IBV CAPITAL

Q4 Partnership Letter
February 2017

Dear Partners,

Apparently, the world is not as economically troubled as once thought. At least, for now, that is the verdict being conveyed by North America's seemingly schizophrenic stock and bond market participants. Over the last few years, we have been questioning the market's intense pessimism in two ways: in our quarterly letters, and by deploying our investment dollars into overlooked US-based industrial and financial companies. The latter has been by far the more rewarding of these two pursuits.

Without subjecting our long-time readers to a complete re-print of past letters, we will summarize our thoughts on the misplaced pessimism as follows: (1) US GDP growth has been good, though not great, and it doesn't need to be[1] (2) global economic growth will produce a spectacular amount of wealth over the long run, so we have an optimistic bias[2] (3) politics is, well, just politics (4) be skeptical of the predictions from weathermen, political pundits, and market forecasters.

While US economic conditions are likely to improve under the policies that President Trump has proposed, all things remaining equal, it will take considerable time before we see a meaningful impact. We should note that our investments are viewed through this lens - or should we say telescope.

Being based in Canada, it's only appropriate that we use Prime Minister Trudeau's infrastructure spending policy to illustrate our point. Over the next ten years, Canada's federal government intends to spend $120 billion on infrastructure. This plan has two phases, with Phase One taking place over the next two years and including $11.9 billion of spending on: public transit (29%), green infrastructure (42%), and social infrastructure (29%). Phase Two will occur over the subsequent eight years and target $108.1 billion in spending. This means that over 90% of this highly anticipated spending, announced in the first budget of our newly-formed government, will occur after Prime Minister Trudeau's first two years in office, with most falling into a projected second-term. This makes his (or any other democratic world leader's) entire long-term infrastructure plan highly susceptible to a change in policy direction, should he not be re-elected. It also means the plan is an unlikely catalyst to immediately boost the economy's growth trajectory.

We attribute this delayed economic impact to the time it takes for governments to transition a cabinet, for new cabinet members to find their desks, choose their desired projects, develop project

[1] Discussed in detail in our Q3 2016 letter: http://ibvcapital.com/q3-2016-partnership-letter-2/
[2] Discussed in detail in our Q1 2016 letter: http://ibvcapital.com/q1-2016-partnership-letter-2/

plans, tender bids, and finally execute the required construction. As we all know, infrastructure construction is *always* on time and under budget, so this last step typically goes as smoothly as the ones that preceded it.

This process and the length of time it takes is not unique to Canada. We anticipate it being particularly relevant in the case of President Trump's ambitious infrastructure spending plan. In fact, we expect even greater delays, due to the President's glaring void of detail on his policy stances and his Cabinet's political inexperience (although they are full of business acumen).

Donald Trump's victory, BREXIT, and Italy's referendum outcome should all illicit intense reflection. The first two events weren't expected to happen (by anyone, including the "experts"), and the Italians would have benefited from voting 'Yes', but instead voted 'No'. The common thread between them? Unexpected market impacts.

BREXIT immediately eliminated $3 trillion of wealth in global stock markets. Within a few days, this precipitous decline had entirely reversed (sans British real estate and the pound). This overarching sanguine market response is predominantly due to delays in invoking Article 50, and consequently, has muted the immediate impact of BREXIT on the economy. As this story unfolds, I would refer new readers to our second quarterly letter[3] in 2016, which illustrates the insignificant global GDP impact of a major recession taking place in the United Kingdom.

The extent of Donald Trump's negative impact on markets lasted only hours, a fraction of the duration of BREXIT's impact, mostly while North American markets were closed. The IBV Capital team watched in awe as Americans elected the most unlikely presidential candidate in modern times. Our investment shopping list, prepared long before the outcome was known, had us eagerly awaiting market turmoil. Unfortunately, market drama didn't ensue and stocks have been climbing steadily ever since. However, with one eye on Twitter and the other on our shopping list, we're ready for some market moving comments.

