8, 2012 (**link**). Since then the company has done what it usually does – execute on its business plan and increase earnings per share at a steady pace. We estimate that the company will earn about $7.30 per share in 2013 and at least $8.30 in 2014. A favourable regulatory ruling last quarter will also provide a tailwind for years to come. Despite the company's consistent execution, its stock has been anything but consistent.

The pullback in Home Capital this past spring was largely the result of a speech given by Steve Eisman, a U.S. hedge fund manager, at the Ira Sohn investment conference in New York. Mr. Eisman recommended that investors short Home Capital's stock given his view that the Canadian real estate market is overvalued (we agree) and that Home Capital is a "sub-prime" lender. Here is what we wrote to our clients back in May:

> *"We continue to believe that Home Capital is misunderstood, particularly by our friends south of the border who recently lived through the U.S. subprime housing debacle. Home Capital is an excellent lender. They do not make "no doc" (undocumented income) or "NINJA" (no income, no job, no asset) loans and their average loan has about 30% homeowner's equity behind them…. At current prices the stock is trading at approximately 7.3x 2013 earnings. We used the pullback as an opportunity to add to our position and believe that in time the stock will trade at materially higher levels."*

Our patience has been rewarded as Mr. Market is now awarding the company a reasonable price to earnings multiple. We remain vigilant as the Canadian housing market is not cheap by any means and Home Capital's shift to its more profitable "traditional" loans has had the effect of increasing the company's exposure to a major housing correction. But with a short position in the stock last reported at around 12% of the company's float, a short squeeze is a real possibility.

*"You're looking for a mispriced gamble. That's what investing is. And you have to know enough to know whether the gamble is mispriced. That's value investing."*

**Charlie Munger**
**Berkshire Hathaway**

When asked what the stock market will do:

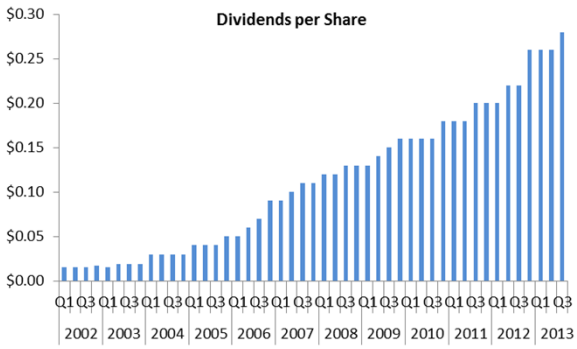
*"It will fluctuate."*

**John Pierpont (J.P.) Morgan**

With the stock currently trading at less than 10 times next year's earnings, and the shorts feeling some real pain, we are still comfortable owning the stock. Our cost base of $48.83 (+70%) and the company's habit of frequently increasing their dividend also makes the stock an easy one to hang on to.

Home Capital is a "compounder" and one worth holding on to for a long time absent more attractive places to put our capital or a change in our view of the company's business.

Our thanks go out to Home Capital's CEO - Gerry Soloway and President - Martin Reid for their exceptional execution and shareholder-friendly stewardship.




## Western Union (NYSE:WU)

Western Union (NYSE:WU) reported decent Q3 results in late October but management's guidance was troubling and caused us to reassess our view of the company. Western Union is facing increasing compliance costs and is slowing its pace of share repurchases in order to preserve its investment-grade credit rating. We decided to sell our position after digesting this news. Western Union is a good company but not a long-term grower like Home Capital. With our purchase price of $12.54 we exited with a healthy profit (+28%). Our one regret was not selling before the quarter. Had we done so, our results would have been even better.

*"Many of the important things about investing are counterintuitive. Low-quality assets can be safer than high-quality assets. Things get riskier as they become more highly respected (and thus appreciate)."*

**Howard Marks**
***Oaktree Capital Management***

*"One of the more painful lessons in investing is that the prudent investor (or 'value investor' if you prefer) almost invariably must forego plenty of fun at the top end of markets."*

**Jeremy Grantham**
*GMO Q3 2013 Letter*

*"Government is best when it gets out of the way of the marketplace by largely restricting its activities to limited regulation, national defense, protection of property rights and provision of public goods."*

**Jonathan R. Laing**
*Barron's*

## Our Dogs

The Value Fund's worst performing holding to date is … cash. That's right, cash. In this low interest rate environment it just sits there, growing nominally and begging us to deploy it. As new clients arrive at GreensKeeper, we seek to reinvest the additional cash but many of our holdings have become less attractive due to their price appreciation. As a result, our cash position steadily builds. In the midst of a rising bull market it has been painful to drag this anchor around. We continue to seek a better home for our cash but the reality remains that we are very picky. Our preservation of capital mindset means that we want to be very confident that the opportunities that we invest in are attractive. While this approach lets us (and hopefully our clients) sleep soundly at night, it has the unfortunate side effect of causing us to miss a few opportunities along the way. On several occasions since our launch we hesitated to purchase a stock, waiting for a more attractive entry point. Unfortunately our occasional hesitation has cost us some performance.

We can confidently make two promises to our clients. First, we will continue to make a few mistakes (hopefully they will mostly be errors of omission). Second, we will continue to learn from them. One of the great things about investing is the perpetual improvement that comes with age and incremental experience.

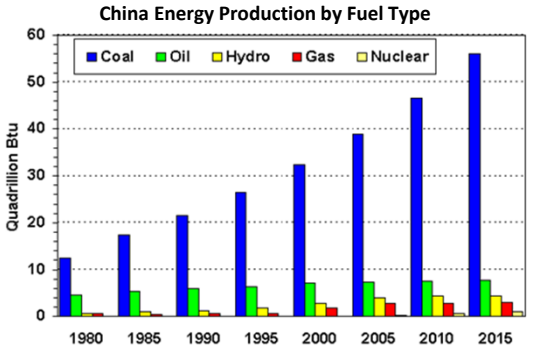
There are a few positives to carrying a cash position. First, holding some cash gives us optionality. In other words, when attractive opportunities present themselves, we can pounce. Second, the fact that cash has been our worst performer also means that every stock that we did purchase is up. Some (Home Capital and Western Union) more than others (Joy Global).

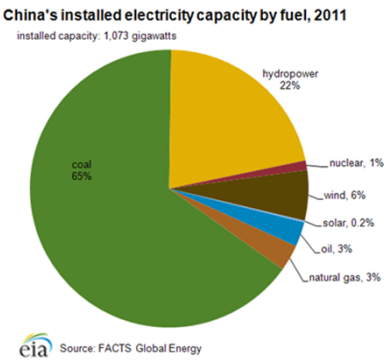
## Joy Global (NYSE:JOY)

We first wrote about our investment in mining equipment maker Joy Global in October 2012 (**link**).[1] The company derives roughly two-thirds of its sales from coal-mining customers and the troubled state of the coal industry, particularly in the U.S., is weighing on the stock.

Coal is a dirty word these days and some wag even labeled it the "new tobacco". The Province of Ontario recently introduced a plan to ban all coal use in its power plants. Pictures of smog-shrouded Chinese cities are carried daily in the news. President Obama, through the Environmental Protection Agency, is curtailing the use of coal south of the border as well. These headwinds, along with slow economic growth across the globe have weighed on coal prices and, naturally, coal mining.

While we can debate the wisdom of North American energy policy, the reality is that we can afford to make decisions that favour the environment over the economy. Canada and the U.S. are wealthy nations. We can afford these trade-offs, even if certain policies may be ill-advised.

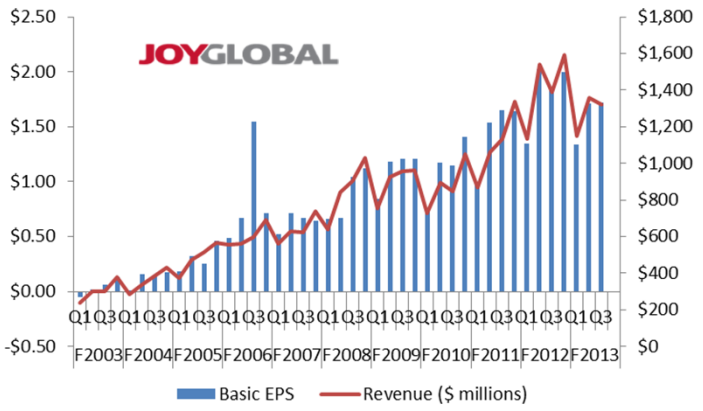



At GreensKeeper, we believe that emerging economies such as China will make different choices. And it is emerging economies that truly matter when it comes to coal. China alone consumes approximately 50% of the world's coal (it is four times the size of the US coal market). Coal is cheap, abundant and a reliable source of energy. It is used to generate 30% of the world's primary energy needs. As China's rise continues, its economy will require more and more energy to fuel its growth. India and other developing countries are no different. Like it or not, we believe that King Coal is here to stay.

[1] *"Mining equipment maker Joy Global could bring investors happiness." - Globe & Mail, October 15 , 2012.*

As one-half of a coal-mining equipment duopoly (with Caterpillar's Bucyrus division being the other half), Joy Global should continue to increase its earnings over the coming years, even if the road will not be a smooth one. And that, in a nutshell, is our investment thesis on Joy Global.




Our investment in Joy Global has been essentially flat (+4%) since we started purchasing the stock about a year ago. This is a disappointing result given the broader market's upward march over this period. Nevertheless, we remain long-term bullish on the name and are comfortable owning it in our portfolio.

## Minding Mr. Market

Long time readers already know that we don't try and time the market at GreensKeeper. We will deploy capital any time that an attractive opportunity presents itself, regardless of market conditions or the state of the economy.

However, we do follow macroeconomic trends and general market valuations to provide useful context when evaluating specific companies and industries. The pictures at right speak louder than words.

These stock barometers, technology IPO valuations and our current struggle to find attractive opportunities are all telling us the same thing. At present, it is probably better to be more fearful than greedy.

**Michael McCloskey**
Founder & President

*"The market value of all publicly traded securities as a percentage of the country's business -- that is, as a percentage of GNP … is probably the best single measure of where valuations stand at any given moment."*

**Warren Buffett**
***Fortune (2001)***

GreensKeeper ASSET MANAGEMENT

# The Scorecard

**Issue #10 – September 2014**

*"Value investing is simple to understand but difficult to implement… The hard part is discipline, patience and judgement."*

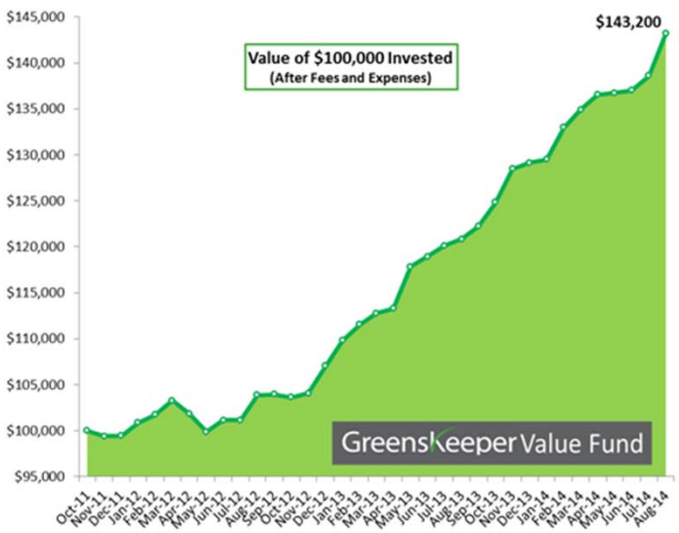
**Seth Klarman**
**Baupost Group**

## Steady Progress

As of August 31, 2014, the Value Fund is up +10.9% in 2014, 18.5% over the past 12 months and 43.2% since inception (all figures are after fees and expenses).

Since inception, we have managed to beat the S&P/TSX Index and have lagged the major US indices. Our preservation of capital mindset and a measured deployment of our initial cash position in a rising market held us back somewhat early on. However, we have since made steady progress. The investment game is a long one.

Long term we believe that we will continue to deliver attractive returns for our clients while thoughtfully managing risk and preserving capital.




| Monthly Results [1] | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2011** | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | **-0.6%** |
| **2012** | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | **7.7%** |
| **2013** | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | **20.6%** |
| **2014** | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | | | | | **10.9%** |

## Express Scripts Holding Company (Nasdaq:ESRX)

A fellow Globe & Mail columnist recently pointed out that many Canadian portfolios suffer from "home bias" (an overexposure to Canadian equities). We have a prescriptive solution.

Express Scripts Holding Company (Nasdaq:ESRX) is the largest pharmacy benefit management (PBM) company in North America. It serves thousands of clients including managed-care organizations, insurance carriers, employers, third-party administrators, public sector and union sponsored benefit plans.

The PBM industry is an obscure one and one that most people are unfamiliar with. PBM services include network pharmacy claims processing, home delivery services, benefit-design consultation, drug-utilization review, formulary management as well as medical and drug data analysis services.

Health care spending in North America continues to grow at rates well in excess of inflation and consume an ever larger share of GDP. Payers retain PBMs to help control their spending on prescription drugs. Improved patient outcomes through monitoring and error reduction are an added bonus.

*"A great business at a fair price is superior to a fair business at a great price."*

**Charlie Munger**
***Berkshire Hathaway***

Express Scripts uses its scale (the company processes 1.4 *billion* prescriptions a year) to negotiate favourable rates with pharmacies, pharmaceutical manufacturers, drug wholesalers and others in the drug supply chain. The company passes along most of the savings to its clients and keeps a sliver of profit from each script for itself (currently about US$5.50 per script). The size of that sliver keeps growing each year due to the operating leverage inherent in the business as the cost of processing an additional script for an existing customer is very low.

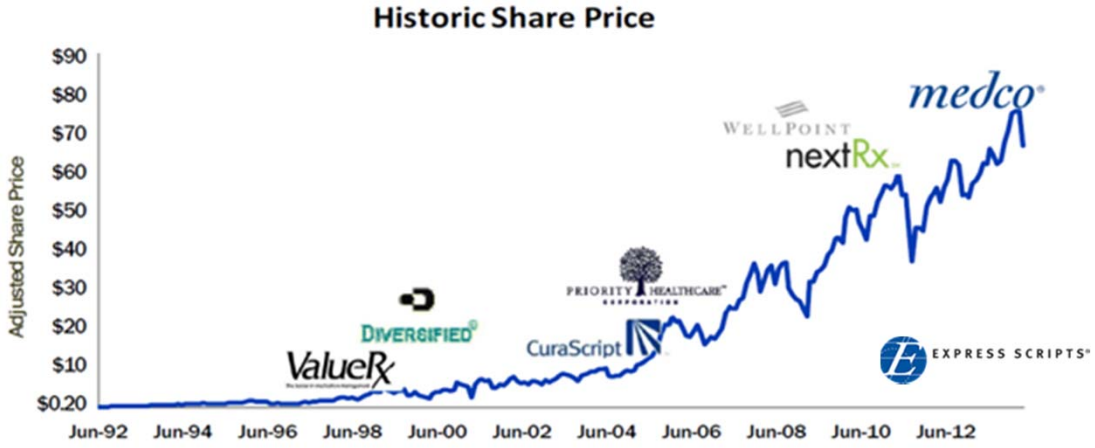
The long-term fundamentals of the PBM industry are attractive. An aging demographic provides a tailwind as drug usage will continue to climb thereby increasing the need to find ways to reduce healthcare costs. Annual drug price inflation also works in a PBM's favour.

Given the scale needed to succeed, over time the PBM industry has consolidated with a few dominant firms controlling most of the market. High customer switching costs and regulatory complexity also help these companies to continually widen their economic moats.

Express Scripts does have competitors - CVS Caremark (NYSE:CVS) and Catamaran Corp. (TSX:CCT) to name a few - and contracts are typically put out to bid at renewal. However, we suspect that the request for proposal process is largely used as a means of keeping the incumbent's pricing in check. PBMs are difficult to displace as evidenced by client retention rates that routinely exceed 95%.

Express Scripts cemented its leading position in the PBM industry with the US$29.1 billion acquisition of competitor Medco Health Solutions in 2012. However the acquisition came with a cost.

Integration efforts have taken time, distracted the company's employees and led to higher than normal customer turnover as client retention fell to 92%. This is now largely behind Express Scripts and the company's execution should improve going forward.



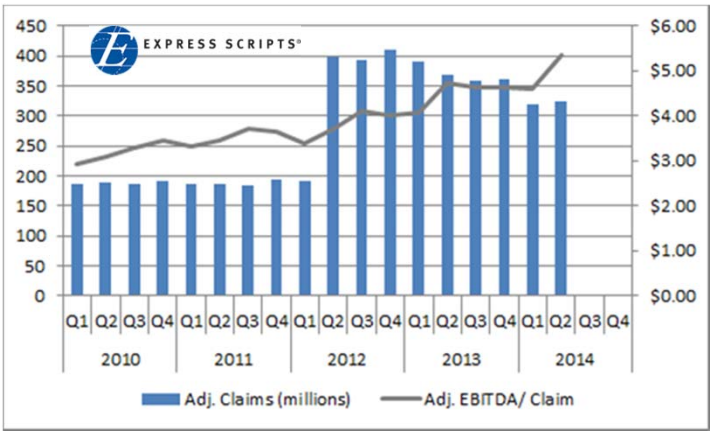

Acquisition accounting from the Medco and other transactions also gave rise to non-cash charges that reduce reported net income and understate the company's true earnings. We believe that the company's estimated free cash flow of over US$5.50 per share in 2014 is more representative of its true *owner earnings*.

Management's guidance to deliver 10%-20% annual earnings per share growth over the long-term appears reasonable to us given their historical track record.

*"I will tell you the secret to getting rich on Wall Street. You try to be greedy when others are fearful. And you try to be fearful when others are greedy."*

**Warren Buffett**
***Berkshire Hathaway***

At our recent purchase price of US$68.66 (less than 9 times pre-tax earnings) we viewed the stock as undervalued. Despite the stock's recent move higher (US$74.55), we still believe the stock is worth purchasing. Management seems to share our view as the company has repurchased over US$6.7 billion worth of stock over the past year and a half and reduced the outstanding share count by 9% all while maintaining the company's investment-grade rating.




Closer to home, we could have invested in Catamaran Corp. - a TSX-listed PBM. However, we prefer to invest based on the quality of the business and the attractiveness of the purchase price, not geography. When you can invest in the industry leader at a discount to both its competitors and the overall market, in our minds the preferred choice is clear: buy quality when it is on sale.

The geography of the company involved does matter but for a different reason than you may think. Our investment approach is to invest in great companies domiciled and operating primarily in shareholder-friendly jurisdictions. Canada, the United States and Western Europe all meet this test. We believe that supremacy of the rule of law combined with their global operations provides a lower risk method of gaining exposure to faster growing developing economies.

## History Rhymes

*"History doesn't repeat itself, but it does rhyme."*

**Samuel Langhorne Clemens**
***a.k.a. Mark Twain***

Since our last newsletter the market has continued its upward climb making bargains even more difficult to find. However, we have managed to find a few quality names like Express Scripts that were selling at a discount.

IPOs of lesser quality continue to come to market, some at mind-boggling valuations. Debt covenants soften while overall leverage ratios creep higher. Historically this has not ended well.

In light of the market environment and the wise words (at top left) of someone that knows a thing or two about investment history, we will continue to own quality and remain patient for opportunities when they present themselves.

You should know that this view is not merely academic. I have over 70% of my immediate family's net worth invested alongside GreensKeeper's clients and I invest our clients capital as I do my own. Long-term, our capital preservation mindset should continue to serve us well.

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT

# The Scorecard

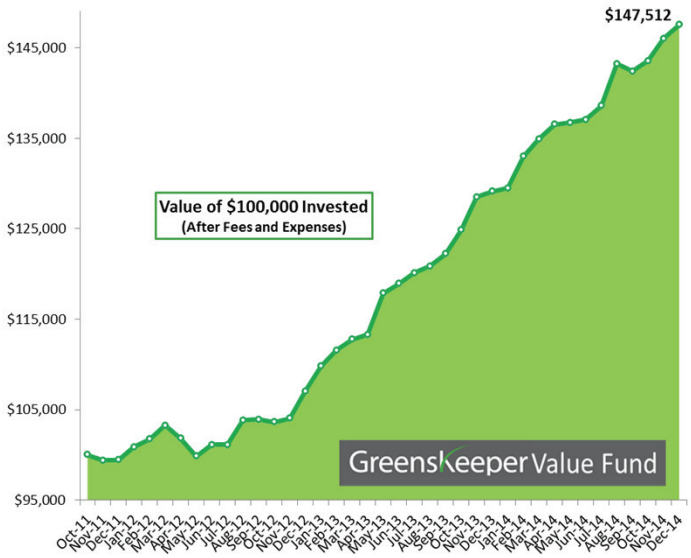
**Issue #11 – January 2015**

## Coattail Riding

The Value Fund was up +14.2% in 2014 (after all fees and expenses). Our steady progress continues through the application of our disciplined investment process.

Our 2014 portfolio turnover ratio of 10.1% was even lower than the 11.3% recorded in 2013. For those unfamiliar with the term, portfolio turnover is essentially the percentage of a fund's holdings that change during a year. For example, a 100% turnover ratio implies that a fund replaces all of its holdings in a given year.

According to Morningstar, the average mutual fund has an 89% annual turnover ratio. This implies that the average holding period for any given stock in an average fund is about 13 months.



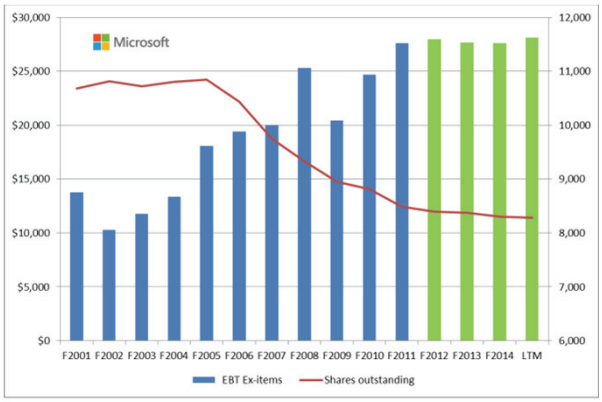

| Monthly Results | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | -0.6% |
| 2012 | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | 7.7% |
| 2013 | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | 20.6% |
| 2014 | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | 14.2% |

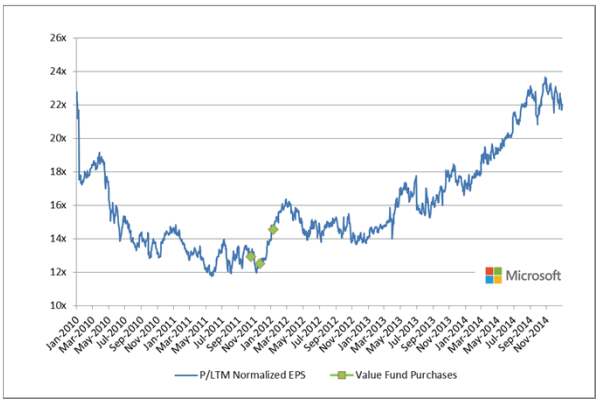
The implication of the Value Fund's significantly lower turnover rate is that we tend to hold stocks for long periods of time at GreensKeeper. An investment strategy with a high turnover incurs additional trading expenses and triggers taxable gains. As value investors, our preferred route to long-term profits is to wait patiently for very attractive investment opportunities. Once we find one, provided that the business' competitive advantage is durable and the company can continue to earn high returns on capital for years to come, the power of compounding makes a long holding period our friend.

## Microsoft Corporation (NASDAQ:MSFT)

We last wrote about Microsoft in April 2012, shortly after having purchased it for the Value Fund. Here was what we wrote about our investment thesis at the time in Scorecard #3 **(link)**:

> *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. We believe that Microsoft's dominant position in their key segments will continue for the foreseeable future. At our average cost of $26.58, we paid 9.7x trailing earnings (3% dividend yield) for one of the best software companies ever created. If we take into account the $45.5 billion in net cash that they had on their balance sheet at the time (we even applied a "repatriation tax" to the offshore component), the multiple was actually 8.2x.*




Fast forward to today. Microsoft's earnings have largely been stagnant but the company continues to repurchase its shares which increases per share earnings. More importantly, the multiple that the market is placing on the shares has expanded significantly. In other words, investors are more optimistic (or less pessimistic) about the company's future prospects.