On the other hand, Italy's referendum's market impact has suggested investors are dismissing the underlying problems it has created. This vote, perhaps not widely followed in North American markets, was to approve reforms to the country's constitution, making the passing of laws more streamlined. Most voters saw it as a vote on Prime Minister Matteo Renzi, who promised to resign if the result was 'No'. By avoiding reforms, Italy, a chronic economic underperformer, has missed a wonderful opportunity to improve their financial and political stability, which would have fostered an environment for future economic growth. Instead, the vote's outcome immediately affected the country's struggling financial system. Banca Monte dei Paschi di Siena's capital raising efforts, specifically designed to repair their balance sheet that was devastated by bad loans, completely stalled.

This capital raising effort was immediately impacted by the uncertainty over how Italy's antiquated bankruptcy laws, which would have been fixed by the reforms, would impact the sale of bad loans and consequently the bank's bailout. Banca Monte is the world's oldest bank and Italy's third largest commercial bank, making it an important financial institution in the country and Europe. If not properly managed, its failure could prompt another confidence crisis in European financial

[3] http://ibvcapital.com/q2-2016-partnership-letter1/

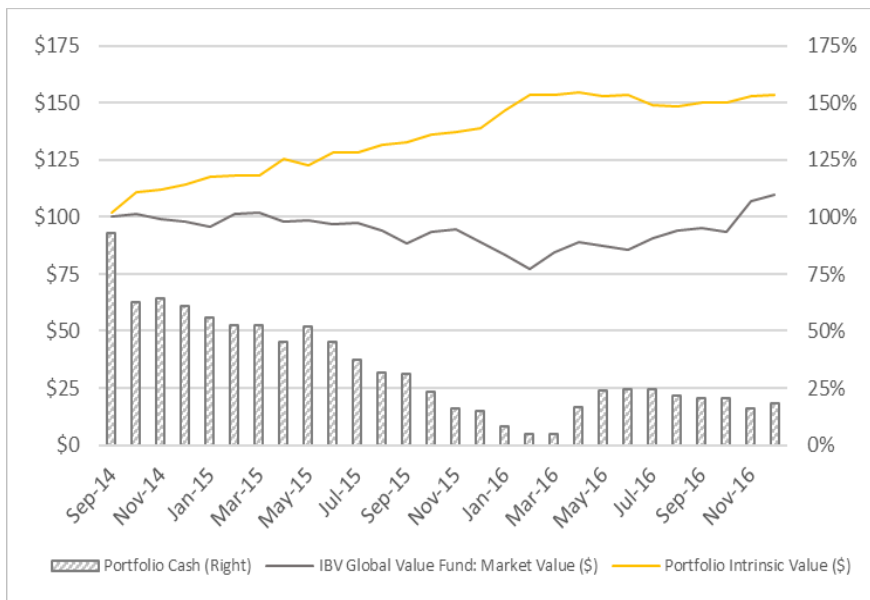
institutions, which has historically crossed to North American shores - hence our intense interest in the reform's outcome and the government's response to the banking situation, which to date has been a clever plan to conduct a non-bailout "bailout".

Our Performance

The market value of our investment portfolio increased by 15.2% in the fourth quarter, and we finished the year up 23.5%. The intrinsic value[4] of our portfolio increased by 2.4% in the quarter and increased 0.2% during 2016. For comparative purposes, during the fourth quarter and all of 2016, the MSCI World Index increased by 1.9% and 7.5%, respectively[5].

Over the past two years, we have diligently applied our rigorous analysis and systematic investment process, purchasing a select few securities that exhibit attractive investment characteristics, and per our calculations, a significant Margin of Safety. Our sole objective has always been (and always will be) to meaningfully increase the intrinsic value of our portfolio, as over time, this has historically led to meaningful portfolio returns. Since our 2014 inception, we have consistently achieved our intrinsic value objectives, and this year, the market value of our portfolio finally began to reflect this fact.

To help you understand what to expect from our investing efforts, we began sharing the intrinsic value of our portfolio and how it has changed over time. Cumulatively, the portfolio's intrinsic value has increased by 50.8%. The market value of our portfolio has responded in an expectedly delayed fashion, increasing by 9.8% over that same timeframe. This leaves our current Margin of Safety gap at 40.0%.