We still own Microsoft although our enthusiasm for the stock is waning. Not because we believe the outlook for the company has worsened. Quite the contrary. Microsoft's new CEO Satya Nadella appears to be making headway on his plan to successfully bring Microsoft into the 21st century. And despite the company's increased capital expenditures in areas such as cloud computing, free cash flow has actually increased to $2.2 billion *a month*. The only thing that has changed, from our perspective, is the share price.

At $26.58 we were very excited to be purchasers of MSFT. But at $46.24 the stock doesn't get us excited anymore. Microsoft is currently trading at about 14x earnings once you factor in the $88.5 billion (yes you read that right) that they hold on their balance sheet. Adding in dividends received and some foreign exchange tailwinds and our total return has been about 110.6% (or 37.8% annualized) since our initial purchase. This is well in excess of market returns over that same period.

*"Eppur si muove." (And yet it moves).*

**Galileo Galilei**
***Mathematician, Physicist and Philosopher***

The efficient market hypothesis (EMH) posits that returns of this magnitude should not exist with a broadly held, large cap stock like Microsoft. To the EMH enthusiasts and university professors that are still teaching this junk, we would point them to the sage words (at left) uttered by Galileo 382 years ago during the Roman Inquisition.

## You're Welcome Warren

In July 2014, we initiated a new position in pharmacy benefit manager Express Scripts (NYSE:ESRX). Since our purchase the stock has performed well and we are up about 31.6% in five months. The reason for writing about the stock again isn't to crow about our short-term results. No, the reason is much more amusing than that.

Warren Buffett has always been ultra secretive when it comes to his investments. Who can blame him. The man's investing acumen is superhuman and disclosing his positions only makes it harder (and more expensive) for him to build positions before "copycats" jump on the bandwagon. We suspect that there is also an element of "intellectual ownership" involved. Great investing ideas are scarce and usually take considerable effort to uncover. Why would you want to volunteer that information to others unless you had to? Warren has referred to the practice of copying another's investment ideas as "riding coattails" and it is fair to say that he looks down on it.

Which brings us now to the plot. The initial disclosure of our investment in Express Scripts was made in September 2014, a few months after initiating our position. We first mentioned Express Scripts in an article that we published in the *Globe and Mail* **(link)** and in Scorecard #10 **(link)**.

Current securities regulations in the United States require large investment managers like Berkshire Hathaway to file quarterly reports (called 13Fs) which disclose their investment positions, albeit with a time lag. Berkshire's latest filing was made on November 14, 2014, and the headlines the next day made us laugh out loud:

We will forgive Mr. Buffett this one time for riding our coattails on Express Scripts. After all, we have benefited so much from his teachings over the years.

All kidding aside, Berkshire was clearly purchasing Express Scripts at around the same time that we were buying it for the Value Fund. Moreover, given the relatively small size of Berkshire's position ($32 million) the purchase was likely made by one of his two investment lieutenants: Todd Combs or Ted Weschler. Nevertheless we took the disclosure as confirmation that we are hunting in the right places at GreensKeeper. Obviously they saw something that they liked, as did we. Only time will tell if our investment thesis proves to be correct.

*"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."*

**Benjamin Graham**
***The Intelligent Investor***

## Open for Business

We now have a 3+ year performance track record with the Value Fund and are in the process of expanding our headcount (in sales). Most of our new business comes to us through referrals from existing clients and for that we thank you.

We are always looking for new clients that share our long-term approach to investing. Our existing clients understand our approach as evidenced by the fact that most of the money that we manage is in our clients' long-term investment accounts (RRSPs, LIRAs, RESPs, etc.). At GreensKeeper, we focus on investing in quality companies with shareholder-friendly management teams. The trick is to patiently wait until they go on sale for reasons that we believe are transitory.

The investment game is a long one. Long term we believe that we will continue to deliver attractive returns for our clients while thoughtfully managing risk and preserving their capital. You should know that our approach is not merely academic. Our founder has over 70% of his immediate family's net worth and 100% of his investible assets invested alongside our clients at GreensKeeper.

If our approach resonates with you, or you just want to chat about stocks in general, we would love to hear from you.

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT

# The Scorecard

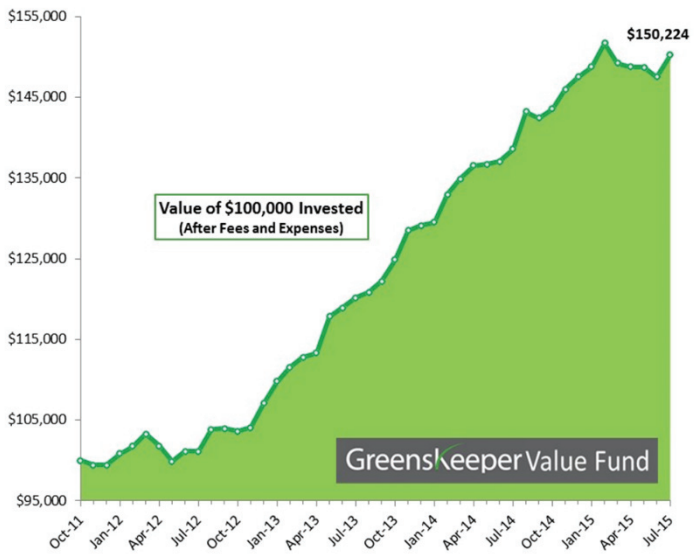
**Issue #12 – August 2015**

## The Red Dragon and King Canute

The Value Fund is up +1.8% (after all fees and expenses) in 2015 as of July 31. Our strategy of not hedging our US dollar exposure continues to benefit the portfolio.

As August draws to a close, the recent market correction and increased volatility is on everyone's mind. We thought it the perfect time to explain why down markets are actually welcomed as *good news* at GreensKeeper. This may sound counterintuitive but if you stay with us for a few pages, it will all become clear.

Needless to say our defensive positioning is serving us well and we put a material amount of our formerly idle cash to work in August. In addition to adding to a few existing positions, we also added a few new stocks to the portfolio.




| Monthly Results | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2011 | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | -0.6% |
| 2012 | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | 7.7% |
| 2013 | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | 20.6% |
| 2014 | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | 14.2% |
| 2015 | 0.8% | 2.0% | -1.6% | -0.3% | 0.0% | -0.8% | 1.8% | | | | | | 1.8% |

Several stocks that we own are worth discussing briefly. AT&T (NYSE:T) completed its acquisition of DirecTV (NYSE:DTV) in July after receiving final regulatory approvals. We realized a gain of over 67% on our position in DTV including foreign currency gains. As part of the transaction we now hold a small position in AT&T as the consideration received included both cash and shares.

Home Capital Group (TSX:HCG) recently disclosed some operational challenges in its business. It seems that a number of Home Capital's mortgage broker partners were doing some naughty things. As a result, the stock sold off 40%. After we spoke with management, a few competitors and others in the industry, we concluded that the company is making the right moves to protect its franchise and that the market has overreacted. Given Home Capital's historical track record of success and the fact that the stock is selling at less than 7 times 2015 earnings, we loaded up on HCG shares for the portfolio. Time will tell if our analysis is correct, but we like our odds.

## The Chinese Equity Markets

China's economic miracle continues its forward progress, despite a few stops and starts. The country's citizens are gradually getting wealthier as a result of the authorities' slow but steady embrace of a market economy (albeit with Chinese characteristics). Capitalism can be a messy business at times and China's frothy stock markets and gambling culture combined in early 2015 to draw in new retail investors. And by investors, we mean speculators.

By the summer, valuations escalated to the point that the price-to-earnings multiple of the main Chinese equity index surpassed 75. With everyone seemingly making money, margin lending and volumes peaked and, predictably, it ended badly in a 40% market collapse.

Valuing stability, China's leaders panicked and tried to prop up the equity markets by any and all means necessary. Companies were strongly "encouraged" to suspend trading of their shares and large shareholders dissuaded from selling. Pension funds were suddenly permitted to invest in equities and state controlled enterprises threw $200 billion into the market. Even Chinese journalists were harassed by police for their "irresponsible and inaccurate" reporting on the stock market. It worked for a few days but ultimately the selloff continued unabated. Which brings us to the tale of King Canute.

*"An economy run by the political elite for a favored class can't advance like one that lets people change their class status by increasing their effort to obtain greater income, and by turning their income into investment capital."*

**Thomas Donlan**
***Barron's***

King Canute the Great was an 11th Century king of Denmark, England, Norway and parts of Sweden. Like most powerful people, those around him praised his greatness and swore that he was all powerful. Growing tired of the incessant flattery all around him, legend has it that King Canute had his throne carried down to the seashore and commanded the incoming tide to halt. When the tide failed to obey and soaked his feet and royal robes the king leapt backwards, saying: "Let all men know how empty and worthless is the power of kings. For there is none worthy of the name but God, whom heaven, earth and sea obey". King Canute was a wise and modest king.

President Xi Jinping and Premier Li Keqiang, the current leaders of China, are undoubtedly two of the world's most powerful people. However great political power can lead to hubris as those that wield it often succumb to the illusion that they have the power to control events that they cannot. Perhaps Messrs. Xi and Li could have spared themselves some embarrassment by studying the tale of King Canute instead of the communist teachings of Karl Marx and Chairman Mao. Free markets exert an invisible economic force that pulls markets much like the moon's gravity creates the earth's tides. And any mere mortal's efforts to simply wish away the irresistible forces of markets will prove as fruitless as ordering the tide to recede.

Overvalued stocks eventually find their proper level and overvalued markets eventually correct. More importantly from our perspective, the converse is also true. Undervalued stocks eventually find their proper level and undervalued markets eventually rise. In other words, value investing works.

## Down Markets are Our Friend

As disclosed at our annual meeting in June, our assets under management have grown in 43 of the 45 months since we launched the Value Fund back in 2011. As a result, the Value Fund has a constant stream of cash coming in from new clients, existing clients that invest more money with us and from dividends. As a result, we are a constant buyer of stocks provided that we can find attractive opportunities.

Market pullbacks are often where we find those opportunities. When the market is down 12.5% from its peak like it was in August, certain stocks that we track can be off significantly more than that. And when they are, we pounce.

*"If you can keep your head when all about you Are losing theirs and blaming it on you,*

*If you can trust yourself when all men doubt you, But make allowance for their doubting too;*
*…*
*Yours is the Earth and everything that's in it."*

**"If" by Rudyard Kipling**

For three main reasons, we prefer down markets at GreensKeeper:

1. As a constant buyer of stocks, we like lower prices knowing that eventually the market will reward us provided that we have made smart choices. Many of our clients are similarly in asset accumulation mode and benefit from lower prices. Provided that you aren't intending to harvest in the immediate future, you should celebrate when you see markets in disarray.

2. Many of the companies that we own generate plenty of excess free cash flow. In addition to using these funds for dividends, some aggressively repurchase their own shares and are also buyers of other public companies. In both cases, lower market prices work to their (and our) advantage.

3. Bear markets and volatility create panic selling, margin calls and the flight response that causes people to sell at exactly the wrong time (when stocks are cheap). Bear markets nurture severe stock mispricing. Very few businesses lose 10-20% of their value in a month. However the market occasionally prices them like they have.

If you are still struggling with this concept of plunging markets being a good thing, let us leave you with one final example that hopefully helps you to internalize it.

Suppose that you own a growing and profitable private business that makes widgets. Every year you sell your widgets, pay your employees and all of your other expenses and are left with a profit of $50,000. Annual profit steadily increases at about 3% each year. At the end of each year, you can take those profits and (i) reinvest them in a growth initiative (e.g. increased marketing, staff), (ii) pay them out to yourself and spend it, or (iii) buy another business (maybe another widget manufacturer). Your decision is likely to be driven by what you view as the most attractive opportunity on a relative basis.

Now, suppose that next door to your widget factory there is a competitor (owned by a Mr. Jones) that also makes identical widgets. Coincidentally, his business also makes a profit of $50,000 a year and grows at the same rate.

The only difference between your respective businesses is that Mr. Jones is a very temperamental owner who loves to babble on incessantly about buying your business and selling his. Every day at lunchtime he shows up at your office uninvited in order to talk about the widget business. Some days he is euphoric and offers you $1,000,000 for your company. Most days he is fairly balanced and offers you $650,000. On occasion he is spooked by some recent event and thinks that the world, and the widget business, is coming to an end. On these days, he will gladly sell you his business for $200,000.

We suspect that most of you, being neighbourly, would listen politely to his daily chatter and then largely ignore him. However, on those days when he is panicked, you would likely consider taking the business off his hands at an attractive price. And on those days where he is offering you $1,000,000, that is probably when you would think long and hard about whether selling makes sense. Assuming that you are not ready to retire and would want to start another business, the attractiveness of his offer would be measured against the attractiveness of the other investment opportunities that were available to you. Presumably you would ask yourself: 'Am I better off selling, paying capital gains taxes and investing elsewhere or simply continuing to own and grow my business?'.

*"Prediction is very difficult, especially about the future."*

**Niels Bohr**
Physicist

As you have probably guessed by now, Mr. Jones isn't your neighbour, he is actually the stock market.[(1)] The difference being that instead of offering to buy or sell your widget business every day at lunchtime, you receive thousands of his offers every second of every trading day. Viewed in this way, hopefully you now understand why volatility and down markets are actually better for you in the long term. If you are long term investor in the stock market and have no plans to liquidate your holdings anytime soon, down markets are a good thing.

Now, we understand that staring at the daily stock quotations that are heading lower will give you heartburn. So our advice to you is quite simple: stop staring at the daily stock quotations.

Plunging markets provide the environment in which the seeds of future capital gains are sown. In a declining market, we acquire more earnings power for each incremental dollar invested. Accordingly, *lower prices reduce the riskiness of an investment*. Provided that we are positioned to act (we are) and can do so with equanimity (we can), fear is our friend. There will be months, and even years, where our returns are less than stellar due to the market environment. Frankly, it doesn't bother us much. For we know that it is in those environments that we accumulate the stocks that lead to long term returns for our investors. We can't predict when markets (or individual stocks) will correct. But we do know how to value certain businesses, how to spot a bargain and how to take advantage of them when they appear.

## Open for Business

We are fast approaching the 4th anniversary of the launch of the Value Fund in 2011 and are pleased to announce the latest addition to our team. Gabriel Rulli joined GreensKeeper at the beginning of July. Gabriel brings over 20 years of investment industry experience to GreensKeeper. Prior to joining the firm, Gabriel was responsible for marketing, client relationships and business development at two Canadian-based boutique value managers: Lorne Steinberg Wealth Management (2010-2014) and I.A. Michael Investment Counsel (1996-2010). As our new Director, Private Clients, Gabriel will fulfill a similar role with GreensKeeper.

We are always looking for new clients that share our long-term approach to investing. Our existing clients understand our approach as evidenced by the fact that most of the money that we manage is in our clients' long-term investment accounts (RRSPs, LIRAs, RESPs, etc.). At GreensKeeper, we focus on investing in quality companies with shareholder-friendly management teams. The trick is to patiently wait until they go on sale for reasons that we believe are transitory.

The investment game is a long one. Long term we believe that we will continue to deliver attractive returns for our clients while thoughtfully managing risk and preserving their capital. You should know that our approach is not merely academic. Our founder has over 70% of his immediate family's net worth and 100% of his investible assets invested alongside our clients at GreensKeeper.

If our approach resonates with you, or you just want to chat about stocks in general, we would love to hear from you.

**Michael McCloskey**
Founder & President

*(1) Inspired by the allegory of Mr. Market: Graham, B., & Zweig, J. (2005). The Intelligent Investor: A book of practical counsel (4th Revised Edition). New York: HarperBusiness Essentials.*

GreensKeeper ASSET MANAGEMENT

# The Scorecard

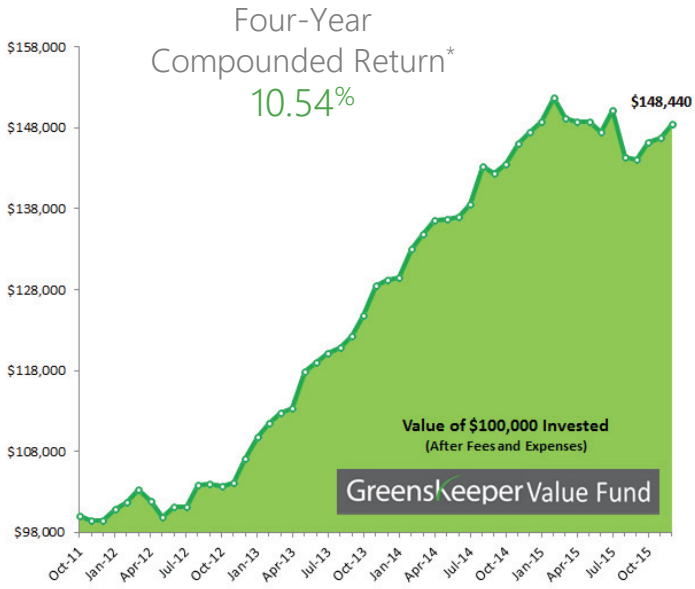
**Issue #13 – January 2016**

## Tug of WaR

The Value Fund finished up +0.63% in 2016 (after all fees and expenses). This was the Fund's lowest full-year return in its four-year history. Needless to say, we are happy to put 2015 behind us. Onward and upwards.

Our strategy of not hedging our U.S. dollar exposure combined with our defensive positioning, both helped us to navigate market headwinds.

Additional detail on the Value Fund's performance for the year and stock holdings will be provided to GreensKeeper clients in the coming months along with our audited financial statements compliments of KPMG.




| Monthly Results | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2011** | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | **-0.6%** |
| **2012** | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | **7.7%** |
| **2013** | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | **20.6%** |
| **2014** | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | **14.2%** |
| **2015** | 0.8% | 2.0% | -1.6% | -0.3% | 0.0% | -0.8% | 1.8% | -3.9% | -0.2% | 1.5% | 0.4% | 1.2% | **0.6%** |

## Act 1 – Scene 1: Prologue

Setting: America, modern day. A land inhabited by a giant named Health Care. He is a friendly giant, mind you, on a noble quest to cure the sick. But his voracious appetite is starting to bankrupt the land.

As you, dear reader, are likely aware, drug prices in the United States are largely unregulated. Drug prices in America are also confusing and opaque. Given the strength of the pharmaceutical lobby south of the border and the fragmented nature of the market, this state of affairs is likely to continue.

As a result of all of the foregoing, health care costs in America continue to escalate at an alarming rate, eating up a growing percentage of the nation's gross domestic product (GDP). The U.S. government does what it can to expand drug coverage while trying to prevent the giant from overtaking the land. Meanwhile, Congressional lobbyists do their best to minimize drug regulation, especially as it relates to pricing. In the absence of regulatory constraints on price increases, the industry's participants have consolidated, seeking scale to improve their relative bargaining power.

**Returns are to Dec. 31, 2015 and are net of all fees and expenses. Mutual funds are not guaranteed, values change frequently and past performance may not be repeated. GreensKeeper Asset Management Inc. assumed the investment management responsibilities of the Value Fund on January 17, 2014. Prior to that date, the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

The health care sector in America, and in other lands, is engaged in a real life tug of war. On one side are participants that benefit from higher health costs such as branded drug manufacturers. Their adversaries are the payers of health care (e.g. employers, health plan carriers) that are fighting to slow drug price inflation through generic substitution and other methods.

## Act 1 – Scene 2: Enter Our Hero

The protagonist of our tale is Express Scripts (Nasdaq:ESRX). The company is the largest pharmacy benefit manager (PBM) in the U.S. and a Value Fund holding. We first wrote about Express Scripts back in September 2014 (**Scorecard Issue #10**). Not much has changed in the year and a half that we have owned the stock. The company has merely processed 2 billion prescriptions, continuously increased its profit per script, generated over $5 billion in free cash flow and repurchased 9.3% of its shares outstanding. Not bad. As a result, the stock is up 16% (constant currency) in a market that is flat. Express Scripts is exactly what we look for in an investment. A mundane, easy to understand business with attractive economics being run by a shareholder-friendly management team.

Long-time followers of GreensKeeper will be familiar with our investment criteria (see inset at right). We have often written about the first and third criteria. However, the second often receives less commentary, even though it is equally as important. Express Scripts and a few other actors in the drug supply chain provide a useful backdrop to illustrate the importance of investing in companies with solid management.

### What we Look For

1. **Select "Great" Businesses**
   - easy to understand
   - attractive underlying economics
   - durable competitive advantages
2. **Solid Management**
   - shareholder-friendly management
   - long-term track record of success
3. **Margin of Safety**
   - wait for our opportunity
   - buy at a large discount to our estimate of intrinsic value

## Act 1 – Scene 3: Corporate Cannibalism

Express Scripts is the type of company that Charlie Munger refers to as a 'cannibal'. No, not that kind. Charlie is referring to corporate cannibalism: companies that 'eat' themselves via share repurchases. Express Scripts is a cash flow machine. The company generates $4.5 billion of cash a year from its operations and only needs to reinvest a sliver of that amount in tangible assets like offices and IT infrastructure.

*"Look at the cannibals."*

**Charlie Munger**
Berkshire Hathaway

If attractive opportunities present themselves, the company pounces as they did with the purchase of competitor Medco for US$29.1 billion in 2012. When they do not, the company returns the excess cash to shareholders.

Believing its shares currently underpriced, as we do, Express Scripts returns excess cash via share repurchases instead of dividends. Critics call this practice *financial engineering* as it reduces shares outstanding and, consequently, increases earnings per share, all else being equal. We call it smart business. Our preference is to own a growing share of an exceptional business in lieu of receiving taxable dividends along the way. Provided that the shares remain undervalued, our hope is that management continues this practice. If, however, the shares becoming meaningfully overvalued, returning excess cash via a dividend is the more sensible approach. At 9.5x trailing pre-tax owner earnings, we still consider the shares attractive given the company's growth prospects. Express Scripts is a prime example of a solid management team that is creating value for GreensKeeper's clients.

## Act 2 – Scene 1: Tug of War

Health care is a very personal and sensitive subject. Most nations would prefer all of their citizens to have unlimited access to life saving drugs at reasonable prices. However, countries have limited means. Accordingly, difficult choices need to be made. There is another factor to consider. Pharmaceutical companies require the ability to earn an attractive profit on successful new drugs in order to be properly incentivized to continue to innovate.

Express Scripts strikes us as a company that is helping to balance these competing interests. They try to responsibly contain drug cost inflation for their clients (payers) while being compensated for doing so. Their interests are largely aligned with their clients and they are financially incentivized to continue to find creative ways to control health costs, reduce waste and improve care.

Express Scripts' business model is built on using its massive scale and buying power to negotiate better rates from the many participants in the prescription drug supply channel. Their in-house clinical experts also ensure that plan members get the prescriptions, care and advice that they need.

## Act 2 – Scene 2: The Antagonists

When asked about a 5400% price increase on Daraprim:

*"Well, you know, we needed to turn a profit on the drug."*

**Martin Shkreli**
Former CEO,
Turing Pharma

The antagonists in this ongoing tug of war include retail and specialty pharmacies, wholesale distributors, branded and generic drug manufacturers. A few of these players have received an inordinate amount of press lately as a result of some questionable conduct.

Enter the now infamous Martin Shkreli, the 'most hated' pharma CEO in America. Martin was the former CEO of Turing Pharmaceuticals. At Turing, Martin identified a number of older drugs he believed underpriced and being entrepreneurial, bought their distribution rights. After doing so, he swiftly implemented price increases.

Hidden pricing power can be a great source of asset undervaluation. After acquiring See's Candies in 1972, Warren Buffett and Charlie Munger quickly learned that they could raise prices 10% each year while customers were largely indifferent. Unfortunately 32-year-old Martin was in a hurry and thought it perfectly proper to raise prices of Turing's drugs overnight by an obscene amount. For instance, the price of Daraprim, a decades-old lifesaving medication for parasitic infections, was increased from $13.50 to $750.00 per pill. A campaigning Hillary Clinton took note of this 'price gouging', as did the Twittersphere, and Martin's world quickly unravelled. Meanwhile, Express Scripts took note and then swift action by arranging for a third-party drug compounder to manufacture a substitute to Daraprim at a cost of $1 per capsule.

The second adversary in our tale is Canadian-headquartered Valeant Pharmaceuticals (TSX:VRX;NYSE:VRX). Valeant was a former market darling whose shares enjoyed a multi-year run. However, the recent scrutiny of Mr. Shkreli's antics combined with an aggressive attack on Valeant from a US short-seller brought unwanted attention to Valeant's business model. As a result, Valeant's shares are down some 70% from their peak.

*"… In terms of the $0 option value, I think it is legal. And maybe it's unusual."*

**Michael Pearson**
CEO, Valeant

*"… the headline really should read Express Scripts continues to do it's job."*

**Tim Wentworth**
President,
Express Scripts

Valeant was largely formed via roll-up [1] and is the product its visionary CEO Michael Pearson. Over the past eight years under his leadership, the company has identified and then acquired many older generic and specialty drug companies. Once acquired, research and development and other operating costs were slashed and drug prices raised, sometimes significantly. The strategy worked well for years but is now quickly unravelling due to a confluence of unfortunate events.

First, Mr. Shkreli's shenanigans at Turing created public scrutiny of rapid price increases on older drugs. Valeant has now received requests for information from a Congressional committee and may be required to testify before Congress. Given the current political environment, the company wisely shifted its strategy and stated publicly that its future price increases will be more modest. A prudent business decision, despite the impact on profits. Second, controversial short-seller Andrew Left of Citron Research alleged that several specialty pharmacies that Valeant dealt with were engaged in questionable and possibly fraudulent activities related to payer reimbursement.

Given the sharp pullback in Valeant's stock resulting from these events and the ownership of the stock by several value investors, we thought Valeant worth a closer look. Unfortunately, we quickly discovered that Valeant's many acquisitions have been financed primarily with debt. Minimizing equity dilution is a quality that attracts us to certain companies. However, doing so through the use of excessive leverage is not for us. The company's debt levels give us heartburn and do not meet our criteria of a prudent investment.[2]

Moreover, while Citron's allegation of impropriety doesn't make it true, Valeant admitted that it did have a business relationship with the specialty pharmacies in question. More interestingly to us, Valeant also revealed that it had previously paid $100 million for a ten-year option to purchase one of those pharmacies for $0. Read that sentence again. If you can explain to us *any* good business reason for structuring the arrangement in this manner, instead of simply buying the business outright, we would love to hear it. Now, that doesn't make the arrangement or the accounting treatment illegal in any way. It simply causes us to question what else is lurking below the surface and reaffirms our decision to stay away from Valeant as a potential investment.

## Act 2 – Scene 3: The Finale

Back to the protagonist of our tale. After watching all of the foregoing unfold around Valeant, Express Scripts conducted an audit of the practices of those specialty pharmacies and other 'captive' pharmacies with ties to Valeant. Ultimately, these pharmacies were terminated from ESRX's authorized network of 70,000 pharmacies.

This constant game of cat and mouse between payers and others in the drug supply chain is where Express Scripts earns its money. Long term, we like having exposure to the pharmaceutical sector via an industry leader that is providing a net savings to the health care system, while still making an attractive return for its shareholders.

*[1] A 'roll-up' is a company grown through multiple acquisitions in the same industry whereby target companies are acquired and then merged into one combined operating entity. Over time, economies of scale are expected to drive increased profitability.*

*[2] As an interesting aside, while Valeant's stock was melting down in November 2015, its CEO received a margin call from his broker – Goldman Sachs. It seems that Mr. Pearson borrowed $100 million from them and used his shareholdings in Valeant as collateral. When the stock imploded and he was unable to repay the loan, his position was liquidated by Goldman, resulting in a 14% decline in the stock on the day. An appetite for excessive leverage in one's personal life is a 'tell' from which we gain insight into a CEO's style.*

## Four Years and Counting

We recently celebrated the 4th anniversary of the launch of the Value Fund and our continued growth at GreensKeeper. On that note, we are always looking for new clients that share our long-term approach to investing. Our existing clients understand our approach as evidenced by the fact that most of the money that we manage is in our clients' long-term investment accounts (RRSPs, LIRAs, RESPs, etc.).

The investment game is a long one. Long term, we believe that we will continue to deliver attractive returns to our clients while prudently managing risk and preserving their capital. You should know that our approach is not merely academic. Our founder has over 70% of his immediate family's net worth and 100% of his investible assets invested alongside our clients at GreensKeeper.

If our approach resonates with you or anyone you know, please give us a call.

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT

# The Scorecard

**Issue #14 – April 2016**

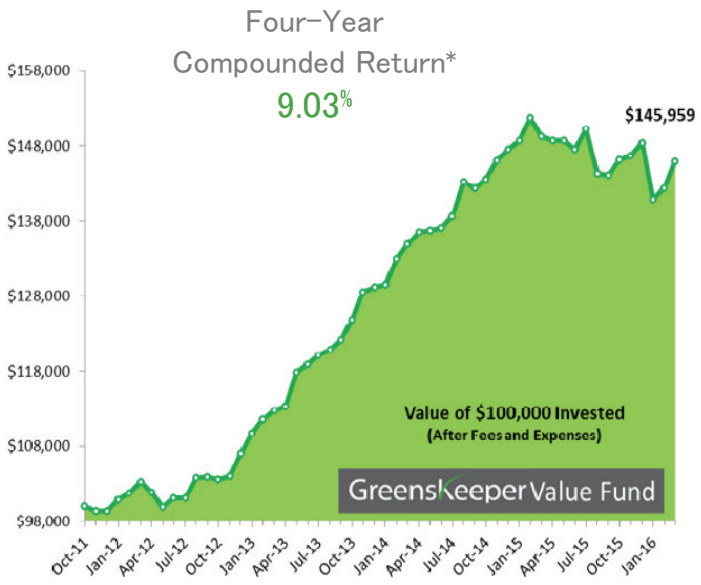
*"It is said that the stock market is the only kind of market where the merchandise is put on sale and all the shoppers run for the exits."*

**Matthew Coffina**
Morningstar

## *Inamatus* Corus

The Value Fund finished down (1.67%) in Q1 2016 (after all fees and expenses). Currencies were the main story in Q1 as the Canadian dollar surged 6.16% against the greenback. We estimate that this sharp move knocked about (4.54%) off of our returns in the quarter as we report our results in Canadian dollars. However, our stance of remaining unhedged remains unchanged.

Hedging imposes costs and acts a drag on long-term performance. We will consider hedging our currency exposures only when we believe that a currency is dramatically overvalued or undervalued. The rest of the time, we are happy to accept greater short-term volatility in exchange for longer-term outperformance.




| Monthly Results | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2011** | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | **-0.6%** |
| **2012** | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | **7.7%** |
| **2013** | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | **20.6%** |
| **2014** | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | **14.2%** |
| **2015** | 0.8% | 2.0% | -1.6% | -0.3% | 0.0% | -0.8% | 1.8% | -3.9% | -0.2% | 1.5% | 0.4% | 1.2% | **0.6%** |
| **2016** | -5.1% | 1.0% | 2.5% | | | | | | | | | | **-1.7%** |

## Corus Entertainment (TSX:CJR.B)

Media stocks remain under pressure these days. It all started back in the fall of 2015 with the selloff in Walt Disney Company's stock (NYSE:DIS) due to subscriber declines in its ESPN division. The stocks of other media companies quickly followed suit.

For a time, it seemed that media analysts and pundits only wanted to talk about the negatives. Cord cutting, cord shaving, media fragmentation, over-the-top services like Netflix, skinny bundles, pick and pay and other challenges. All of which would lead to doomsday scenarios, in their opinion. Fear reigned and media stocks sold off as a group. Given the sector's history of solid free cash flow generation, we quickly took notice and got to work.

**Returns are as of March 31, 2016 and are net of all fees and expenses. Mutual funds are not guaranteed, values change frequently and past performance may not be repeated. GreensKeeper Asset Management Inc. assumed the investment management responsibilities of the Value Fund on January 17, 2014. Prior to that date, the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

*"…most investors are not in a position to do for themselves much of what is needed to get the most from their investment funds."*

**Philip Fisher**
Legendary Value Investor

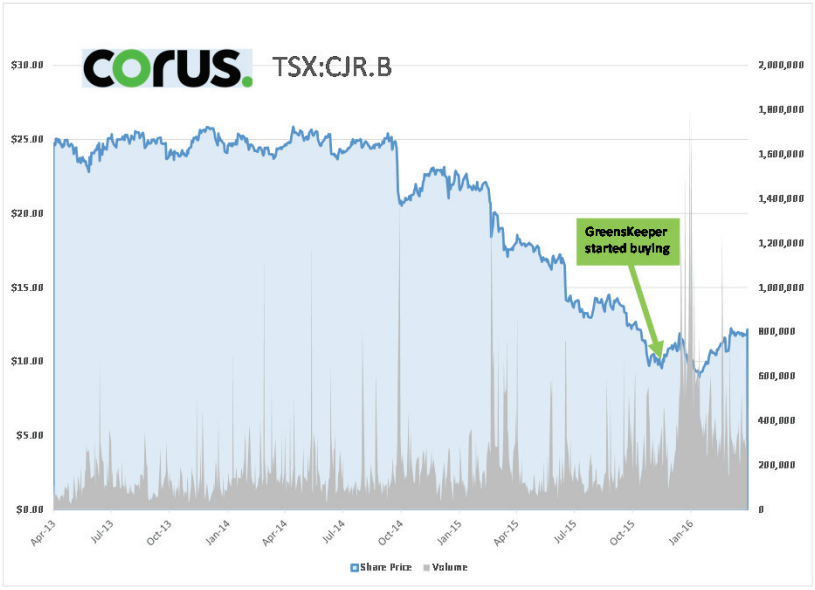
Having reviewed the financial statements of many public media companies and the regulatory landscape, we then spent some time analyzing the factors that are disrupting the industry. We spoke with a number of media participants. Our conclusion was that while media will continue to face these challenges, owners of high- quality, "must-have" content should continue to prosper.

Oddly enough, the most attractive stock that we found in our investible media universe was one that we know very well. In fact, it is right in our own backyard: Toronto-based Corus Entertainment. Corus is one of Canada's largest media and content companies. Their assets include 45 specialty TV channels (e.g. Disney Channel Canada, W Network, HGTV Canada, Food Network Canada), 15 conventional TV stations (Global) and 39 radio stations. Not only was Corus' stock cheap due to the above-noted macro concerns, recent regulatory decisions of the Canadian Radio-television Telecommunications Commission (CRTC's "Let's Talk TV") were further weighing on the stock. Add in a soft Canadian economy that was impacting the company's advertising revenues and some company-specific execution issues which led management to lower their earnings guidance in 2015 and you can understand the stock's 45% selloff for the year.

There are certain aspects of the Canadian media landscape that we find more attractive than the US competitive environment. Like many industries in Canada, the media sector is largely protected from foreign competition. Foreign ownership and control of Canadian media and broadcasting assets is prohibited under Canadian law. As a result, *regulation* is one of the **moats** that protects Canada's media companies. Add to that the importance of *scale* and unique media content (powerful *brands*) and these multiple moats work together to give companies like Corus the ability to generate attractive and sustainable profit margins.

With the stock trading at less than six times free cash flow, less than eight times earnings and sporting a 11.4% dividend yield (paid monthly no less), we believed the macro and company-specific concerns overdone. Accordingly we started accumulating the stock in December 2015. Being media, sure enough the drama quickly ensued.

Within a month of initiating our position, the company reported quarterly results that exceeded our (and analysts') expectations. However, this was entirely overshadowed by the surprise announcement of a massive acquisition of Shaw Media from Shaw Communications for $2.65 billion. The proposed acquisition was about 1.5x larger than Corus pre-transaction, added leverage and required the issuance of many Corus shares. Being a related-party transaction (Shaw and Corus are both controlled by the Shaw family of Alberta), minority shareholder approval was required.




After digesting the news, we analyzed the transaction and its impact on our view of Corus' intrinsic value and the pro-forma risk profile of the combined company. Our conclusion was decidedly mixed.

*"All man's miseries stem from his inability to sit in a room alone and do nothing."*

**Blaise Pascal**
Mathematician, Physicist and Philosopher

*"Never underestimate the value of doing nothing."*

**Winnie-the-Pooh**

On the positive side, the strategic rationale of the transaction is highly compelling. By adding scale, Corus is now the same size as Bell Media with each controlling content that represents 35% of the English TV viewership market in Canada (70% combined). Add in Corus' dominant market share with desirable audiences (Kids and Women), and the company should have pricing power with the major Canadian distributors and media buyers (advertisers).

We reckon that there were two negatives to the deal. First, the transaction added leverage to the combined company. We believe that it will take Corus two years to get its debt levels back to our preferred range, and management has signalled that using free cash flow to deleverage is their top priority. The second negative was the purchase price. The headline purchase multiple paid by Corus was fair. Not cheap mind you, but fair for high-quality media assets. However, Corus used their materially undervalued stock as currency to fund a good portion of the transaction. They did so in two ways: by issuing numerous shares to the seller and by completing a concurrent public equity offering. By doing so, they effectively paid more than the headline number suggests. Consequently, we believe that Corus transferred some of the value of the company from its existing investors (that would be us) to the seller and new investors.

Our preference would have been for Corus to pass on the deal. But once management and the majority of shareholders approved the transaction, our decision became whether to hold or sell. We believe that pro-forma the transaction, the newly combined company was trading at 6.4x free cash flow (up from 5.7x pre-deal). In other words, not as cheap as before, but still very cheap.

Having concluded that the shares remained an attractive investment, we added to our position when the stock price declined after the transaction announcement. The Value Fund's average cost is $9.90 per share. With the stock currently trading at $12.35 and having received $0.38 in dividends to date, we are up about 28% on our investment to date. But it is still far too early to come to any conclusions. We will continue to closely monitor the company's progress. Our investment thesis is largely dependent on the industry's continued monetization of media content at attractive rates, management's execution and a successful integration of Shaw Media. If this unfolds as expected, we believe that the Value Fund's investment in Corus will turn out quite nicely.

## GreensKeeper Annual Meeting – June 9, 2016

Mark your calendars! GreensKeeper's 5th Annual Meeting will be held on **Thursday, June 9 at 7:00 p.m.** We are once again hosting it at the Mississaugua Golf and Country Club (invitation to follow). Clients, potential clients, friends and family are all welcome.

As per our custom, our founder will make a brief presentation on our value investing methodology and selected investments. Then the fun begins as we open the floor to attendees to ask any and all questions about the Value Fund or investing in general.

We are always looking for new clients that share our long-term approach to investing. If you know of anyone that is growing tired of their current investment returns and interested in learning more about GreensKeeper and value investing, please bring them along.

The investment game is a long one. Long term, we believe that we will continue to deliver attractive returns to our clients while prudently managing risk and preserving their capital. You should know that our approach is not merely academic. Our founder has over 70% of his immediate family's net worth and 100% of his investible assets invested alongside our clients at GreensKeeper.

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT

# The Scorecard

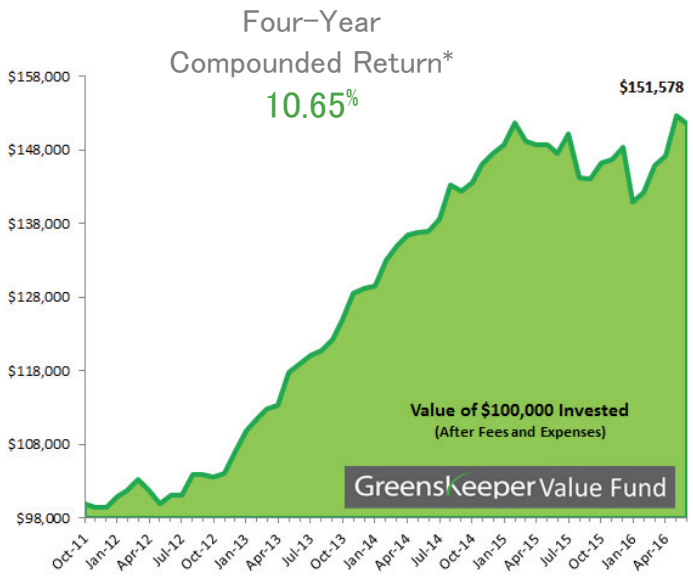
**Issue #15 – July 2016**

## Noise

After a slow start to the year, the Value Fund finished up +3.85% in Q2 (after all fees and expenses) and is up +2.11% year-to-date (YTD).*

Our best performers for the quarter were Corus Entertainment +13.3%, Urbana Corp. +12.6% Exxon Mobil +12.1% and Express Scripts +10.4%. Our laggards were Swatch Group (15.0%), Home Capital (8.7%) and Wells Fargo (2.1%).

Fortunately our gainers outperformed our losers and also managed to overcome a (1.5%) currency headwind during Q2. The strengthening of the Canadian dollar has been about a (6.0%) headwind for the portfolio YTD. We remain unhedged given our belief that once the US Federal Reserve decides to finally raise US interest rates, this headwind will reverse and add to our future returns.

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| **2011** | - | - | - | - | - | - | - | - | - | - | -0.6% | 0.0% | **-0.6%** |
| **2012** | 1.4% | 0.9% | 1.5% | -1.4% | -1.9% | 1.3% | 0.0% | 2.7% | 0.1% | -0.3% | 0.4% | 2.9% | **7.7%** |
| **2013** | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | **20.6%** |
| **2014** | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | **14.2%** |
| **2015** | 0.8% | 2.0% | -1.6% | -0.3% | 0.0% | -0.8% | 1.8% | -3.9% | -0.2% | 1.5% | 0.4% | 1.2% | **0.6%** |
| **2016** | -5.1% | 1.0% | 2.5% | 0.9% | 3.7% | -0.7% | | | | | | | **2.1%** |

## Business TV

Most mornings when I wake up I turn on the business cable channels to get a sense of what is happening in the world and overseas markets before digging into the financial newspapers. CNBC's Squawk Box and Bloomberg Surveillance are my usual go-to favourites.

On days when the guests are CEOs of quality businesses, I can watch for hours. Learning about how a company is navigating the economic environment and generating future earnings is always a good use of time. However some days the viewing is less than compelling despite the entertaining personalities of the hosts and the TV is off before it is even warm. The recent Brexit referendum is a case in point.

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*"Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."*

**Warren Buffett**
Berkshire Hathaway

Over the past month, segment after segment was focused on the United Kingdom's referendum on remaining in the European Union (also known as "Brexit"). Now, make no mistake - this was an event of major significance to the British electorate and their economy. But whether or not they chose to leave the EU, the impact on the companies that we own in the Value Fund was largely immaterial. Speculation about the outcome of the vote and predictions about the equity markets' reaction to each outcome were discussed *ad nauseum*. So I tuned out and went back to reading financial reports and valuing businesses that we would like to own (at a price). The vote to leave the EU ultimately passed and the market sold off. The next morning I added to our positions in two companies whose operations are almost entirely based in North America. Within days markets recovered and life went on.

To be clear, I had no particular insight into which way the vote was going to go. Nor did I know how the market would react or how long it would take to recover once the market did sell off. But I do know how to recognize stocks that are undervalued and how to seize opportunities that present themselves.

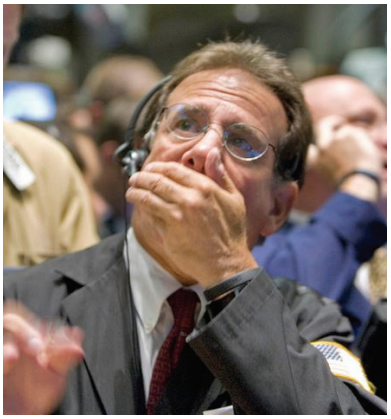
At GreensKeeper, we firmly believe that the short-to-mid-term direction of the markets cannot be successfully predicted with any consistency. Yes business cable channels will always find a so-called 'expert' that made a recent prediction that was spot on. But I would posit that market Nostradamuses simply do not exist. The reason is that short-term market moves are driven by investor sentiment which is undeniably moody. But over the long-term markets do rise due to inflation and retained earnings. Long-term, what truly matters are earnings and equity valuations.

To prove our point, here is an interesting experiment that you can try. Take any reputable daily newspaper like the *Globe &Mail* or *the Wall Street Journal* and set it aside for one month. Then come back to it and see how much of the information in it is still relevant to your investment portfolio. You may be surprised at how little truly matters. While it is important to keep abreast of current events, long-term investment decisions are based on factors that generally change quite slowly. It is on those factors that we remain focused.

## Environment Matters

Having worked on Bay Street for 15 years, including more than half that time in Investment Banking, I learned that when capital markets are at there extremes, it is unhelpful to be around others in the finance industry. Being "in the flow" may be helpful for day traders, but certainly not for long-term value investors.

When markets are rising and it seems like everyone around you is making money, valuations are usually lofty. In other words, it is a time to be cautious. However, we humans are social creatures and are wired to follow the crowd. Seeking safety in numbers may have helped us successfully evade predators on the savanna in prehistoric times, but it is precisely the wrong approach in investing. Unfortunately this bias is innate and simply tugs at us when we are in the presence of others. No one likes to miss any of the fun.



*"The big money is not in the buying and the selling; it's in the waiting."*

**Charlie Munger**
Berkshire Hathaway

Being around others when markets are in freefall is equally unhelpful. I recall a specific week in the fall of 2008 when markets were plummeting and the global financial sector appeared ready to implode. It was a historic time and one that is seared into my memory. Stocks in quality companies like Starbucks **(Scorecard #1)** were practically being given away and I was putting additional cash to work. It is difficult enough to have the conviction to invest in turbulent times. It is emotionally discomforting and being around others who are in panic and trying to talk you out of it only amplifies that discomfort.

Successful value investing requires being different than the crowd. Stocks are cheap only when they are unloved by the masses. Sometimes they are cheap for a valid reason. But on occasion, the market overreacts and opportunity presents itself.

Warren Buffett located his investment partnership in out-of-the-way Omaha, Nebraska for a reason. It is the same reason that GreensKeeper's headquarters were set up in Oakville, Ontario instead of downtown Toronto. Successful value investing requires extreme discipline, patience and conviction. Creating a calm environment which nurtures these attributes is helpful. By creating an environment where we can spend time reading and thinking away from the emotional pull of the crowd, it improves our odds of making intelligent investment decisions. It also keeps us focused on studying companies, their financial results, valuations and the overall economic and business environment. In other words, what really matters in investing.

Avoid the noise.

## GreensKeeper's 5th Annual Meeting

Thank you to those who made it out to our 5th Annual Meeting last month. We had a great turnout and as always, we enjoyed spending time with our clients and potential clients.

We are continuing to grow both the firm and our assets under management. A heartfelt thanks to our existing clients for referring GreensKeeper to others. Please keep them coming!

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT

# The Scorecard

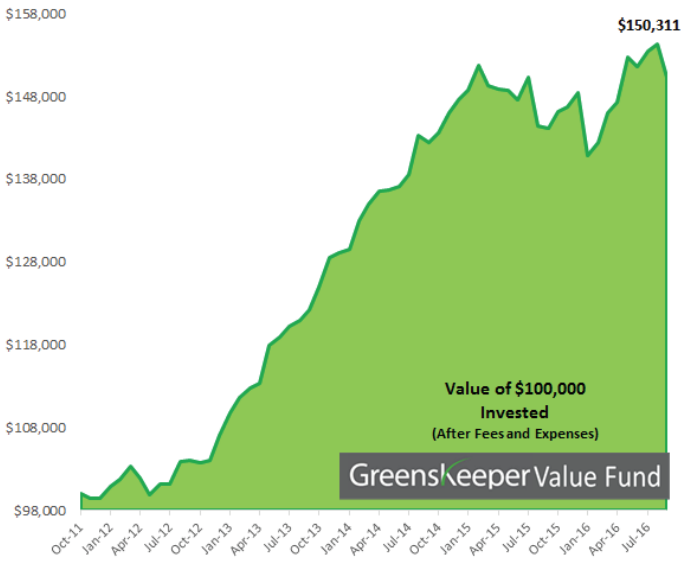
**Issue #16 – October 2016**

## Do The Right Thing

The Value Fund finished down (0.8%) in Q3 (after all fees and expenses) and is up a modest +1.3% year-to-date (YTD).* Our best performers for the quarter were Cisco Systems +10.6% and American Express +5.4%. Our laggards were Home Capital (15.7%) and Coach (10.3%).

Our heavy weighing of US Financials (the worst-performing S&P Sector in September) and our holdings in Wells Fargo (NYSE:WFC) in particular were the primary contributors to the fund's pullback in September.

Given the recent events surrounding Wells Fargo and our holdings of the stock, it is the main topic of this quarterly Scorecard.