[4] We would encourage all new readers to visit the "Our Liquid Conglomerate" section of our Q2-2016 investment letter to assist them in understanding the meaning and importance of our portfolio's intrinsic value.

[5] "**IBV Global Value Fund**" consist of USD$ IBV Capital Global Value Fund LP Class M unit returns, gross of fees. Inception date of this class is October 1, 2014. "**Portfolio Intrinsic Value"** represents IBV's internally calculated intrinsic value for the cumulative securities within the IBV Global Value Fund. "**MSCI World Index**" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures are found on Page 7.

The market value of our portfolio increased rapidly during the final six months of 2016. With most positions increasing at around the same pace, the impact on the portfolio's weightings was most apparent in our cash position. This year represents a perfect case study of how we think about and utilize cash. At the end of 2015, our cash position stood at 15%, reflecting our sentiments on investment opportunities at the time. As the markets plunged in January and February, we deployed nearly all our cash, dropping it to 6%. By mid-year, as select investments reached their intrinsic values, we sold them, rebuilding our cash (for future deployment) to 25%. We have since finished 2016 with 19% of the portfolio in cash, which once again reflects our sentiments on the availability of investment opportunities that meet our investment criteria.

Portfolio Developments

This past quarter dramatically changed the market value and composition of our portfolio. However, it did not meaningfully change what companies we're invested in. As of this writing, our largest investments are still in the US Financial sector - specifically, Bank of America and Citigroup. We have been invested in these two banks for over six years (pre-dating the launch of the IBV Capital Global Value Fund), and our investment thesis has continued to play out over this period.

Since the inception of the IBV Capital Global Value Fund, we built our position in these two institutions during very select times. We first bought a small stake when the Greek debt crisis sparked fear in financial markets of the disintegration of the European Union. Then, earlier this year, when the market was paralyzed with fear as the oil crisis hit its peak and the world's economy was in "peril", we got very greedy, increasing our combined positions by 29% in Bank of America and Citigroup to represent 26% of the fund's portfolio.

During both periods, we used our deep understanding of these banks to assess whether these events would cause irreparable damage to their fundamentals. In the case of the Greek debt crisis, their exposure to that economy was miniscule. In addition, the European Union, as they had in the past, was positioning themselves to overcome immense internal political differences to avoid a messy default. We outlined our thoughts on how Greece would ultimately impact the globe in our 2015 Semi-Annual letter[6] – the truck is far in the world's rear-view mirror now.

Similarly, the market's reaction to Bank of America and Citigroup's commercial loan exposure to the oil and gas space earlier this year was completely unreasonable. Not only were their respective loan exposures small (both funded and unfunded), relative to their balance sheet and tangible common equity base, but both banks' other segments were performing well enough to offset any uptick in write-offs. The United State's well diversified economy is remarkably versatile and adaptable, making isolated industry events (beyond financial institution failure and housing) more manageable.

Now that the industry has moved beyond this "scare" (there will be more "scares" in the future – of that we assure you), the fundamentals of these banks are moving to the forefront of investors'

[6] http://ibvcapital.com/2015-semi-annual-partnership-letter/

minds. Trump's election, with a platform of lower corporate taxes and less regulations, has merely added fuel to the already impressive potential earnings power of these institutions. While we welcome the prospect of fast and sustainable economic growth, it's important to note, we have not changed our fundamental projections based on a policy hyperbole.

On the financial regulatory front - an appropriate topic considering the rhetoric that exists today - we have a counter-intuitive view. While most complain about the oppressive nature of current banking regulations, we think increased regulation enhances larger institutions' (such as the ones we own) competitive advantage or "moat". The complexity of these regulations, while admittedly adding costs, is deterring new entrants (read fintech) to the space. This relegates those who would like to compete in financial services to the fringes, or forces them to partner with an established bank to be successful. Further, economies of scale mean the cost of compliance is more easily dispersed over a large institution than smaller institutions, creating an advantage within the banking industry itself. Finally, by promoting a focus on risk management, a by-product of intense regulatory scrutiny, it's helping to improve all banks underwriting practices, making them much safer investments. Regulation, while expensive to implement and maintain, is a big bank's best friend.