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| **2013** | 2.6% | 1.6% | 1.1% | 0.5% | 4.0% | 0.9% | 1.0% | 0.6% | 1.1% | 2.2% | 2.9% | 0.5% | **20.6%** |
| **2014** | 0.3% | 2.7% | 1.5% | 1.2% | 0.1% | 0.2% | 1.1% | 3.3% | -0.6% | 0.8% | 1.7% | 1.0% | **14.2%** |
| **2015** | 0.8% | 2.0% | -1.6% | -0.3% | 0.0% | -0.8% | 1.8% | -3.9% | -0.2% | 1.5% | 0.4% | 1.2% | **0.6%** |
| **2016** | -5.1% | 1.0% | 2.5% | 0.9% | 3.7% | -0.7% | 1.2% | 0.5% | -2.5% | | | | **1.3%** |

## Spike Lee's Masterpiece

As a lover of film, I found myself reflecting on the recent passing of actor Bill Nunn who played the memorable role of Radio Raheem in Spike Lee's 1989 film *Do the Right Thing*. Having seen the movie during my formative years and given the film's cultural significance and controversial ending, I remember it well.

The film's title comes from a line given by another memorable character - DA Mayor – when he tells the film's protagonist Mookie to "always do the right thing" in life. That advice is equally useful when evaluating the management teams of companies that we are considering an investment in. After determining that a company possesses attractive economics and is also undervalued, we attempt to evaluate whether or not management is shareholder friendly. When evaluating a management team's skill, candour with shareholders and their capital-allocation decisions, we assess whether or not they 'do the right thing' for the company's stakeholders.

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## Wells Fargo & Co. (NYSE:WFC)

In early September, Federal regulators fined Wells Fargo $185 million after discovering that the company's employees had been secretly issuing credit cards and other banking products to customers that hadn't requested them. Now, in any large organization, there will always be a number of employees engaged in wrongdoing. But this was different. It turns out that this fraudulent activity involved 1.5 million unauthorized bank accounts and 565,000 credit cards. Moreover, the misconduct had been going on since 2011 and the company had fired at least 5,300 employees that were involved. The scale of the problem caught our attention, and also that of the U.S. Congress in the midst of an election.

Wells Fargo Chairman and CEO John Stumpf was unceremoniously hauled before the Senate and House of Representatives to testify about the affair. As shareholders, we watched the proceedings with great interest. Despite expressing his regret for the improper activities of certain employees, Mr. Stumpf's answers to Congress left them (and me) disappointed. In short, he did not seem to grasp the gravity of the situation nor did he seem willing to accept any of the blame.

*"Mr. Stumpf … evidently your definition of 'accountable' is to push the blame to your low-level employees who don't have the money for a fancy PR firm to defend themselves."*

**U.S. Senator Elizabeth Warren**

Wells Fargo is known for its cross-selling prowess. Most consumers require numerous banking products throughout their lifetime (e.g. mortgages, credit cards, lines of credit). Whereas the average US customer has fewer than 3 products with their main bank, Wells Fargo prided itself on its industry-leading average of over six. Not being satisfied, Stumpf created an "Eight is Great" campaign to increase that metric further. This is where I believe that Mr. Stumpf lost the plot.

Incentives drive behavior and the senior management of any business is responsible for putting the proper incentives in place and defining a company's culture by setting the tone at the top. Wells Fargo employees were clearly incentivized to cross-sell which isn't bad per se. However, the stories that have since come to light demonstrate that the level of pressure being put on branch-level employees was unhealthy.

To make matters worse, several employees complained to senior management about the problem and were either ignored or fired. The fake products reportedly earned the company less than $2.6 million in fee income which has since been refunded. To give you some context, Wells Fargo earned $22.3 billion over the past year.

*" Integrity is doing the right thing … when no one else is looking or will ever know…"*

Charles Marshall
Author

A major goal of capturing more of a customer's banking business is to increase switching costs (e.g. making it more difficult for them to move their business elsewhere). Most consumers prefer the convenience of dealing with just one financial institution provided that they are offered competitive rates and decent service. Implicit in that relationship is that the products being offered are either desired and/or needed by the customer.

In our opinion, the entire affair has been poorly handled by both Mr. Stumpf and Wells Fargo's board of directors. This was a management and board failure that was entirely avoidable had the issues been properly addressed earlier when they first came to light. Fortunately, Mr. Stumpf finally, albeit belatedly, realized the seriousness of the situation and did the right thing by tendering his resignation. Being the CEO comes with the perks of extraordinary compensation. But it also comes with the responsibility of leadership which includes accountability when things go awry.

While Mr. Stumpf's resignation, in and of itself, will not put an end to this unfortunate chapter for Wells Fargo, it is a necessary first step in putting the matter behind the company. Wells Fargo has also committed to reimbursing affected customers and "making it right". A good start. The entire episode is disappointing to us as shareholders and has caused real reputational damage to the company. With that said, where to from here with our investment in Wells Fargo? Back to first principles.

## Our Current View

Banking is largely a commodity business. In any commodity business, having a lower product cost than your competitors can be an attractive competitive advantage provided that the advantage is sustainable. In banking, scale and a low cost of deposits are two such advantages.

Wells Fargo has one of the lowest cost of deposits in U.S. banking due to their massive branch network and scale. The bank currently has $900 billion of deposits on hand with a remarkably low average cost of 0.16%. To a bank, deposits are its *cost of goods sold* as they lend those deposits out at higher rates and earn a spread known as a bank's Net Interest Margin (NIM). Wells Fargo currently earns a NIM of 2.82% on $1.73 trillion of interest-earning assets which produces about $47 billion of pre-tax net interest income.

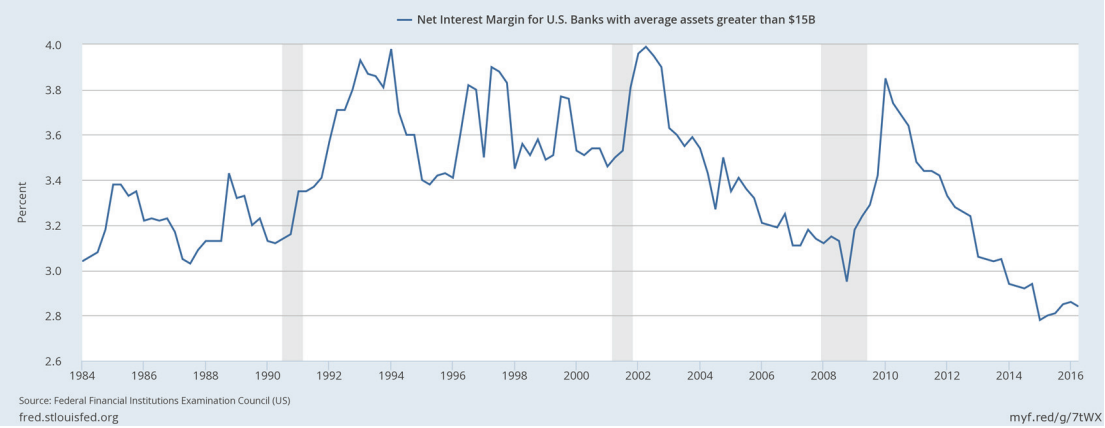
The bank is also very diversified in its business lines with lending being only about one-half of its revenues. Non-interest income (service charges, investment fees, credit card fees, etc.) from a diverse group of businesses generates another $41 billion in revenue. Add up those two income streams, deduct salaries, loan loss provisions and other operating costs and Wells Fargo generates about $33 billion of pre-tax income or about $4.00 per share (after-tax). It is a *very* good business.

However, the fake-accounts scandal has done real brand damage to the company. Banking, like investment management, is a business of trust. Wells Fargo will certainly lose some customers and some business as a result of their improper behaviour. There will be additional fines and likely additional litigation and settlements. But in our view, the core earnings power of Wells Fargo and the business franchise remains intact. Unless a material number of customers refuse to deal with Wells Fargo going forward and decide to leave the bank, we believe that this self-inflicted wound will heal in time as the headline risk dissipates. We believe that most customers that were not directly affected will be disappointed but then stay put rather than go through the hassle of moving their accounts, mortgages, etc.

Further, we have no reason to believe that the bank's conservative underwriting culture, which served them so well during the 2008 U.S. housing crisis, has been affected in any way. Loan delinquencies and charge-offs remain very low and the U.S economy remains healthy. The company's attractive return on assets (ROA) and operating leverage also appear to remain intact. At US$45.20 the stock currently yields 3.36% and Wells Fargo has consistently returned capital to shareholders through share repurchases. In this regard, the pullback in the stock is actually a positive as they can retire more shares for each buyback dollar spent.

*"If something cannot go on forever, it will stop."*

**Herbert Stein**
Economist




Equally as important to our investment thesis is our long-term view on interest rates. Eventually the US Federal Reserve will start to raise rates from their current all-time lows. Perhaps as soon as December. The result of increasing interest rates will be a widening Net Interest Margin on the company's $1.73 trillion of earning assets. A 0.25% increase in the Federal Reserve Rate will add approximately $600 million to the company's net interest income in the first year alone. As recently as 2009-2011 the company earned a NIM of 4.16% (vs. 2.88% today). We estimate that a reversion to those historical margins in a more normalized interest rate environment would increase earnings by over 70%. Now, that is unlikely to happen any time soon. But we like the fact interest rates should provided a tailwind for the company for years to come.

For all of the foregoing reasons, we remain comfortable owning the stock which we started buying in 2012 at $30.27 and have collected over four years' worth of dividends along the way. In summary, we believe that Wells Fargo's problems are surmountable and the stock modestly undervalued at current prices. Wells Fargo is a *compounder* that should continue to increase its *intrinsic value* for many years to come provided that its management team regains their focus on the customer and avoids additional self-inflicted wounds.

## We've Moved

After six years we have moved offices (albeit only one building over). Please note our new address and phone number:

GreensKeeper Asset Management Inc.
2010 Winston Park Drive, Suite 200
Oakville, Ontario L6H 6P5
Tel. 905.827.1179

We are continuing to grow both our team and our assets under management. A heartfelt thanks to our existing clients for referring GreensKeeper to others. Please keep them coming!

**Michael McCloskey**
Founder & President

GreensKeeper ASSET MANAGEMENT INC.

The Scorecard
Issue #17 - February 2017

*"Everyone must choose one of two pains: The pain of discipline or the pain of regret."*

**Jim Rohn**

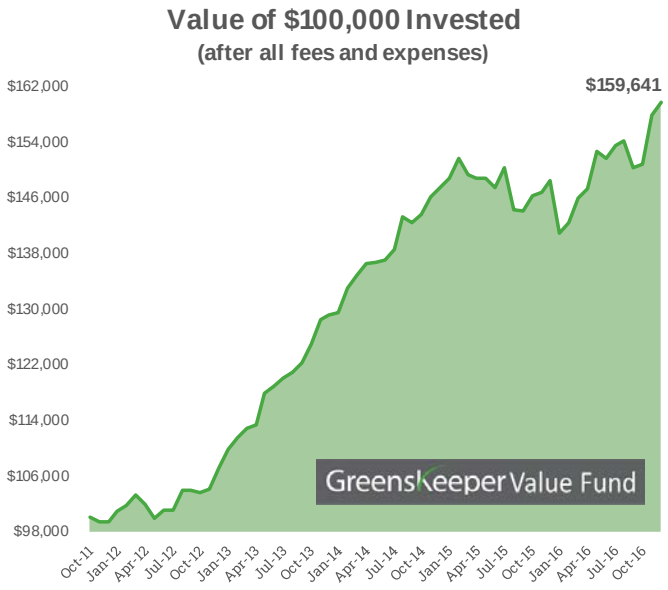
Author and Entrepreneur

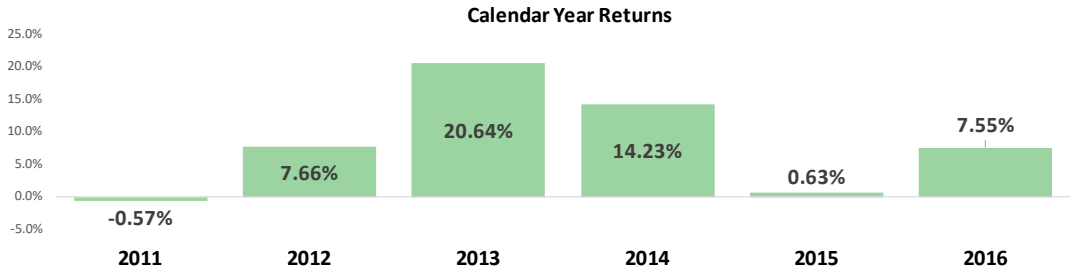
## Avoiding Stupidity

The Value Fund returned +6.21% in the fourth quarter (net of fees and expenses) and we also established a number of new stock positions. Our best performers for Q4 were Urbana Corp. +34.7% and Wells Fargo +24.5%. Our worst performer was Cisco Systems (4.7%).

For the year, the Value Fund finished +7.55% (net). Currency headwinds from a strong Canadian dollar cost us about 3% of performance for the year. Overall, it was a so-so year for the Value Fund.

Additional detail on the Value Fund's performance for the year and stock holdings will be provided to GreensKeeper clients in the coming months along with our audited (KPMG) financial statements.




*Notes: All returns and Value Fund details are based on Class A units and are net of all fees. The Value Fund was launched on November 1, 2011. Prior to January 17, 2014 the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

## Amazon.com, Inc. (Nasdaq: AMZN)

Before you jump to conclusions, we will state at the outset that we do not currently, nor have we ever owned Amazon in the portfolio. However, an examination of the company will help you to understand our stock filtering process and how we think about capital allocation at GreensKeeper.

We were inspired to write about Amazon after reading a recent newspaper article touting the stock. The author acknowledged that the company generates razor-thin profit margins and that the stock trades at a "ridiculously high" price-to-earnings multiple (171x to be exact). However, the columnist's conclusion was that despite the ridiculously high P/E, the stock was worth purchasing as it was likely to be even more pricey a year from now. That advice left us scratching our heads and eager to share a different perspective on the (un)attractiveness of Amazon as a potential investment.

*" I think part of the popularity of Berkshire Hathaway is that we look like people who have found a trick. It's not brilliance. It's just avoiding stupidity. "*

**Charlie Munger**

While the future is always uncertain, let's be generous and assume that over the next five years, all of the following things transpire at Amazon (we would characterize this as an optimistic scenario):

1. Revenue continues to grow at 20% per year;
2. Profit margins triple from 1.6% at present to 4.9%;
3. The company doesn't issue any more stock options; and
4. Amazon is able to finance its growth without issuing any additional shares.

If all of that happens, Amazon will earn approximately $32 per share in 2021 versus $4.90 today. At the current share price of $839, this implies a 26x price-to-earnings multiple on those future earnings. By comparison, one of the best retailers in the world - Costco (Nasdaq:COST) - currently trades at a 30x price-to-earnings multiple. In other words, even if things go very right for Amazon, shareholders may not earn a satisfactory return given the current stock valuation.

Now, what could go wrong? First, the law of large numbers suggest that Amazon will likely struggle to maintain its current 20% revenue growth rate for the next five years. Second, even the best of retailers struggle to earn a 4.9% profit margin. For example, Costco earns about a 2% profit margin. Finally, dilution via stock options is virtually guaranteed. From our perspective, the risk/reward proposition for Amazon is markedly unattractive.

Recommending the stock based on a different view of how the future will unfold for Amazon is perfectly legitimate.[1] However, recommending the stock because it is likely to be even more pricey a year from now isn't. In fact, it has a name in the investment industry. It's called the *greater fool theory*. We would posit that this is not investing, it is pure speculation. Amazon may ultimately turn out to be a profitable investment - only time will tell. But for GreensKeeper and our clients, we will take Charlie Munger's advice (at left) and simply pass. A component of compounding capital is avoiding unforced errors. With a broad investment universe in which to look for value, we prefer putting our money to work when the odds of a favourable outcome are decidedly in our favour.

## Thinking Like an Investor

The Amazon case study also highlights another important investing concept. Despite our distaste for the stock at current prices, we wish to be clear on one point. Amazon is an amazing company. Under CEO Jeff Bezos' visionary leadership, the company continues to grow rapidly by reinventing retail and online business services. As a consumer, we are big fans as our 14 orders of the past six months will attest. It is the *valuation* that we take exception with as illustrated in the graphic below.

Source: visualcapitalist.com, Yahoo Finance and Google Finance.

[1] For example, rapid expansion of higher margin services such as Amazon Web Services could cause future profit margins to exceed our 4.9% "optimistic" assumption. Unlikely in our view, but still feasible.

Amazon belongs to that class of companies that are wonderful from the perspective of the consumer. They deliver fantastic products and services and lower costs for us all. But as an investor, that is not nearly enough. In order to meet our standards and make it past our investment screening process, we require much more.

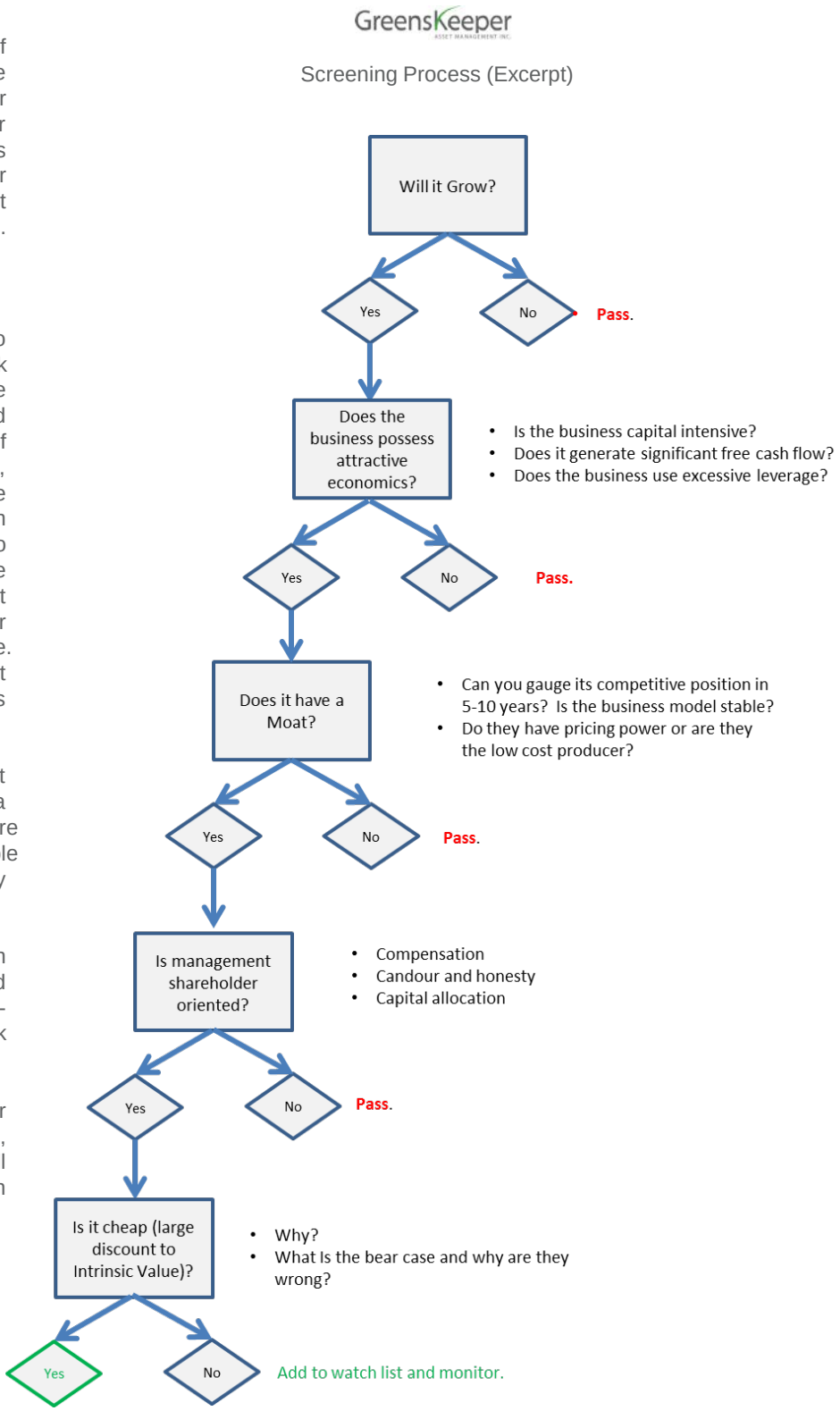
## Our Screening Process

Businesses that we invest in also need to possess attractive economics. We look for companies that generate attractive returns on the capital that they employ and that generate plenty of free cash flow. If they do not, we simply pass. If they do, we still need to be convinced that the company's profitability is sustainable. In other words, the business needs to possess a durable competitive advantage that gives us the confidence to predict that the business will continue to deliver attractive returns on its capital in the future. Capitalism ensures that high profits attract competition which tends to lower margins and profits over time.

It is only certain special companies that possess both attractive economics and a moat that protect them from future competition. **Moats** come in multiple forms including patents, regulatory licenses, scale or a consumer brand.

Finally, for the few companies still in consideration, we need to be convinced that the management team is shareholder-friendly. In other words, they need to look after our interests and not just their own.

Very few companies make it through our stock filtering process. For those that do, we refer to them internally as our "All Stars". This is the fertile ground in which we hunt for opportunities.



But being an All Star is still not enough as even the best business is not worth an infinite amount of money. The price of a stock relative to our calculation of its true worth or **intrinsic value** is critically important. It is when you can find an All Star trading at a big discount to its intrinsic value that you will experience truly superior investment returns.

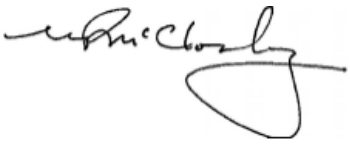
When the stars all line up, not only will the business continue to deliver increasing profits for years to come, but eventually what those earnings are worth will be repriced by the market. The combination of dividends, earnings growth and multiple expansion lead to killer returns for investors. It doesn't happen often, but on occasion these opportunities present themselves like **Starbucks** did in 2008. And that, in a nutshell, is how value investors like GreensKeeper succeed in the stock market while also mitigating risk.

## Five Years and Counting

On October 31, 2016, we marked the five-year anniversary of the Value Fund and celebrated by welcoming a new employee to the GreensKeeper team. Michelle Tait is now assisting us with administration, compliance and also helping out with client enquiries. Our growth would not be possible without the support of our existing clients who continue to refer new clients to us. Thank you!

For those less familiar with our firm, you should know that we invest our own money alongside our clients (in my case, over 70% of my family's net worth and 100% of our investible assets). We are employee-owned and our clients get to deal with the principals of the firm who actually make the investment decisions. We are believers in capital preservation and disciplined practitioners of a time-tested valuing investing methodology which should be a component of every investor's portfolio.

In short, we are different. If you are interested in learning more over coffee, feel free to give either Kristine Beese or I a call.



Michael McCloskey
President & Founder

GreensKeeper ASSET MANAGEMENT INC.

The Scorecard
Issue #18 - April 2017

*""How did you go bankrupt?" Bill asked.*

*"Two ways," Mike said. "Gradually and then suddenly."*

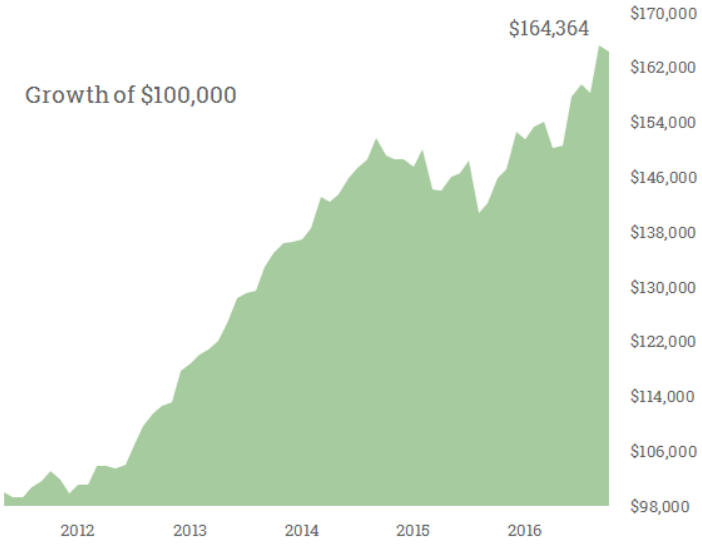
Ernest Hemingway
**The Sun Also Rises**

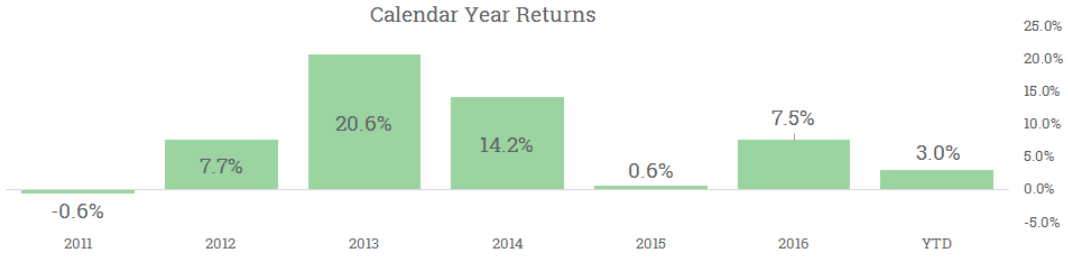
## Cruel, Cruel Irony

The Value Fund returned +2.96% in the first quarter (net of fees and expenses) despite currency headwinds of approximately 0.8%.

Our best performers for Q1 by portfolio contribution were S&P Global +21.6%, Visa +13.9% and Cisco Systems +11.8%. Our laggards were our energy names, namely Exxon (9.1%) and Chevron (8.8%).

We established one new position during the quarter, added to several others and trimmed some of our year-end holdings. While the markets remain expensive, we have been able to find a few attractive pockets of value.




*Notes: All returns and Value Fund details are as of March 31, 2017, based on Class A units and are net of all fees. The Value Fund was launched on November 1, 2011. Prior to January 17, 2014 the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

## Home Capital Group Inc. (TSX:HCG)

Over the past year, Home Capital's stock is down (84%) and the company has lost over $2 billion of market value. Over a billion dollars of that decline happened *in the past 7 days.* The reason? A classic run on the bank. From my prior investment banking experience, I know the sector and the company very well. However, it has been so long since a bank failed in Canada that I actually had to look it up (1996 it seems).

Before delving into what is causing the current meltdown, let me first repeat what I wrote in our 2016 Annual Report about the company:

> During 2016 we also fully exited our position in Home Capital Group (TSX:HCG). This is a stock that we have purchased and sold on several occasions over the past five years. At one price we viewed it is attractive, and at another less so. More recently there have been two main issues that have factored into our decision to exit the stock. First, as the media reminds us daily, the Canadian housing market is not cheap.

That doesn't mean that a selloff is inevitable. However, it does mean that the risk for mortgage lenders like Home Capital is heightened. Second, there have been a number of company-specific issues that gave us pause. Third-party mortgage broker fraud, the retirement of the founding CEO and slowing mortgage origination. We concluded that we were better off taking profits and investing elsewhere.

For the Value Fund and all of our clients, we are watching Home Capital safely from the sidelines. But we are still watching it closely as there are many lessons worth learning and we may yet be provided with a direct (or indirect) opportunity as a result of the current panic.

**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.

*"Liquidity is like oxygen: when it's abundant you don't notice, when it's not, it's all you notice."*

Warren Buffett

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 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.

**Cruel, Cruel Irony**

Due to this funding model, *banks are creatures of the public's confidence*. Once that confidence is lost, a bank's ability to continue to do business is put in jeopardy as it needs to constantly attract deposits in order to fund its business. Several years ago, Home Capital encountered a major mortgage fraud issue in its business which the market had previously learned about and digested. However, one week ago the Ontario Securities Commission (OSC) released allegations[1] of misleading disclosure relating to that incident against the company and some of its current and former officers. One of the OSC's mandates is to maintain public and investor confidence in the integrity of the capital markets which is presumably why they brought the allegations forward. Ironically, their actions have had the effect of spooking Home Capital's investors and exacerbating the stock's selloff.

Similarly, Home Capital's board fired its former CEO Martin Reid one month ago given the company's financial underperformance and the board's view that the company should be doing better. In a more recent statement, the board pre-released decent Q1 financial results and stated that they "recognize that we have had our share of challenges recently and the confidence of our stakeholders has been understandably shaken." Both board actions were meant to bolster confidence, but ironically seem to have heightened investor concerns about the company. Ratings agencies also took notice of the management changes and the OSC investigation and downgraded the company.

Canada's banking regulator is the Office of the Superintendent of Financial Institutions or "OSFI" as it is more commonly known. Part of OSFI's mandate is to control and manage risk and ensure that Canadian banks are sound. Unlike the US, Canada's banking sector sailed through the Great Recession with flying colours.

[1] None of the allegations have been tested or proven at a hearing or in court and the company has responded that they are without merit and will be vigorously defended. We make no comment regarding the veracity of the allegations.

With OSFI's reputation intact, Home Capital is certainly front and center with Canada's banking regulator at the moment. A little-known fact is that several years ago OSFI encouraged Home Capital to broaden its funding sources by growing demand deposits. Historically, almost all of Home Capital's funding came from fixed-term deposits (GICs) which were locked in and closely matched to the term of the company's assets (mortgage loans). Demand deposits represented $2.5 billion of Home Capital's funding at the end of 2016 (vs. only $0.1 billion in 2012). In the past month, $591 million of those demand deposits have in fact been demanded by customers and are now gone. Even though they are fully guaranteed by the Canadian government (via the CDIC), depositors are fearful and withdrew their money creating a funding issue for Home Capital.

As a result, yesterday morning Home Capital announced a one-year funding deal with a major institutional investor. Under the facility, $2 billion will be available to the company but at an interest rate of 10%. In addition, the loan comes with a $100 million non-refundable commitment fee. For perspective, Home Capital earned $247 million in all of 2016. This secured loan has an effective interest rate of at least 15% and would represent only a fraction of the company's $16 billion of deposits and GICs. Compare that rate with the 2% that Home Capital was paying on its deposits and the fact that the company earned an average of 4.24% on its assets in 2016. In other words, they can't earn a spread borrowing at 15% and lending at lower rates. You can now understand the equity market's reaction. The irony here is that OSFI's goal of reducing risk by having Home Capital diversify its funding sources may have perversely have contributed to the current run on the company's funding. Term deposits may not be renewed, but generally aren't payable on demand.

Over the past few years, a number of short sellers have been betting on Home Capital's demise. Some have been suggesting that the company is an outright fraud while others have made inflammatory statements in an effort to make mountains out of financially-immaterial molehills. The reality is that the shorts have a perverse economic incentive to try and incite panic as deposit-taking lenders are vulnerable to runs. Another reality is that most of these investors have been shorting Home Capital because of Canada's expensive housing market, the fact that Home Capital is a "pure play" on the Canadian housing market and their prediction of a Canadian housing price crash.

We concur that housing is overvalued in Canada. However, to date housing prices have continued to appreciate without any meaningful blip allowing Home Capital to make enormous profits along the way. In fact, Home Capital just pre-released that it earned $58 million in Q1. They were and remain a good lender. Over the past week, these short bets turned out to be very profitable, but ironically for different reasons than most short sellers anticipated. Their investment thesis was focused on perceived problems with the company's assets (loans), whereas the stock's recent collapse has been caused by the company's liabilities (deposits). The shorts got it right, but for the wrong reasons, and their actions likely contributed to the current bank run.

### The Next (Final?) Chapter

So how does the Home Capital saga, which is still very much in progress, ultimately play out? We can foresee several possibilities. But unfortunately we do not believe that we can properly assign probabilities to each scenario or determine with enough certainty the valuation of the company's shares in each case. As a result, we plan to continue to watch Home Capital from the sidelines (but as always, reserve the right to change our minds as the facts change).

Scenario 1 – Home Capital manages its way through the crisis, albeit badly scarred. This will take plenty of time as deposits aren't the only current challenge. The company requires a new CEO and needs to regain the confidence of third-party mortgage and deposit brokers that refer business to them. The company's earnings will be severely diminished (or worse) in 2017 and a short-term dividend suspension likely. But in time, they may recover and hopefully preserve the company's >$20 per share of book value and live to fight another day.

*"History doesn't repeat itself, but it does rhyme."*

Mark Twain

Scenario 2 – OSFI arranges for a major Canadian bank to buy Home Capital, possibly with a regulatory backstop protecting the buyer against losses for a period of time until the business is stabilized. This makes the situation "go away" as long as the buyer is large enough that its solvency isn't brought into question as a result. This scenario reminds me of the acquisition of Bear Stearns by JP Morgan in 2008. Jamie Dimon of JP Morgan was allegedly willing to pay $4-5 per share but the deal was ultimately done at $2. The reason? Former Treasury Secretary Hank Paulson was reported to have insisted on a lower price to avoid the moral hazard of using public funds to bail out private shareholders. Remember Mark Twain's advice (at left).

Scenario 3 – OSFI puts Home Capital into resolution mode – in other words, they provide enough short-term liquidity to Home Capital and oversee an orderly liquidation of the bank's assets and the full and orderly repayment of depositors. But this doesn't fully deal with a key problem. The company's $11 billion of non-prime mortgages will come up for renewal in the next few years. If Home Capital isn't around to renew them, who is? The company built its business lending to borrowers that the major banks wouldn't or couldn't lend to.

There are likely other scenarios that I haven't even considered. But I am certain that the significance of properly managing this situation is not lost on anyone involved. Home Capital's main competitor Equitable Group Inc. (TSX:EQB) has seen a 40% decline in its shares over the past few weeks. Other smaller financial services companies shares are selling off and even the larger banks started to wobble yesterday. Contagion is very dangerous in banking and it can happen very quickly.

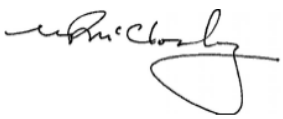
The latest chapter in the Home Capital saga is a sad one. In 1986, a talented real estate lawyer named Gerry Soloway decided to become an entrepreneur by founding a Canadian mortgage company called Home Capital. In the company's first year, Home Capital had revenue of less than half a million dollars and the company lost a nominal amount of money. Last year, Home Capital earned profits of almost $250 million on its $29 billion of assets under administration. Over the decades, Home Capital had been one of the best performing stocks on the TSX. How this ultimately plays out is too tough for us to handicap. But we do hope that it ends well for everyone involved. That visionary founder and the company's many honest and hard-working employees deserve a better ending to what had been a wonderful Canadian success story.

## Annual Meeting

GreensKeeper's 6th Annual Meeting will be held on Thursday, June 1 at 7:00 pm at the Mississaugua Golf & Country Club. Additional details will follow shortly via separate invitation.

For those less familiar with our firm, you should know that we invest our own money alongside our clients (in my case, over 70% of my family's net worth and 100% of our investible assets). We are employee-owned and our clients get to deal directly with the people who actually make the investment decisions. We are believers in capital preservation and disciplined practitioners of a time-tested valuing investing methodology that should be a component of every investor's portfolio.

In short, we are different. If you are interested in learning more over coffee at our Oakville office or downtown Toronto, feel free to give me a call.



Michael McCloskey
President & Founder

April 27, 2017

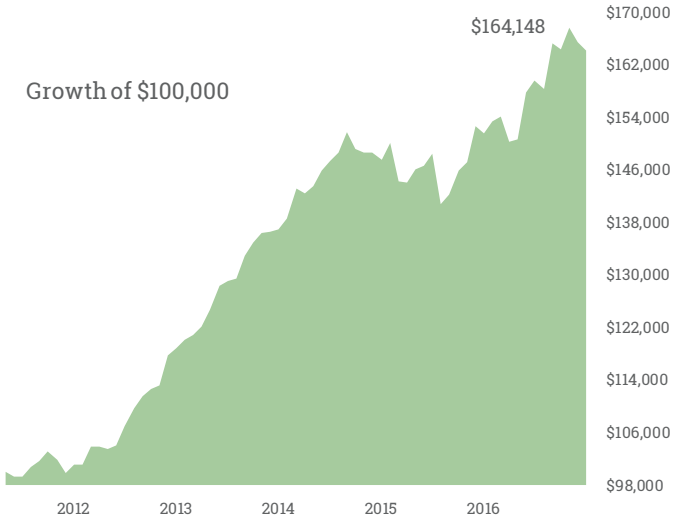
GreensKeeper
ASSET MANAGEMENT INC.

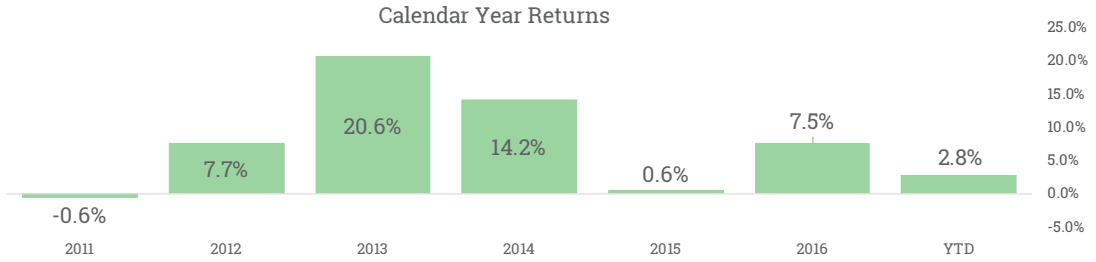
The Scorecard
Issue #19 - July 2017

## Twin Pandemics

The Value Fund was down (0.13%) in the second quarter and is up 2.82% year to date. The continued weakening of the US dollar and our US-centric holdings have held back our returns when measured in Canadian dollars (the Value Fund's reporting currency).

Our best performers for Q2 by portfolio contribution were Novo Nordisk +25.1% (discussed in detail on page 2), American Express +6.5% and Anthem +13.8%. Our biggest laggards were IBM (11.7%) and Chevron (7.4%).

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We are finding a few underpriced situations these days and made a timely addition of a new consumer discretionary stock to the Value Fund in Q2. Solid earnings followed and we are off to a good start. As we may still accumulate additional shares, we will disclose this new holding in a future letter. During the quarter we fully exited our holdings in Express Scripts (NYSE:ESRX). We had assumed that the company would be unable to renew its largest customer – Anthem (NYSE:ANTM) – when the contract comes up for renewal in 2020. However, we underestimated how profitable that contract was to the company which they finally disclosed to the market. Based on previous communications with the company's management, we felt misled on that point. Having profitably trimmed our holdings previously, we ended up with a small loss on our overall investment in the company.

We also fully exited our holdings in Bed, Bath & Beyond (Nasdaq:BBBY). The juggernaut that is Amazon (Nasdaq:AMZN) is making life difficult for most retailers these days. While Bed, Bath & Beyond remains very cheap by conventional metrics (6.9x trailing P/E as of the date of writing), we believe that their moat is being drained and their future profitability at risk due to changing consumer shopping habits. Given our initial assessment of the risks involved, our position size was always modest at less than 3.5% of the portfolio. Overall our investment cost us (0.35%) of performance. The lesson learned: determining the *durability* of the competitive advantage(s) of our investee companies is incredibly important. Chalk this one up to experience.

*"The intelligent investor is a realist who sells to optimists and buys from pessimists."*

Benjamin Graham

*The Intelligent Investor*

## Novo Nordisk A/S (NYSE:NVO)

Value Fund holding Novo Nordisk is the world leader in diabetes care with a global market share of 27% by value (46% by insulin volume). The company was founded in 1925 and is headquartered in Denmark. However, its origins have a uniquely Canadian connection.

In the early 1920s, Dr. Frederick Banting and Charles Best conducted pioneering research on animal pancreases at the University of Toronto. Their research eventually led to the discovery of insulin and earned Dr. Banting the 1923 Nobel Prize in Medicine. Prior to their discovery, the treatment of diabetes consisted of a severely restricted diet which usually led to death within a year or two of diagnosis. And while a cure for diabetes remains elusive to this day, the advent of insulin has dramatically improved both life expectancy and quality of life for those stricken with the illness.

Dr. Banting and his colleagues patented their invention but considered the idea of profitable commercialization unseemly. Their goal was to make their life-changing invention safely available to as many diabetics as possible. Consequently, they sold their patent to the University of Toronto for $1 (you read that right). However, it quickly became apparent that the University did not have the ability to produce insulin in the quantities needed to meet the growing demand. Ultimately commercial licenses were granted to several pharmaceutical companies including a predecessor to Novo Nordisk.

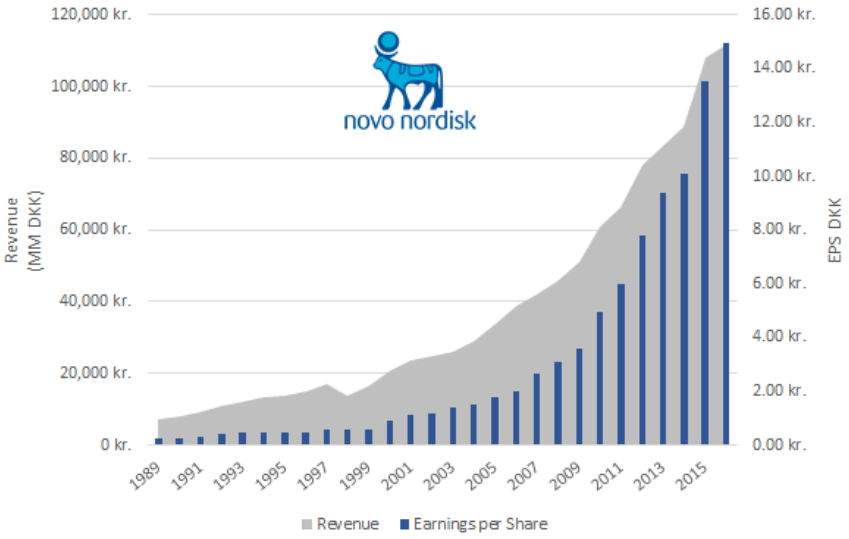
### Novo Nordisk's Economic Moat

Fast forward almost a century and today the diabetes industry is dominated by a three-firm oligopoly consisting of Novo Nordisk, Eli Lilly (NYSE:LLY) and Value Fund holding Sanofi SA (NYSE:SNY). These three companies have managed to continually innovate by creating more effective and safer iterations of insulin and delivery devices that benefit diabetics. Each new innovation also gives them additional patent protection which has kept potential competitors at bay and allowed them to continually increase prices.

The economic **moat** enjoyed by the "Big 3" extends beyond mere patent protection. The manufacture of insulin is a complex process involving trade secrets and a significant initial investment in manufacturing facilities. For example, Novo Nordisk will spend US$1.5 billion this year to expand its production facilities in the US and Europe. In addition, insulin is manufactured biologically. Unlike small-molecule pharmaceuticals (most drugs), the molecular structure of biologics is large and complex as they are derived from living sources. Biological "copies" are not identical, they are merely bio-similar. This is a relatively new area of medicine and the regulatory framework is still evolving such that getting a biosimilar approved is more complicated than with generic drugs. Given the complexity of manufacture, discounting on biosimilars is unlikely to be as aggressive as with traditional drugs thus limiting pricing pressure.

The advantage of scale production and the need for scale in distribution (Novo Nordisk has a sales force of 16,000+) lends itself to an industry with just a few, large competitors.

Finally, once a diabetic finds an insulin that works well for them, they tend to stick with the same brand creating a consumer switching cost that locks in customers. The longstanding reputation (brand) of these companies also helps to perpetuate the status quo. Doctors and their patients want to know that they can trust the quality of the insulin being injected.



Limited competition, patent protection, brands, customer switching costs and barriers to entry – combine them all and you can understand why the Big 3 have enjoyed pricing power and have been able to increase prices frequently. The result? Novo Nordisk enjoys 85% gross margins, 42% operating margins and returns on equity approaching 100%. This is an incredible business.

**The Opportunity / Investment Thesis**

Novo Nordisk has a debt-free balance sheet, net cash of US$1.08 per share and pays a healthy dividend. Historically, Novo Nordisk has traded at price-to-earnings multiples over 20x. But the stock has had a major selloff due to two cuts to profit guidance which led to recent management changes. The company's current (lowered) guidance is for annual operating profit growth of at least 5% (down from its historical 15%).

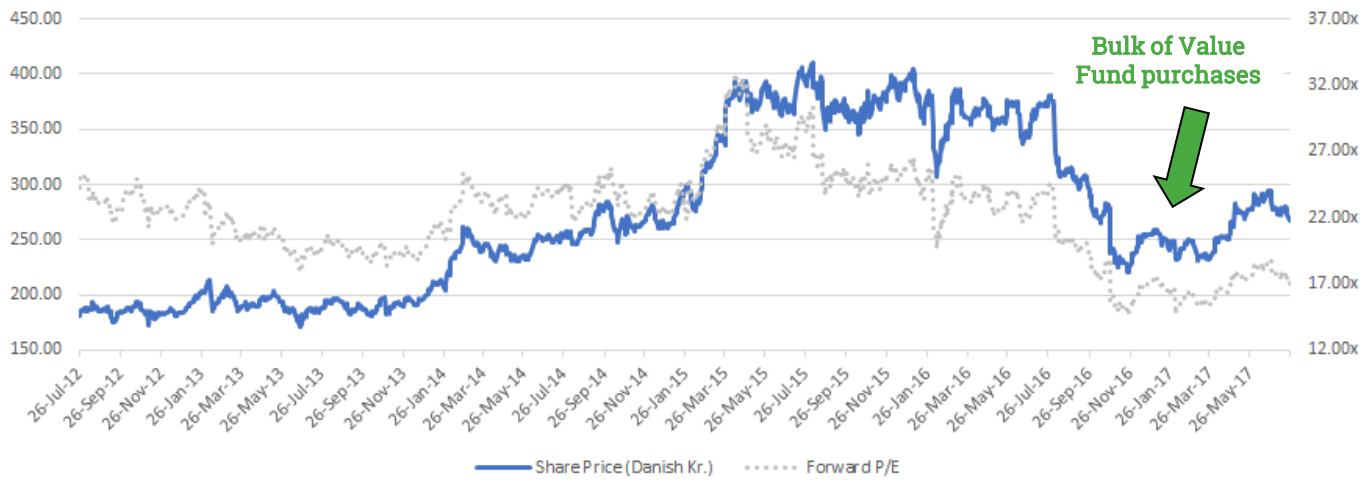
The company's recent stumbles were caused by pharmacy benefit managers (PBMs), governments and other payers in the US using their growing clout to aggressively demand discounts and play off the Big 3 against each other or risk formulary exclusion. In addition, biosimilar products are slowly but surely being introduced to the market. This changing dynamic makes it increasingly critical for the Big 3 to make meaningful improvements to next-generation insulins in order to continue to demand premium prices.

Despite improvements in the treatment of diabetes, it remains a global pandemic. According to the World Health Organization (WHO), over 422 million people worldwide suffer from the disease. And as populations age in developed economies and improving standards of living lead to greater obesity levels in developing countries, the number of type 2 diabetics in particular will continue to grow. As a result, the Big 3 will have a huge tailwind at their back for many years to come.

Novo Nordisk gets solid marks for shareholder-friendly capital allocation. The company is a prodigious generator of free cash flow and has a demonstrated track record of returning almost all that money to shareholders through a combination of dividends and share repurchases.

Novo Nordisk's shares trade on a number of European exchanges however we prefer to own the American Depository Receipts (ADRs) that trade on the New York Stock Exchange (NYSE:NVO). We started accumulating shares in the Value Fund beginning in late 2016 and added to our position on several occasions in 2017. Our holdings in the company represented approximately 4.6% of the portfolio at June 30.

With an average cost of US$35.89 per ADR (or 229 Danish Kroner per share) we were able to buy the stock at a below-market 15x earnings multiple – in our minds a bargain for an above-average company likely to grow faster than both the economy and most companies. We are currently up +19.5% on our investment however it is far too early to declare victory. We anticipate that our investment thesis will play out over many quarters (and years). Given Novo Nordisk's business economics, history of continual innovation and success at managing the business over the past 92 years, we like our chances.



*"What the wise do in the beginning, fools do in the end."*

Warren Buffett

## Exchange-Traded Funds (ETFs)

We are bombarded daily with advertisements for the latest iteration of exchange-traded funds (ETFs). Created by Vanguard pioneer Jack Bogle back in 1976, the concept has more than taken on a life of its own. I am often asked for my opinion on ETFs which I can boil down to a few salient points.

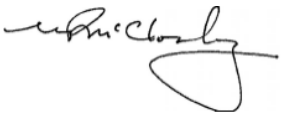
Select high-quality ETFs can have a place in any equity investor's portfolio. But most investors don't understand what they are buying or that the major market indices that many track are price weighted. In other words, the more expensive a stock, the more of it you end up owning in an index-ETF. This is the exact opposite of our more rational value investing approach. As stocks sell off they actually become more attractive, not less so. We think that the next major market correction, whenever it comes, will bring a few unpleasant surprises to ETF holders.

Secondly, there are a lot of poor-quality companies out there that we prefer to avoid. For example, at its peak valuation, Valeant Pharmaceuticals (TSX:VRX) accounted for 6.1% of Canada's S&P/TSX Composite Index. Shades of Nortel circa 2000. Again, we prefer to mitigate investment risk by owning high-quality businesses at undervalued prices and avoid the rest.

Finally, diabetes isn't the only pandemic currently spreading around the globe. As the Oracle so aptly put it: "What the wise do in the beginning, fools do in the end." Do investors really need a Global X Millennials Thematic ETF (NASDAQ:MILN), a tiny $6 million fund that targets companies that they deem attractive to Millennials? Or how about the Nashville Area ETF (NYSE:NASH) which owns diverse companies that happen to be located in Nashville, Tennessee? No doubt there will be additional thematic and multi-leveraged ETFs coming to market in the near future. Whenever there is market demand, the investment industry is sure to keep feeding it while it lasts. We would also posit that these are vehicles for speculation, not investing.

Okay, rant over. But I should mention that instead of investing via ETFs, I prefer to invest my own money directly alongside GreensKeeper's clients (in my case, over 70% of my family's net worth and 100% of our investible assets). We are believers in capital preservation and disciplined practitioners of a time-tested valuing investing methodology that should be a component of every investor's portfolio.

In short, we are different. If you are interested in learning more over coffee at our Oakville office or downtown Toronto, feel free to give me a call.



Michael McCloskey
President & Founder

GreensKeeper
ASSET MANAGEMENT INC.

The Scorecard
Issue #20 - October 2017

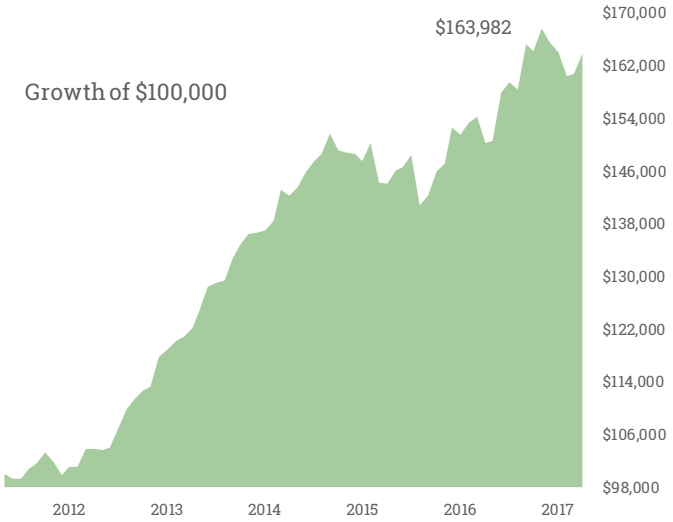
*"The single greatest edge an investor can have is a long-term orientation."*

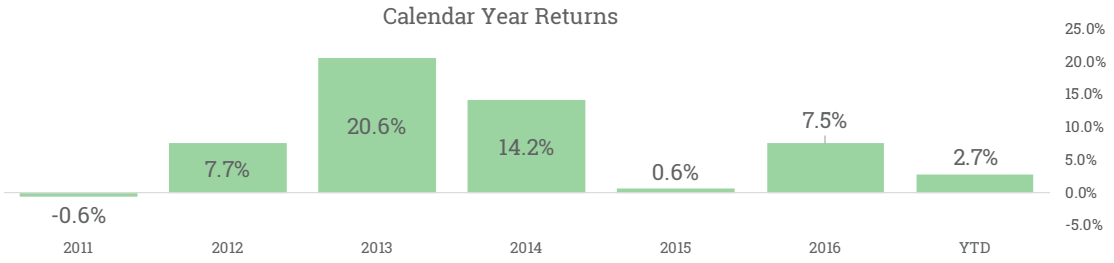
Seth Klarman
*Baupost Group*

## A Money Making Machine

The Value Fund was flat (0.10%) in the third quarter and is up 2.72% year to date.

Currency movements were immaterial during Q3. The Canadian dollar has started weakening since September 11 and we are now recapturing some of the (6.5%) in performance that its previous rise has cost us this year (Canadian dollars are the Value Fund's reporting currency). We purposely accept this currency volatility in exchange for saving the hedging costs along the way.




*Notes: All returns and Value Fund details are as of September 30, 2017, based on Class A units and are net of all fees. The Value Fund was launched on November 1, 2011. Prior to January 17, 2014 the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

Our best performers for Q3 by portfolio contribution were **Berkshire Hathaway** +8.2%, **American Express** +7.4% and **Novo Nordisk** +12.3%. Our biggest laggards were **Allergan** (15.7%), **Coach** (14.9%) and **Nike** (12.1%).

During Q3 we added **CVS Health** (NYSE:CVS) to the portfolio. You are likely familiar with their retail pharmacies but may not know that CVS also owns a major pharmacy benefit manager (PBM) that competes with former Value Fund holding **Express Scripts**. Many retail stocks are currently underperforming due to the threat posed by **Amazon**. More specifically, there are reports that Amazon is contemplating a move into the online pharmacy space which is weighing on CVS' stock – hence the opportunity. We believe that pharmacy – a highly regulated business - is more difficult to tackle than selling general merchandise. In addition, CVS' PBM is an underappreciated jewel and it recently won a major PBM contract with health insurer **Anthem** (NYSE:ANTM). We like CVS' long-term prospects and the risk/reward at these prices.

In August we sold about half of our position in **Corus Entertainment** (TSX:CJR.B) due to price appreciation and our view of the stock's intrinsic value. Factoring in dividends, we were up about 49% in 18 months and decided to take some profits. Subsequent to quarter end, we added a new European-based company to the portfolio. As we may still accumulate additional shares, we will disclose this new holding in a future letter.

## Visa, Inc. (NYSE:V)

Value Fund holding Visa, Inc. is the world leader in retail electronic payments. Visa, along with competitor **MasterCard**, form a global duopoly in the sector. Visa is an incredible business. The company grows steadily without much capital reinvestment required, adds value to both consumers and retailers and is very difficult to compete against. Visa is truly a money-making machine.

A simplified overview of Visa's business model is warranted as it is often misunderstood. You have probably never given Visa's business much thought despite having a Visa-branded card in your wallet. While often thought of as a credit-card issuer, Visa is actually a technology company. Visa owns and operates VisaNet – a highly secure and reliable global network that authorizes, clears and settles financial transactions. Visa operates an open loop or four-party system consisting of (i) Issuers, (ii) Merchant Acquirers, (iii) Retailers and (iv) Consumers (cardholders).

In an open-loop system, credit and debit cards are actually issued by banks (e.g. RBC, Scotiabank) – known as Issuers. Visa authorizes these banks to issue Visa-branded cards and the Issuers agree to follow Visa's rules and pay Visa certain fees.

Retailers that wish to accept Visa as a payment method enter into an agreement with a Visa-authorized bank (called Merchant Acquirers) who agree to help the retailer process and settle transactions. Merchant Acquirers ensure that Visa's rules are followed and pay Visa certain fees.

When a card is presented by a consumer for purchase at a retailer, VisaNet routes the payment request for authorization to the Issuer bank. VisaNet's algorithms simultaneously analyze the transaction to detect and prevent fraud. Within one or two seconds the transaction is approved (or not) and the settlement of funds takes place between the two banks and the retailer within a few days.

An often misunderstood point is that Visa does not take any credit risk – that risk sits with the Issuing Bank that grants you the card, sets your credit limit and sends you your monthly statement. Visa simply sits in the middle - facilitating payment transactions and collecting a modest fee from Issuers and Merchant Acquirers that averages about $0.18 per transaction. That may not sound very impressive until you realize that VisaNet processes over 116 billion transactions every year or more than 3,700 *per second!*

The Four-Party System (Open Loop)

### Visa's Economic Moats

Visa is such a good business that you would think that others would try and replicate it. Easier said than done. Visa's business is protected by multiple competitive advantages or moats. The first is brand. Trust is extremely important when it comes to payments. Many years of usage by consumers and investment in security by the company gives all parties involved the confidence to use a Visa card. Second, Visa benefits from a network effect. Consumers want to use cards that are accepted by most merchants and merchants want to accept cards carried by most consumers. This virtuous circle is very powerful and difficult to replicate. To date, alternative payment providers, even those started by reputable and powerful companies (e.g. Apple Pay, PayPal) have generally partnered with Visa and MasterCard. Replicating their global payment networks and technological prowess is not a small feat.

Visa also benefits from switching costs. It is a major undertaking for an Issuing bank to switch all of its credit card customers to another branded card. Finally, Visa benefits from scale. Visa is largely a fixed-cost business. The incremental cost of processing an additional transaction is close to zero. Operating margins at Visa are currently 66% *and rising!* As a result, the company sensibly focuses on driving cards in circulation, card usage and volume.

**Business Tailwinds**

Visa also benefits from a number of macro trends. Cash usage continues to decline as consumers around the world are choosing to pay more often using plastic as incomes and standards of living rise. The secular trend of online commerce also plays into Visa's hands as online payments are all non-cash. According to the Nilson Report, Visa currently represents about 54% of all global payment transactions and Mastercard another 26% (or 80% combined). Given their dominance, both companies possess pricing power and regularly increase their prices.

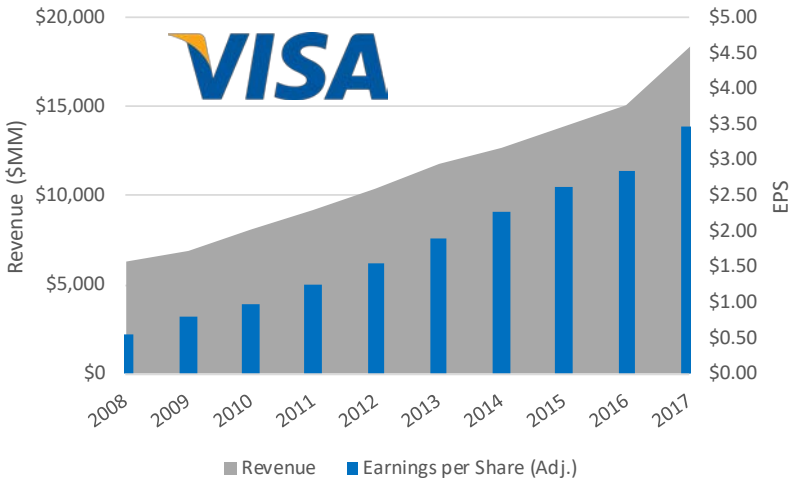
Visa acquired Visa Europe for over $20 billion in mid-2016. Visa Europe was previously owned by European financial institutions and operated as a not-for profit enterprise much like Visa was prior to its initial public offering (IPO) in 2008. We expect that the integration of Visa Europe over the next few years will follow Visa's historical path of expanding volumes and margins given Visa's experience and global scale.

**Valuation**

As a result of all these factors, Visa has been able to consistently grow its revenues at double-digit rates and earnings even faster through operating leverage. Over the past five years, Visa earned a cumulative $24.7 billion in earnings and paid out *all of it* to shareholders through a combination of rising dividends and share repurchases.

Without question, Visa is a remarkable business. But even great businesses are not worth an infinite amount. We believe that Visa will earn at least $4.00 over the coming year and should comfortably grow earnings per share at a double-digit pace for some time. Combined with the quality of the business and its capital-light nature, we believe the stock is worth at least 25x earnings or about $105. Many people think that value investing is all about low price-to-earnings (P/E) multiples. It is not. Value Investing is about buying something for less than its intrinsic value. A fast growing and high quality company is worth a lot more than a slower growing and inferior business. It is the comparison of price to intrinsic value that matters, not simply the relative P/E ratios.

We started buying Visa in late 2016 at a P/E in the low 20x range and our average cost is $79.38. Visa is our fifth-largest position in the Value Fund but with the stock trading at close to $110, we believe it fully valued at present and do not plan to add to our holdings at these prices. However, we are happy to allow our unrealized capital gain to compound at a reasonable rate unless and until a better opportunity presents itself.



*"Investing should be more like watching paint dry or **watching grass grow**. If you want excitement, take $800 and go to Las Vegas."*

**Paul Samuelson**
late U.S. economist and
Nobel Prize winner

## Risks

There is risk in any investment and Visa is no exception. Regulation is probably the biggest risk facing the company. Visa's dominance and market power make them an easy target for regulators who prefer to cap their prices and shape rules that Visa imposes on Issuers and merchants choosing to participate in the Visa ecosystem. Class action lawsuits by consumers and merchants for monopolistic practices are another related risk.

Cybersecurity is another critical risk faced by the company. A data hack similar to the one engulfing **Equifax** would be very damaging to Visa's business. Fortunately, the company knows this and spends a lot of time, effort and money on that front. Consumer spending is cyclical and while a recession wouldn't expose Visa to credit risk, it would certainly slow payment volume growth. Finally, a disruptive technology could come along and create added competition. We believe that this is unlikely, but not impossible. We will continue to monitor these and other risks but remain long-term bullish on our investment in Visa.

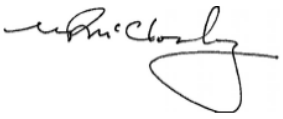
## Talk is Cheap

In a world of extremely low interest rates and an overvalued Canadian real estate market, we believe that equities remain an attractive asset class for Canadians. However, market valuations remain elevated – which is why we don't own the market.

Instead, we seek to invest in high-quality but undervalued companies with solid balance sheets. In the present environment we are very focused on risk mitigation and capital preservation when selecting investments.

These are not merely empty statements. We take the responsibility that comes with managing people's money very seriously. We are humbled by the trust that our clients place in us and work hard to ensure that that trust is continuously deserved. You should also know that I have over 70% of my family's net worth and 100% of our investible assets invested alongside the firm's clients. We walk our talk at GreensKeeper and believe in aligning interests.

In short, we are different. If you are interested in learning more over coffee at our Oakville office or downtown Toronto, feel free to give me a call.



Michael McCloskey
President & Founder

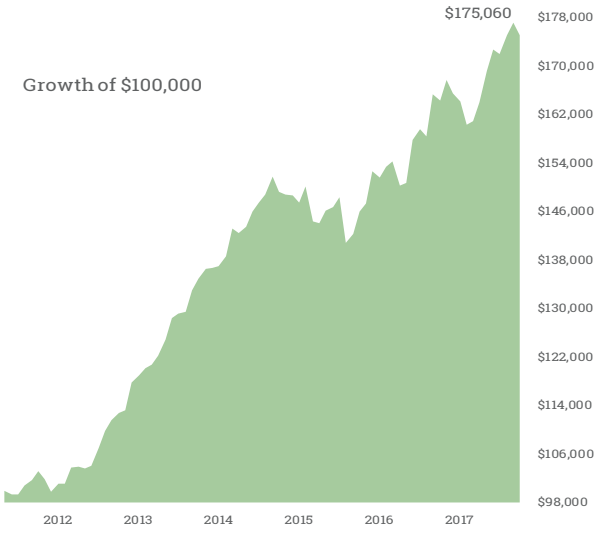
GreensKeeper ASSET MANAGEMENT INC.

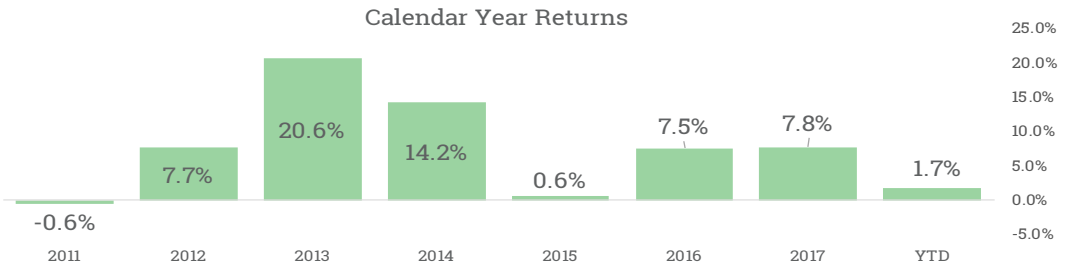
The Scorecard
Issue #21 - April 2018

## Compounding Knowledge

The Value Fund was up +1.75% in Q1 vs. the S&P/TSX which was down -4.52% and the S&P500(CAD) which was up +1.74%.

Markets are off to a rough start in 2018 and volatility is on the rise. The prior calm lulled a number of "investors" to short the VIX (fear index), presumably because they believed that turbulent markets had been abolished. Their investments were recently wiped out. Regular readers will not be surprised to learn that we avoided this folly (and the Bitcoin mania as well).

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The U.S. dollar – which hurt us last year – strengthened and provided a 2.4% tailwind in Q1. These ups and downs tend to even out over time.

Our best performers for Q1 by portfolio contribution were **Booking Holdings** (Nasdaq:BKNG) +19.7% - a new position that we added to the portfolio in Q4 2017 when it was known as **Priceline Group** - and portfolio stalwart **Cisco Systems** (Nasdaq:CSCO) +12.0%. Our biggest laggards were **Wells Fargo** (NYSE:WFC) -13.6% whose challenges continue and **American Express** (NYSE:AXP) -6.1%. We also fully exited our position in **Corus Entertainment** (TSX:CJR.B) after they reported disappointing results. Overall, Corus was a good investment for us as we bought cheap, sold most of it last August at $13.92 and earned monthly dividends along the way. But the media industry is rapidly changing and the risks of continuing to own the name have increased so we decided to move on.

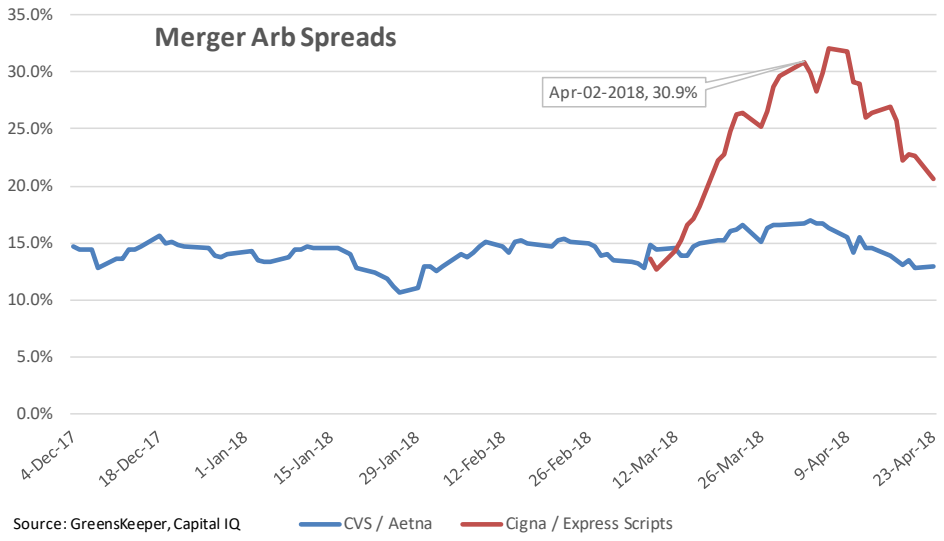
## Express Scripts Holding Co.

We purchased shares in **Express Scripts** (Nasdaq:ESRX) in March. Longtime readers will recall that we have owned the stock previously and our previous articles on the company can be found here and here. But our reason for owning it this time is entirely different. Here's what changed.

On March 8, 2018 Express Scripts announced that it had agreed to be acquired by health insurer **Cigna Corporation** (NYSE:CI) in cash and stock merger. If the deal closes, a holder of an ESRX share will receive about $91.00 in value, or a 31% premium to where the stock was trading at the time. As expected, Express Script shares rose on the news and Cigna's declined. But then something interesting happened.

In merger situations like this, the target company (Express Scripts) will typically trade at a modest discount to the deal price to reflect the risk of the transaction not closing and time value (sellers don't get their consideration until the deal closes). The discount is referred to as the merger arbitrage spread and it generally declines over time as closing becomes more certain and imminent.[1]

What is interesting is that the spread on this transaction ballooned to over 31% in early April and Express Scripts started trading at a price *lower* than the undisturbed price that the stock was trading at prior to the deal announcement. Read that sentence again. We think the proposed transaction is similar to the pending combination of **CVS Health** (NYSE:CVS) and **Aetna** (NYSE:AET). But that second deal has consistently traded at a more reasonable spread of 15% or less. We have yet to hear of a compelling reason why the Express Scripts spread is so wide. So we promptly analyzed the situation and bought Express Scripts for the portfolio on April 2. Here's our rationale.




There are only two possible outcomes:

A. The transaction closes and we earn a 30% return. We have assumed that the transaction takes a year to close but if it closes by year end (management's view), our annualized return will be closer to 40%.

B. The transaction doesn't close. In this scenario, Express Scripts stock will sell off, but likely not much lower that where it is currently trading which is also close to our estimate of the stock's intrinsic value absent the deal. But Cigna will be obliged to pay Express Scripts a break fee of up to $2.1 billion if the deal fails. A nice consolation prize which further mitigates our risk.

What are the odds of each outcome? As the financing for the transaction has been secured, there are only two feasible reasons why the transaction doesn't close. First, the shareholders of both companies need to approve the deal. Express Scripts' shareholders will certainly approve it given the deal premium. Cigna shareholders may not like the deal. But Cigna management initiated the deal and will do their best to garner support. In addition, Cigna's shares are broadly held with the largest shareholders being passive index funds who are likely to follow management's lead.

[1] *Often, investors in Merger Arbitrage situations will go long (buy) the target and short (sell) the acquirer's stock. By doing so, they benefit as the spread narrows but can lose heavily if the deal doesn't close. We don't short and even if we did, our investment thesis supports a long-ESRX position without a corresponding short position in Cigna.*

*"The two rules of fishing are to fish where the fish are, and don't forget the first rule."*

Charlie Munger

The real risk is if regulatory approval from the U.S. Department of Justice is not obtained. We see no compelling policy reasons to block the deal, but you never know.

We think the odds of a successful closing are at least 50% (several analysts believe it is much higher, but we like to be conservative). If it does close, we earn a terrific, low-risk return. If its doesn't, we may suffer a modest loss. The asymmetric payoffs and our familiarly with Express Scripts and its industry gives us comfort in making this calculated bet. To date, the spread has narrowed and we are up +10.9%. But it is early and only time will tell how this situation ultimately plays out.

If you are interested in learning more, our investment thesis in Express Scripts was published by Barron's a few weeks ago. For hard core stock analysts, a more detailed investment memo containing our analysis can be found here.

We generally prefer investments in companies that will compound their value over time. However, in an expensive market where bargains are hard to come by, special situations like this can greatly enhance returns while still mitigating risk. To paraphrase Charlie Munger (at left), you need to look for bargains wherever they present themselves. Finally, it is worth pointing out that we were in a position to act quickly on this opportunity because of our prior work on Express Scripts. Investment knowledge, like interest, compounds over time.

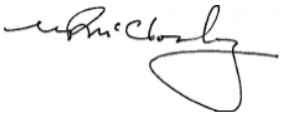
## 2018 Annual Meeting

GreensKeeper's 7th Annual Meeting will be held on **Wednesday, June 13 at 7:00 p.m.** at our usual spot - the Mississaugua Golf & Country Club. Additional details can be found here.

If you are interested in learning more about investing, come join us! The meeting is open to clients, potential clients, friends and family. After a brief presentation, we open the floor to Q&A so please bring some tough questions with you.

If you plan to attend, just RSVP to either myself or Michelle Tait via email to help us to plan the logistics.

April 23, 2018



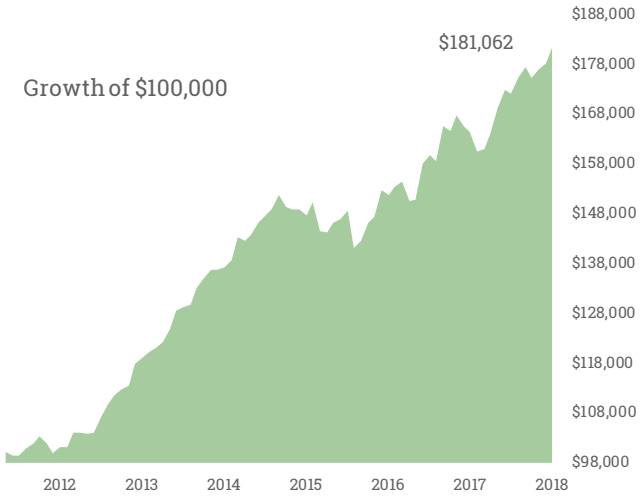
Michael McCloskey
President & Founder

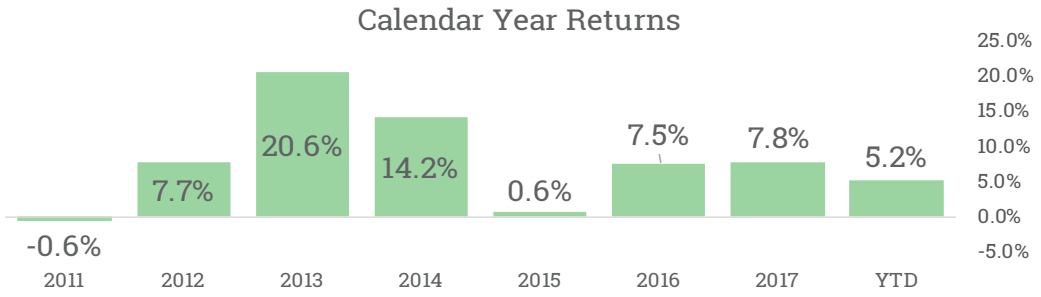
GreensKeeper ASSET MANAGEMENT INC.

The Scorecard
Issue #22 - July 2018

## Index Surgery

The Value Fund gained +5.2% (net of fees) for the six-months ended June 30, 2018. During this period the S&P/TSX Total Return Index gained +1.9% and the S&P500 gained +2.6% including dividends (+7.4% measured in Canadian dollars – the Value Fund's reporting currency).

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Currency movements that lowered our returns in both 2016 and 2017 reversed and have helped us so far in 2018. At times these movements will make us look brilliant and at other times foolish. Our view is that neither description is deserved. Currencies generally move within broad ranges and short-term movements are largely noise. We purposely accept this volatility in exchange for forgoing the hedging costs along the way. Our currency strategy remains unchanged and has been written about at length.

## Recent Annual Meeting

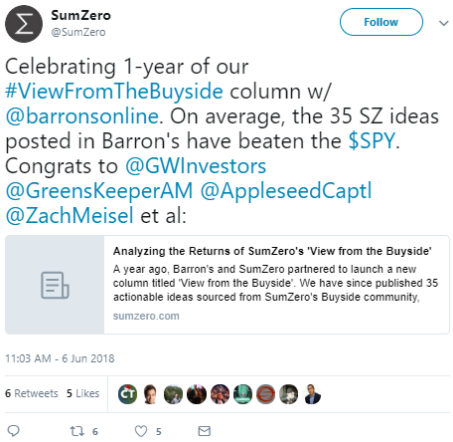
Thank you to the 40 people that attended our Annual Meeting on June 13. For those who weren't able to join us, a copy of the presentation along with a video recording of the event is now available on our website.

## Portfolio Review

At mid-year, 97% of the portfolio was invested in 22 common stocks (1% Canadian and 96% foreign) and 3% was invested in cash and equivalents.

Our top three contributors year-to-date were all technology stocks: online travel agent **Booking Holdings** (Nasdaq:BKNG) +16.7%, credit card network **Visa** (NYSE:V) +16.2% and industry stalwart **Cisco Systems** (Nasdaq:CSCO) +12.3%.

Our large bet (6.8% weighting) on **Express Scripts** (Nasdaq:ESRX) is performing according to plan with the stock up +16.4% since we purchased it in April. Our recent writeup of our investment thesis for Express Scripts can be found in **Scorecard #21**. Our idea was published in Barron's and was recently ranked as one of the best performing ideas from the View From The Buyside column. In an expensive market, good ideas are hard to find. But they are out there. It just takes a lot of effort to uncover them. We remain bullish on our investment in ESRX as we continue to believe that the announced merger with **Cigna** (NYSE:CI) will receive regulatory and shareholder approvals and eventually close. Consequently, we expect the stock to gradually move towards the $92.00 deal price (vs. $79.45 today).




Our biggest performance detractors for the first half of the year were diabetes care leader **Novo Nordisk A/S** (NYSE:NVO) -14.1% and telecom giant **AT&T** (NYSE:T) -17.4%. Novo Nordisk remains well positioned to benefit from the growing number of people worldwide that are afflicted with the disease. Diabetes is truly a global pandemic. We are sitting on a decent gain on our investment and view the recent pullback as temporary. The future for AT&T is less certain. We inherited the stock as part of the consideration received on the takeover of our prior investment in **DirecTV** (we took some cash on the deal as well). The media and telecom landscape continues to change rapidly and AT&T is trying to adapt as evidenced by their recent acquisition of Time Warner. We like the 6.1% dividend yield but their balance sheet and industry shifts both make us cautious. We are closely monitoring the company's progress.

During the first half of 2018 we also initiated a few new positions including **Alphabet** (Nasdaq:GOOG) - also known as Google. Their dominance in search (>90% market share) is unlikely to be disrupted despite regulatory attempts to punish the company for abusing its market power. When people use the Google search engine, the company has a window into what is on our minds at that precise moment in time. That is a very valuable asset and advertisers are willing to pay to get in front of us at these critical moments. Google's AdWords is the gatekeeper and the company should continue to monetize its search traffic at high margins for years to come. The company's "Other Bets" like self-driving cars (Waymo) are less certain but we aren't counting on them as part of our valuation for the company. If they do pan out it's gravy. That said, we wouldn't bet against the company when it comes to innovation. Google has a winning culture underpinned by its top-notch engineering talent and its reliance on data-driven decision making. For those interested in learning more about the company, we recommend the book *How Google Works* written by former CEO Eric Schmidt and former SVP Products Jonathan Rosenberg.

Finally, during the first half of 2018 we fully exited our positions in **Allergan** (NYSE:AGN), **Corus Entertainment** (TSX:CJR.B), **Gilead Sciences** (Nasdaq:GILD), **Pandora A/S** (CPSE:PNDORA) and **Swatch Group** (SWX:UHR).

We finished the period with unrealized gains on our equity investments of approximately $5.8 million. The Value Fund is well positioned as the companies that we own are of high quality and should continue to increase their intrinsic value over time. A snapshot of the entire portfolio at June 30, 2018 can be found on the Schedule of Investment Portfolio on page 5 of the Financial Statements provided to GreensKeeper clients in our 2018 Half-Year Report.

## Index Surgery

We have previously mentioned in passing a few of the shortcomings of the major stock market indexes but some recent market events justify dissecting them further.

Going back to first principles, the first stock market index was introduced in 1896 by Charles H. Dow as a barometer of how the equity markets were performing. Mr. Dow's eponymous index is still in existence today, however its small number of constituent stocks (30) and calculation based on price weighing[1] vs. market capitalization make the Dow Jones Industrial Average (DJIA) a less-reliable gauge of how the broader markets are faring.

A more widely followed index is the S&P500 whose constituents comprise the 500 largest companies listed on the major US stock markets as measured by market capitalization. While this is arguably a better measuring stick for the US equity markets than the DJIA, the S&P500 Index has its own shortcomings.

For example, as a company's shares rise in price and the valuation becomes more expensive, its weighting in the S&P500 Index increases. Index investors end up owning more and more of expensive companies and less and less of cheaper ones. **Amazon** (Nasdaq:AMZN) alone accounted for 33.4% of the S&P500's gains through June 30, 2018 (see table below). As we previously wrote in the *Globe and Mail*, while Amazon is a gift to consumers, we have no interest in owning the stock at its current valuation. We are of the same opinion for another top index contributor and market darling: **Salesforce.com** (NYSE:CRM). With the company trading at a valuation of 65x forward earnings (232x trailing), we just don't get it and will take a pass. Best to leave pricey stocks like this to others who think that we are missing something.

**S&P 500 Total Return Index**

**Top Contributions YTD (to June 30, 2018)**

| COMPANY | Index Contribution | Total Return |
|---|---|---|
| Amazon.com Inc | **33.41%** | 45.35% |
| Microsoft Corp | **17.79%** | 16.31% |
| Apple Inc | **17.15%** | 10.25% |
| NetFlix Inc | **13.73%** | 103.91% |
| Mastercard Inc 'A' | **6.94%** | 30.23% |
| Facebook Inc Cl'A' | **6.91%** | 10.12% |
| Visa Inc'A' | **5.64%** | 16.55% |
| Adobe Systems | **5.60%** | 39.13% |
| Cisco Systems | **4.45%** | 14.09% |
| NVIDIA Corp | **4.39%** | 22.58% |
| UnitedHealth Group | **4.30%** | 12.05% |
| Boeing Co | **4.10%** | 14.93% |
| salesforce.com inc | **3.87%** | 33.42% |
| NIKE, Inc'B' | **3.75%** | 28.12% |
| Alphabet Inc'A' | **3.58%** | 7.19% |

Stocks owned in the Value Fund

Source: S&P Dow Jones Indices

Having a growing portion of your portfolio invested in expensive stocks is the exact opposite of what we would argue is our more rational value investing approach. As stocks decline in price, they actually become more attractive (and less risky). Overvalued companies can also sell off quickly when market sentiment changes. For example, **Facebook** (NYSE:FB) issued results last week that were below expectations and the stock sold off (17.2%) in one day. Given the company's size - and hence large index weighting - it accounted for almost all (86%) of the S&P500 Index's decline for the day.

[1] Price-weighted indices like the Dow Jones Industrial Average (DJIA) are calculated such that higher-priced stocks have a greater index weighting than lower-priced ones, even if the lower-priced stock is in a company with a market capitalization that is larger than the higher-priced stock.

**GreensKeeper's view on Cryptocurrencies:**

*"Speculative assets like Bitcoin attract capital, aggressive promoters and then fraudsters. We prefer to simply stay away."*

**Annual Meeting**
**June 13, 2018**

Markets have been rising for some time so passive index investors tend to become complacent and forget about the risks that they are taking. As we wrote in Scorecard #19:

> *"... there are a lot of poor-quality companies out there that we prefer to avoid. For example, at its peak valuation, Valeant Pharmaceuticals (TSX:VRX) accounted for 6.1% of Canada's S&P/TSX Composite Index. Shades of Nortel circa 2000. Again, we prefer to mitigate investment risk by owning high-quality businesses at undervalued prices and avoid the rest."*

The foregoing observations should not be taken to mean that market indices aren't useful to investors. Index levels and their movements are useful barometers of broader market conditions. Our main point is that investors need to dig beneath the headline numbers to understand what is really going on before reading too much into them. Which leads us to one final observation about indexes.

The massive fund flows into passive index investments strike us as herding behavior that has yet to be tested by a market panic. Markets occasionally do extraordinary and unexpected things on short notice and we humans are emotional creatures after all. Panic selling of stocks will likely induce index redemptions which will in turn force certain index funds to sell stocks in order to fund them thereby creating a negative feedback loop. We have no desire to be market Cassandras, but this setup vaguely reminds us of the portfolio insurance phenomenon of the 1980s that played a role in the 1987 market crash. We think that the next major market correction, whenever it comes, will deliver a few unpleasant surprises to passive index investors. Caveat emptor.

## A Different Approach

In a world of extremely low interest rates and an overvalued Canadian real estate market, we believe that equities remain an attractive asset class for Canadians. However, market valuations remain elevated – which is why we don't own the market.

Instead, we seek to invest in high-quality but undervalued companies with solid balance sheets. In the present environment we are very focused on risk mitigation and capital preservation when selecting our investments. We walk our talk at GreensKeeper and believe in aligning interests which is why I have over 70% of my family's net worth and 100% of our investible assets invested directly alongside GreensKeeper's clients. In short, we are different.

If you are interested in learning more over coffee at our Oakville office or downtown Toronto, feel free to give me a call.

July 30, 2018

Michael McCloskey
President & Founder

## Fear and Courage

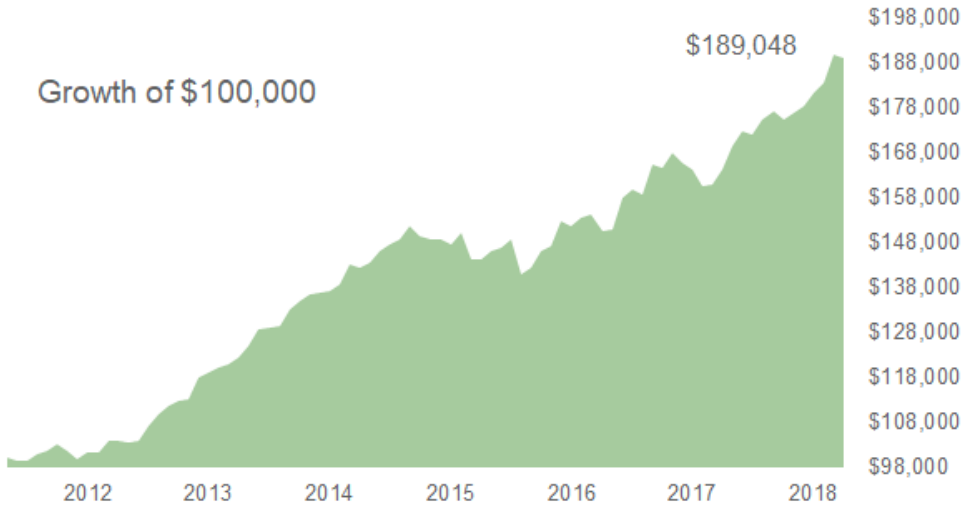
The Value Fund gained +4.4% in Q3 and is up +9.9% for the nine-months ended September 30, 2018. Year-to-date the S&P/TSX Total Return Index has gained +1.4% and the S&P500 is up +10.6% (+13.7% measured in Canadian dollars – the Value Fund's reporting currency). Currency moves lowered our returns in Q3 but have helped us modestly in 2018.

Before diving into a portfolio review, the October market selloff is worth discussing. As of October 27, the S&P/TSX is down -7.4%, the S&P500 -8.8% and the Nasdaq -10.9% for the month. So why are we so sanguine? It isn't just due to the fact that we are faring better than the major indices as we have during past pullbacks (we are down -5.5% this month). The real reason is that as longtime students of the market we have seen this movie play out before and plan to take advantage of it.

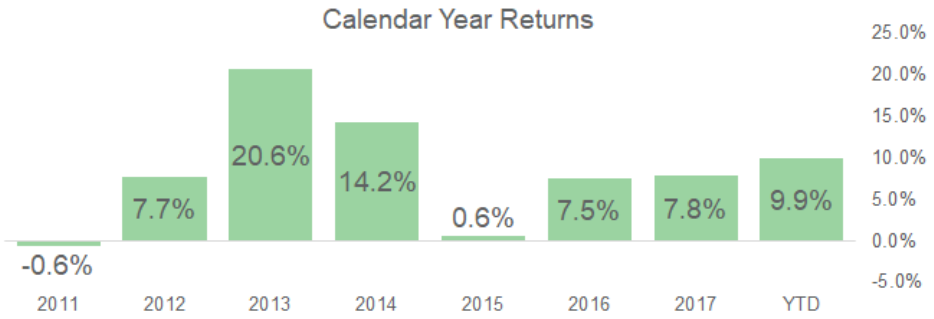
Every day for the past decade, CNBC, BNN Bloomberg and others have paraded a stream of intelligent guests voicing strong opinions about the equity markets' next move. Occasionally their predictions were right. Often they were wrong. In our opinion, they are all missing the point and playing the wrong game (but it does make for entertaining TV).

When asked about the current market selloff and our prediction of the future market direction we simply shrug and admit that we have no idea. We also believe wholeheartedly that no one else does either. That may not make for great television – but we believe it to be true.

In order to be a successful equity investor, one must: (i) be able to accept the fact that markets will do crazy things from time to time and (ii) be able to keep one's wits about one when they do. Volatility is the price one pays for equity-like returns. With risk-free (treasury) yields averaging about 2% since we launched the Value Fund, you could have invested $100,000 without any worry and watched it grow to ~$114,680. Instead, we have taken the bumpier ride and even with the recent decline have grown it into ~$178,670. Even with the occasional severe pullback, we are still much farther ahead.




*Notes: All returns and Value Fund details are as of September 30, 2018, based on Class A units and are net of all fees. The Value Fund was launched on November 1, 2011. Prior to January 17, 2014 the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*




*Notes: All returns and Value Fund details are as of September 30, 2018, based on Class A units and are net of all fees. The Value Fund was launched on November 1, 2011. Prior to January 17, 2014 the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm.*

We also know that when markets are frothy, it is best to avoid folly. In bull markets, it is tempting to invest in Bitcoin and emerging industries such as the Canadian cannabis sector, especially when everyone else seems to be making money doing it. At the risk of missing out on all the fun, we have been and will remain disciplined. While the cannabis sector will certainly grow, current valuations led us to conclude that it will end badly for most "investors".

There is a concept in cycling that has been adopted by famed value investor Tom Russo that resonates with us – namely the **capacity to suffer**. There will be times when our prudent value investing approach will be out of step with the markets and we will experience the pain of looking foolish for ignoring expensive and/or poor-quality stocks. But our long-term and patient approach when things aren't going our way serves us well when panic returns. The ability to endure short-term pain (be it psychological, emotional and/or physical) often leads to long-term rewards. Buffett has often said that temperament is more important than intelligence in investing. Fortunately we were wired a certain way that happens to be helpful in the investing arena.

We can't predict *when* markets (or individual stocks for that matter) will correct. But we do know for a fact that they will. Markets continuously oscillate between greed and fear, albeit with varying frequencies. We also know that over the long term, markets rise due to inflation and the accumulation of retained earnings. That is a rising tide that we wish to take advantage of for many years to come.

> "Prediction is very difficult, especially about the future."
>
> Niels Bohr– Physicist, Nobel Laureate

While we can't time short-term market moves, we do know how to value certain businesses, how to spot a bargain and how to take advantage of them when they appear. Plunging markets provide the environment in which great opportunities (the seeds of future capital gains) are found.

In a declining market, we are able to acquire additional earnings power for each incremental dollar invested. Accordingly, lower stock prices actually *reduce* the riskiness of an investment. When the market is down 7-10% from its peak, certain stocks that we track can be off significantly more than that. And when they are, we pounce. For long-term investors, widespread fear is our friend.

## Portfolio Review

In Q3 we closed out our position in **Express Scripts** (Nasdaq:ESRX). We have previously laid out our investment thesis in detail. Given our familiarity with the company, our conviction on the M&A situation and our assessment of limited downside risk, we made a large bet (6.8% weighting) that the acquisition by **Cigna** (NYSE:CI) would successfully close. Once all regulatory and shareholders approvals were obtained, the deal spread narrowed significantly and we fully exited the stock. We ended up with a +23% return on our Express Scripts investment in just over five months.

During the quarter, we also fully exited our previously-undisclosed position in **Williams-Sonoma** (NYSE:WSM). Our investment thesis was straightforward. In late 2016 the stock sold off significantly due to fears of emerging competition in furniture and home goods from online competitors **Amazon** (Nasdaq:AMZN) and **Wayfair** (NYSE:W). With the economy healthy and the housing market in good shape, we viewed the selloff as overdone and acquired the stock at $48.52 per share.

Our view was that WSM's strong brands (including Williams-Sonoma, Pottery Barn, West Elm, etc.), physical stores and customer loyalty would enable the company to successfully fend off these emerging online competitors. Importantly, WSM has also fully embraced online selling for consumers that prefer that option. Over 50% of the company's sales are through its online (higher-margin) channel. The company's debt-free balance sheet also gave WSM the ability to maneuver.

Fast forward 20 months and the company delivered revenue growth, decent margins and increasing dividends. The market rerated the stock and we sold out in August at $71.21 per share. Our overall gain was +52.3% with dividends included. Even today, the market remains enamored with fast-growing but unprofitable online companies such as Wayfair. We find the valuation discrepancies mindboggling:

| | WILLIAMS SONOMA | wayfair |
|---|---|---|
| Market Capitalization | $4,584 | $9,751 |
| Sales | $5,457 | $5,697 |
| Net Income | $264 | -$358 |
| Adj. EPS | $3.96 | -$2.91 |
| Share Price* | $56.90 | $108.73 |
| P/E (trailing) | 14.4x | nm |

Currency in millions of US$ (except per share items).

* As at October 27, 2018

In addition to our sales of ESRX and WSM, our top three contributors for Q3 were **Berkshire Hathaway** (NYSE:BRK.A) +14.7%, **Cisco Systems** (Nasdaq:CSCO) +13.1% and **Visa** (NYSE:V) +13.3%. Our laggards for the quarter were **Wells Fargo** (NYSE:WFC) -5.2%, **S&P Global** (NYSE:SPGI) -4.2% and **Booking Holdings** (Nasdaq:BKNG) -2.1%. Subsequent to the quarter we have trimmed a few existing positions and started adding a few new names that have been selling off steeply in October. We will save a discussion of these latest moves for a future newsletter.

## Bookshelf

I recently had the pleasure of attending an investment conference in Toronto where the keynote speaker was Bill Browder - the author of *Red Notice* which is one of my favourite books on the investment industry.

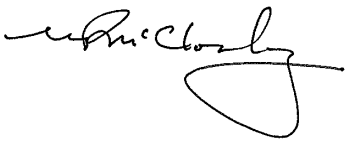
Red Notice is a gripping and sad but true story about corruption in post-Soviet Russia and the author's quest to deliver justice to the family of his former accountant Sergei Magnitsky. Mr. Magnitsky was murdered by the Russian state while wrongfully incarcerated in prison.

The book reinforced in my mind why we avoid investments in countries like Russia, China and Saudi Arabia that fail to embrace the rule of law. Beyond taking in the book's investment lessons, I was inspired by Mr. Browder's courage in trying to right a grave injustice despite his long odds and powerful adversaries. To date, he has been successful in getting a "Magnitsky Act" enacted in the US, Canada and several other countries to punish those responsible.

Unfortunately Mr. Browder's fight has come at a tremendous personal cost. His considerable security detail is a stark reminder that Mr. Browder will likely live the rest of his life in constant fear of being killed by the Russian state. I highly recommend Red Notice to finance and non-finance professionals alike.

We recently updated the Bookshelf section of our website with some of our favourite reads. We are voracious readers at GreensKeeper but can't read everything. If you come across something that is noteworthy, please drop me a note.

October 27, 2018



Michael McCloskey
President & Founder

## Facebook Redux

The Value Fund returned +5.3% in 2018 net of fees and expenses (or approximately +7.1% gross). We managed to outperform both of our benchmarks in 2018. The S&P/TSX Total Return Index finished down -8.9% for the year. The S&P500 Total Return Index was down -4.4% for the year. Measured in Canadian dollars (the Value Fund's reporting currency) the S&P500 Total Return was up +3.9% for the year.

This was our seventh consecutive year of positive returns. An aging bull market finally turned ugly in Q4 with steep declines in both October and December. The major North American stock indices sold off about 20% during the quarter. It was in this panicked environment that our portfolio shone. High quality companies that are undervalued tend to hold up under stress much better than former market darlings that trade at crazy valuations. Patience and hard work eventually pay off. Preserving capital by thoughtfully managing risk remains a cornerstone of our investment framework at GreensKeeper.

Given our significant U.S. stock holdings, the 8.6% appreciation of the US dollar in 2018 helped us. It basically retraced most of the 9.4% decline of the prior two years which lowered our returns in both 2016 and 2017. Exchange rate impacts on returns tend to be a wash over the long term. A more detailed explanation of our view on currency hedging (and our bias for not doing so) can be found here.

### Reflections on the Market

The business media constantly tries to dissect, in painstaking detail, the root causes of market volatility and to predict the market's future direction. Especially when markets are selling off. We are often asked for our own opinion on the subject. As longtime students of the market and investor psychology, we have come to the following conclusions.

Humans are genetically hard-wired to look for patterns and to come up with tidy narratives to explain complex events. Unfortunately, this predisposition often leads us to see patterns where none actually exist. It is our way of dealing with uncertainty. Uncertainty makes us uncomfortable. So we come up with explanations for each market move because attaching a plausible story to them makes us feel better. But that doesn't make these stories true.

The way that we process memory also causes us to think short-term.[1] We take current events and extrapolate them far into the future. As social creatures, we are also heavily influenced by the actions of others (crowd behavior). As a result, both fear and euphoria tend to be contagious. At its extremes, markets are driven purely by investor sentiment (fear and greed).

When fearful, investors focus on all the world's problems (trade wars, rising interest rates, etc.) which supports their gloomy narrative. As a result, they become risk averse and willing to part with stocks at almost any price. When euphoric, investors see the world through rose-coloured glasses. This confidence leads them to become risk-seeking and willing to purchase stocks at irrationally-high prices. During bullish periods, investors forget about risk.

When we find our emotions at either of these opposite extremes, we need to recognize it and to be cognizant of our blind spots. We need to keep calm and rely on analysis and logic, not emotion. The right temperament is essential to being a successful investor. One of our investing heroes put it this way:

> *If you're not willing to react with equanimity to a market price decline of 50% two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you're going to get… compared to the people who do have the temperament and who can… be more philosophical about these market fluctuations.*
>
> *Charlie Munger*

Longer term, valuations drive market prices. Rising stock prices may make us feel good in the moment, but they also increase the risk of owning equities. Plunging prices make us fearful so we try to avoid pain by selling (fleeing) despite the fact that lower prices actually make owning equities less risky. Learning to fight these innate human emotions are critical to investment success. It is hard. Without possessing the proper temperament, it is nearly impossible.

The market selloff of Q4 2018 created opportunity for us. Certain stocks that we follow sold off more severely than the market indices. As a result, we started several new positions late in the year, added to a few existing positions and exited others as better opportunities arose. We are not usually this active with the portfolio but try our best to react with equanimity when opportunity knocks.

[1] See, for example, Chapter 13 "Availability, Emotion and Risk" of *Thinking Fast and Slow*, by Daniel Kahneman – Nobel Prize winner in economics. For other recommended reading, please visit our bookshelf.

## Portfolio Review

Our biggest contributor to the portfolio in 2018 was our investment in **Express Scripts** (NASDAQ:ESRX). This was a "special situation" investment related to Cigna's pending (now completed) acquisition of the company which we wrote about in detail previously. When stocks are expensive, finding value often leads us to unconventional corners of the market. Given our familiarity with Express Scripts based on a prior investment, our conviction on the M&A situation and our assessment of limited downside risk, we made a large bet (6.8% weighting). We ended up with a +23% return on our Express Scripts investment in just over five months and the investment added about 1.2% to the portfolio returns for the year.

Our second-largest contributor for the year was furniture and home-goods retailer **Williams Sonoma** (NYSE:WSM). As reported in Scorecard #23, we bought the stock after a steep selloff in late 2016. After reporting strong results in September 2018, the market rerated the stock and it started trading above our estimate of fair value. As a result, we swiftly and fully exited our position. We rarely time stock purchases or sales perfectly, but in the case of WSM we nailed it. Our exit price of $71.21 was close to the stock's high for the year. Including dividends, our investment in WSM added about 1.1% to our returns for the year.

Technology stalwart **Cisco Systems** (Nasdaq:CSCO) was our third-largest contributor, adding about 1.1% to portfolio returns for 2018. We have continuously owned Cisco since inception of the Value Fund in 2011. While popular during the dot-com era of the late '90s, the stock was unloved and trading at less than 10x earnings ex-cash when we started buying it (below $18.00). Cisco may be slow growing, but it is a cash machine and uses that cash to acquire emerging technologies and rewards shareholders through a combination of growing dividends and share repurchases. Eight years on from our initial purchase, we are sitting on a sizable capital gain in an investment that we contend has been low risk given the quality of the business and our attractive entry price.

Rounding out the top five contributors for the year were **Visa** (NYSE:V) and **Berkshire Hathaway** (NYSE:BRK.A/B). These high-quality companies continue to grow earnings and should thrive for many, many years to come.

On the negative side of the ledger, **Wells Fargo** (NYSE:WFC) continued to disappoint and was our worst performer in 2018. We were initially attracted to the company due to its historical track record. At its core, Wells Fargo is a well-diversified bank with a prudent lending culture and low-cost deposit base. As a result, the company has historically delivered high returns on assets (ROA) and returns on equity (ROE) leading to attractive returns for shareholders. Unfortunately management lost the plot. In an effort to accelerate growth, senior management put undue pressure on employees which led to multiple scandals that hurt customers, damaged the company's reputation and provoked a regulatory backlash. We believe that Wells Fargo will get through this period intact but remain disappointed as this was an entirely self-inflicted wound. Our investment in Wells Fargo detracted (0.8%) from portfolio returns in 2018.

Another disappointment during 2018 was our remaining stake in **Corus Entertainment** (TSX:CJR.B). We set out our investment thesis for Corus in Scorecard #14. At the time of purchase, our analysis led us to conclude that it was one of the cheapest media stocks in North America. Despite a few twists and turns, the company delivered reasonable results and we sold half of our position at a sizable gain in 2017. Unfortunately we should have sold it all. In January 2018 Corus delivered very disappointing results and we sold the balance of our position at a loss. The gains that we made on Corus in 2017 plus the significant dividends received along the way were five times greater than the losses incurred in 2018. So overall Corus was a very profitable investment for us (buying cheap usually leads to decent results). However, when we sold the first-half of our position, Corus was only modestly undervalued. In other words, our margin of safety had largely disappeared. We try and learn from our mistakes and in hindsight, should have sold it all in 2017 and invested the proceeds elsewhere. (Hard) lesson learned.

Lest we finish this portfolio commentary on a sour note, 2018 was a good year for the Value Fund. We outperformed both of our benchmarks and almost every major asset class in an environment that was downright ugly at times. More importantly, many of our investee companies increased their *intrinsic value* at an attractive rate. We don't mind the recent market chaos as it gives us an opportunity to find bargains. In addition, many of our companies generate excess cash which they use to repurchase their own shares. Lower stock prices allow them to get more value for each dollar spent and should lead to superior long-term results provided that these companies continue to execute well on their core businesses.

We finished the year with a net cash position of about 9.9% and unrealized gains on our equity investments of approximately $4.6 million on a $25.8 million portfolio. Additional portfolio disclosures including performance statistics can be found on the pages immediately following this letter. Once KPMG completes its audit of the Value Fund's Financial Statements in March, we will provide clients with a more detailed snapshot of the entire portfolio at year end.

## Facebook

One of the stocks that sold off significantly more than the market in 2018 was **Facebook** (Nasdaq:FB). With stock off as much as 40% from its peak, we took note and established a position.

We previously wrote about Facebook at the time of its initial public offering (IPO) back in 2012. Here's what we had to say about the company at that time:

> *Facebook may be an amazing social utility, but it is too early to tell if it will evolve into a cash generating machine like Google. Facebook is approaching 1 billion users, a truly astonishing feat. However, its business model is still evolving as the company struggles to find ways to monetize this traffic.*
>
> *So how do you value a business like Facebook? I would argue that it can't be done. In my opinion, you cannot predict with any degree of certainty how much money the company will make in the coming years or whether or not they will be displaced by a newer technology. In other words, prudent investors should stay away.*

At the time, Facebook was trading at $30 a share versus $150 today. Were we wrong in not purchasing? Perhaps. But as prudent value investors, we stand by our earlier assessment that it was too early at the time to know how Facebook would unfold (at least in our minds). But six years on, many of our questions have now been answered. In any event, the company's current challenges combined with the market selloff gave us an attractive entry price in Q4 2018.

Since its IPO, Facebook has made massive strides. Monthly active users of the platform went from 0.9 billion to 2.3 billion today. The company's IPO revenue run rate of $4 billion now exceeds $50 billion and what was a modestly profitable company will earn over $21 billion this year. Facebook has become a cash machine. The company has successfully migrated from the PC era to mobile. Emerging competitors were either eliminated via acquisition (Instagram, WhatsApp) or their popular features copied and integrated into Facebook's offerings (e.g. Snapchat). Facebook and its sister platforms are now *the* dominant social media networks and given the quality of its wide moat via network effects, that will likely be the case for many years to come.

Facebook also benefits from the increasing percentage of advertising spending that is allocated to digital platforms. Despite Facebook's significant size, these tailwinds helped the company to grow its revenues by an impressive 35% in 2018. This growth rate will inevitably slow, but at our average purchase price of $141.29 per share, we paid about 16.5x current year earnings ex-cash. For context, this is lower than the overall market multiple for a high-quality company that is growing much faster than the market.

The Facebook selloff from its July 2018 peak was due to several well-reported scandals. The company's platform was used by bad actors to influence the 2016 US presidential election. The company also has a history of paying less attention to user privacy than they should and the Cambridge Analytica scandal is but the latest incident.

Users are mad (as they should be). Mark Zuckerberg and Sheryl Sandberg have made mistakes. But they are smart, determined to fix the issues plaguing the company and we believe that they will get through this difficult period.

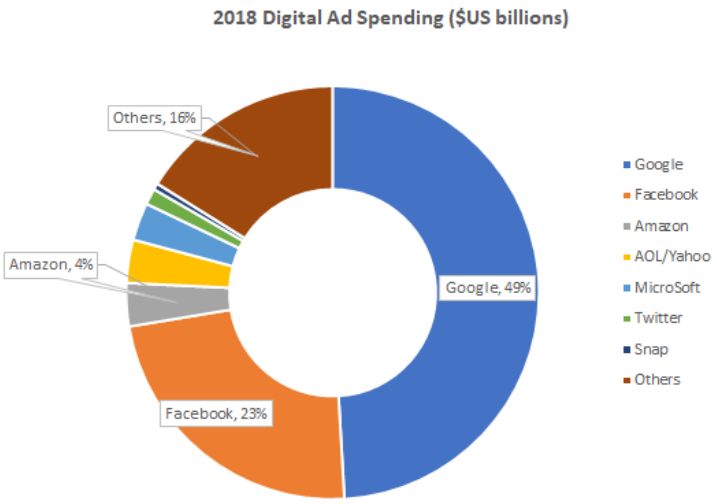
Angry users of the platform will vent. But given the utility of the free service and the amount of time, effort and content that users have invested into the platform, our bet is that they will stay. Habits are hard to break. The latest user trends do not suggest that people are abandoning the platform. In fact, the number of users of Facebook-owned platforms is still growing. Given the number of users and the highly-personalized data that the company has on its users, advertising dollars will continue to flow to Facebook.

Another oft-voiced concern raised is the emergence of Amazon as a competitor for digital ad dollars. Yes, Amazon is attracting ad dollars but the actual numbers speak volumes. As the table and chart below illustrate, Facebook and Google are completely dominant. In fact, over the past two years these two companies have captured practically *all* of the incremental digital advertising spending in the world.

The reason is quite simple. Given the quality and vastness of the data that these two companies have amassed on their billions of users, advertising on the platform can be highly targeted and is thus very effective. In fact, a recent survey of US digital ad buyers reported that Google and Facebook platforms delivered the highest returns on advertising investments for 86% of respondents.[2]

Digital Ad Spending - $US Billions

| | 2015 | 2016 | 2017 | 2018E |
|---|---|---|---|---|
| Digital Adverising | | | | |
| Google | $67 | $79 | $95 | $116 |
| Facebook | $17 | $27 | $40 | $55 |
| Amazon | $2 | $3 | $5 | $8 |
| AOL/Yahoo | $5 | $5 | $5 | $8 |
| MicroSoft | $5 | $6 | $7 | $7 |
| Twitter | $2 | $2 | $2 | $3 |
| Snap | $0 | $0 | $1 | $1 |
| Others | $53 | $56 | $54 | $38 |
| TAM - Digital | $151 | $178 | $209 | $237 |
| Digital as % Total Ad Spend | 32% | 36% | 41% | 44% |
| TV | $175 | $182 | $178 | $183 |
| Other Media | $141 | $133 | $122 | $119 |
| Total Ad Spend | $466.4 | $493.0 | $509.3 | $538.6 |
| | | | | |
| Capture of Incremental Digital Spend | | | | |
| Google | | 43% | 53% | 74% |
| FB | | 35% | 43% | 54% |
| | | 79% | 96% | 129% |




*Sources: GreensKeeper estimates, Statistica, MAGNA; Recode; eMarketer*

Facebook is doing the right thing by hiring thousands of additional employees to address its challenges. The additional costs associated with these initiatives will cause margins to compress over the short term. But with gross margins of 85% and operating margins of 48%, the company has margin to give and growing revenues will mitigate the impact of margin compression. Eventually, artificial intelligence (AI) will automate many of the less-efficient procedures currently being used. Unlike other media companies, content is provided by users - for free! Instagram and WhatsApp are only beginning to be monetized. Facebook has rapidly matured into a great business.

The risk of regulatory intervention is real and one that we will be monitoring closely. We think that it will be more difficult to regulate social media companies than people think. Especially by politicians that fail to comprehend basic facts such as how these platforms actually work. As with all of our investments, we reserve the right to change our mind as the facts and the future present themselves.



[2] Cowen and Company - December 2017 survey.

We like the fact that the company has over $41 billion of cash and no debt. We also like the fact that management has started to aggressively repurchase its shares ($14 billion worth over the past year) and the stock's selloff allows them to reduce their share count even faster. We agree with management's focus on increasing user engagement and make investments in the long-term health of their platforms at the expense of short-term profitability.

Our bet is that Facebook will successfully navigate their current challenges and those that will inevitably arise in the future. We also believe that the company will be making materially higher profits five and ten years from today. If they do, the combination of revenue growth, rising profits and a lower share count should turn Facebook into a highly profitable long-term investment for the Value Fund.

## 2019 and Beyond

My capacity to devote an even greater percentage of my time to analysis and stock selection has dramatically improved with the addition of Michelle Tait to the GreensKeeper team two years ago. Michelle does a fantastic job handling client enquiries, regulatory compliance and other administrative functions which frees up my time to do what I love most. Thank you Michelle!

I also want to thank all of our clients for the trust that you have placed in us. Investing your money (alongside our own) is something that we take very seriously. We are also appreciative of the referrals that you send us. We grew our assets under management (AUM) once again in 2018, as we have every year since inception, thanks to you.

Eight years in, My Painting (also known as the Value Fund) is not yet finished, nor will it ever be. My passion for reading and lifelong learning drive me to hone my craft in order to deliver attractive returns to the firm's clients. We will remain consistent and disciplined in our approach for many years to come.

Michael P. McCloskey

President, Founder &
Chief Investment Officer

GreensKeeper
ASSET MANAGEMENT INC.

# GreensKeeper Value Fund

As at December 31, 2018

## Fund Details

| | Class A | Class F* | Class G** |
|---|---|---|---|
| Fund Codes | Pending | Pending | Pending |
| NAV | $15.07 | $15.28 | $11.66 |
| MER (%) | 1.8% | 1.3% | < 1.8% |

| | |
|---|---|
| Load Structure | No Load |
| Performance Fee | 20% over 6.0% annual hurdle |
| Min. Initial Investment | $50,000 |
| Min. Investment Term | 1 Year |
| Registered Plan Status | 100% Eligible (RRSPs, TFSAs, RESPs, RDSPs, LIRAs, RIFs, etc.) |
| Inception Date | November 1, 2011 |
| Type of Fund | Long equity, Long-term capital appreciation |
| Fund Category | Global Equity |
| Currency | CAD |
| Valuations | Monthly |
| Redemptions | Monthly on 30 days' notice |
| Distribution Frequency | Annually (December) |

| Fund Distributions (Class A) | Dec. 31 | ($/unit) |
|---|---|---|
| | 2012 | $0.2318 |
| | 2013 | $0.2147 |
| | 2014 | $0.6542 |
| | 2015 | $0.2939 |
| | 2016 | $0.5416 |
| | 2017 | $0.0000 |
| | 2018 | $0.5752 |

## Service Providers

| | |
|---|---|
| Investment Manager | GreensKeeper Asset Management Inc. |
| Custodian | National Bank Independent Network |
| Auditor | KPMG LLP |
| Administrator and Registrar | SGGG Fund Services Inc. |

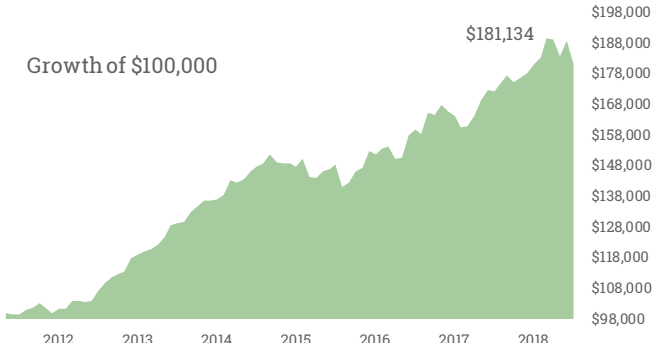
## Investment Objective

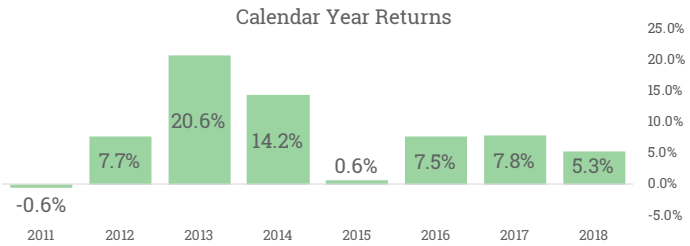
To deliver absolute returns to unitholders (net of all fees) in excess of both the S&P/TSX Index and the S&P500 Index (measured in Canadian dollars) over the long term. The Fund seeks to accomplish its set objective through investments in a concentrated portfolio, primarily in equities from any sector and market capitalization.

## Investment Eligibility

Accredited Investors including Investment Advisors (IAs) with long-term time horizons seeking to better protect and diversify their clients' equity portfolios.

## Portfolio Performance (Class A)




| | | | Annualized | | | |
|---|---|---|---|---|---|---|
| Compound Returns[1][2] | 1 MO | YTD | 1 YR | 3 YR | 5 YR | Inception |
| Value Fund | -4.0% | 5.3% | 5.3% | 6.9% | 7.0% | 8.6% |

## Portfolio Allocations

| Asset Mix * | |
|---|---|
| U.S. Equity | 80.7% |
| Cash and Equivalents | 9.9% |
| European Equity | 8.0% |
| Canadian Equity | 0.9% |
| U.S. Options | 0.5% |

| Sector | |
|---|---|
| Technology | 30.8% |
| Financial Services | 17.6% |
| Insurance | 16.1% |
| Cash & Equivalents | 9.9% |
| Healthcare & Pharma | 7.8% |
| Consumer & Retail | 6.9% |
| Industrial | 5.1% |
| Energy | 2.8% |
| Communication & Media | 2.5% |
| Other | 0.5% |

* Based on corporate domicile.

# GreensKeeper Value Fund

## Portfolio Manager

Michael McCloskey
B Sc, JD, MBA, CIM, AR
Founder, President &
Chief Investment Officer
905.827.1179
michael@greenskeeper.ca

Our founder is among our largest investors and has over 70% of his family's net worth invested alongside our clients.

- Former Investment Banker (2002-2010)
- Former Lawyer (Partner), Securities and M&A (1995-2002)

## Statistical Analysis [3]

| | Value Fund | S&P/TSX | S&P500 ($CAD) |
|---|---|---|---|
| Fund Beta vs. Selected Index | n/a | 0.39 | 0.47 |
| Standard Deviation | 6.2% | 8.3% | 10.0% |
| Sharpe Ratio | 1.23 | 0.57 | 1.59 |
| Best Month | 4.7% | 5.3% | 6.9% |
| Worst Month | -5.1% | -6.3% | -6.6% |
| Percentage Positive Months | 72.1% | 62.8% | 72.1% |
| Maximum Drawdown | -7.1% | -14.3% | -9.0% |
| CAGR Since Inception | 8.6% | 5.3% | 17.6% |

## Investment Philosophy

We follow a time-tested value investing process and conduct bottom-up fundamental research to identify attractive and underpriced equity investments for the portfolio. GreensKeeper believes in buying an interest in a quality business for less than its true worth or *intrinsic value*. That discount provides us with our *margin of safety* to safeguard our clients' investments.

### Aversion to Leverage

Aversion To Leverage : We avoid the use of leverage. As a result, we are never forced to sell when market conditions are difficult (and stocks are undervalued).

### Our Best Ideas

Only our best ~20 ideas find their way into the Value Fund. We prefer to assume shorter term volatility in exchange for what we expect will be longer-term outperformance.

### How We View Risk

We reject the premise that volatility is the proper way to define and measure risk. Instead we believe that risk is best defined as the risk of a permanent loss of our clients' capital.

## Disclosures

[1] All returns are as at December 31, 2018. [2] GreensKeeper Asset Management Inc. (GKAM) assumed the investment management responsibilities of the Value Fund on January 17, 2014. Prior to that date, the Value Fund was managed by Lightwater Partners Ltd. while Mr. McCloskey was employed by that firm. [3] Where applicable, all figures are annualized and based on monthly returns since inception. Risk-free rate calculated using 90-day CDN T-bill rate. * Class F Units are for purchasers who participate in fee-based programs through eligible registered dealers. ** Class G Units are for purchasers and dealers who have greater than $1 million managed by GreensKeeper and who enter into a Class G Agreement with us. Class G Units are not charged a management fee or performance fee by the Fund as Fees are paid directly to the Manager pursuant to the Class G Agreement.

This document 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 GreensKeeper Funds (collectively, the "Funds"). Any such offer or solicitation will be made to qualified investors only by means of an offering memorandum and only in those jurisdictions where permitted by law. GKAM 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. Investments should be evaluated relative to an individual's investment objectives. The information contained in this document is not, and should not be construed as, legal, accounting, investment or tax advice. You should not act or rely on the information contained in this document without seeking the advice of an appropriate professional advisor. Please read the Fund offering memorandum before investing.

The Funds are offered by GKAM and distributed through authorized dealers. Trailing commissions, management fees, performance fees and expenses all may be associated with an investment in the Funds. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may reduce returns. There is no guarantee that the investment objective will be achieved. Past performance should not be mistaken for, and should not be construed as an indicator of future performance. The performance figures for the GreensKeeper Value Fund include actual or estimated performance or management fees and are presented for information purposes only. This document has been compiled by GKAM from sources believed to be reliable, but no representations or warranty, express or implied, are made as to its accuracy, completeness or correctness. All opinions and estimates constitute GKAM's judgment as of the date of this document, are subject to change without notice. GKAM assumes no responsibility for any losses, whether direct, special or consequential, that arise out of the use of this information. 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. 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 GKAM's knowledge the information throughout the presentation is current as of the date of the presentation, but we 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.

GreensKeeper
ASSET MANAGEMENT INC.

## GreensKeeper Value Fund

### Disciplined

Value Investing is simple, but not easy. At GreensKeeper we put in the work and have the proper temperament to succeed in the stock market.

### Alignment of Interests

Our founder is among our largest investors and has over 70% of his family's net worth invested alongside our clients. Does your investment manager have any of his/her own money invested alongside yours?

### Owner Managed

Our clients deal directly with the people actually making the investment decisions. Do you know who is managing your money?

**#DemandMore**

GreensKeeper
ASSET MANAGEMENT INC.

## GreensKeeper Value Fund

### Testimonials

Don't just take our word for it. See what our clients are saying :

*"My family has known Michael for over 20 years and we have invested in the Value Fund. He has a track record of success and we sleep soundly at night knowing that he is growing our investments safely."*

**Dr. Erin Ray,**
Anesthesiologist
Royal Victoria Hospital

*"I have known Michael for over 15 years and consider him a valued and trusted adviser. His prudent investment approach for the long term that ignores the short term market volatility is the reason we have invested much of our long term savings with him."*

**Erik de Witte**
Entrepreneur, Former President
TD Financing Services

*"Michael has a conservative yet productive approach to selecting companies to invest one's hard earned cash. I will be increasing my level of funds with Michael."*

**Peter McDonnell**
Retired, Former President
Adcom Inc

*"We began investing with GreensKeeper in 2013. A large portion of our three grandchildren's education money is guided by Michael McCloskey and his patient advice. We have a long-term view towards investing and trust in the fund's risk aversion strategy for preservation of capital. I recommend GreensKeeper to my friends and family."*

**Timothy A. Brown**
President & CEO
ROI Corporation

The foregoing testimonials are from existing GreensKeeper client families and may not be representative of the views of all people or investors. Certain testimonials were provided unsolicited and others were provided by request.