When speaking about Bank of America and Citigroup's valuations, most refer to book value, a proxy for their liquidation value. We suspect, based on their per share earnings power from larger deposit bases, higher interest rates, lower non-interest expenses, and continued share repurchases, that this conversation will soon shift to a price-to-earnings discussion. By this metric, banks are tremendously undervalued, relative to both the market and historical trends. We're still quite pleased with our two "financial utilities" and will continue to hold them.

A discussion about banks has made it into most of our investment letters, a trend many of our early readers have surely noticed. So not to seem unnecessarily repetitive, we'll explain why. Besides being our largest investment, we gravitate towards this space because it represents a vast investible universe that's often misunderstood by market participants. This leads to swaths of companies, especially smaller ones, being left completely untouched by knowledgeable investors. We suspect this is because banks are notoriously complex, they have unique business models, and their financial statements (and FDIC reporting documents – a great source of detailed data) are confusing and cumbersome to analyze. It may also be attributed to the financial crisis that, not unlike the Savings and Loans crisis in the 1980's, only enhanced the anxiety of investing in banks. We're confident that over time, the frequency and attractiveness of investment opportunities in this industry will exceed those of other industries, making our focus on the space, time well spent.

On occasion, we've spoken with readers who astutely note our seeming lack of interest in Canadian banks. Since Canadian financial institutions represent 35% of the TSX and our team is Canadian, it would appear their absence in our portfolio is an error of omission. We're afraid this is not the case. Canada navigated the financial crisis well, but we sense this has instilled overconfidence in the soundness of our financial institutions and their underwriting practices. Today, US financial institutions, after having appropriately corrected their past misdeeds, represent a much more attractive investment in terms of value, growth, safety and transparency.

Similar to increasing our bank exposure, our investments in Enbridge Preferred Shares at an

average entry price representing a 31% discount to par (we own two different issues) were particularly timely. As discussed in our 2015 Annual Letter[7], the high yield bond and preferred rate reset market in Canada was unravelling quickly. Falling oil prices were prompting falling Canadian GDP growth projections and consequently lowering interest rates - creating a dour investment environment. As investors began realizing their "safe" yield in widely held preferred shares would be eliminated upon a rate reset, they began dumping their investments.

Enbridge, whose business model has remained largely intact despite oil price declines, had multiple preferred share issues, with some being tied to US interest rates. At the time, these US dollar denominated issues enjoyed surprisingly high interest rate spreads above five-year US Treasury rates, considering Enbridge's credit quality. So, over the course of the first quarter, when these US rate reset preferred shares were washed out alongside their Canadian counterparts, we continued our buying ways, increasing our position by 30% to represent an 8% stake in the portfolio. With markets calming over the course of the year, these issues began trading much closer to par and now the rate resets that will occur in 2017 and 2019 should significantly increase the dividends we receive.

Running on all Cylinders!

While being selective about how we use our time, promoting education of financial markets and investing is an important pursuit of the team at IBV Capital. For this reason, we continue to speak candidly with our present partners and investing community about investing, markets, and business in general.

This includes our focus on providing informative and transparent quarterly letters as well as attending speaking engagements and writing the occasional article:

- This fall, I participated in a panel discussion in Calgary with the purpose of sharing my insights with business owners who are considering selling their companies. The response to the panel was overwhelming. Most of the conferences 250+ participants hadn't considered the tectonic shift from being a business owner to being a wealth manager and what that would mean for them and their families.

- In December, Advisor.ca released a column we wrote on value investing[8]. It's a succinct primer on how we think about investing and business in general. We would encourage you read it.

- On March 1st, I'm participating as a speaker alongside a group of influential portfolio managers, at the Toronto CFA Society's Equity Symposium. At this event, each speaker will have 20 minutes to present a top investment idea and walk the audience through their detailed thesis. We believe this to be an excellent way to share how we approach an

7 http://ibvcapital.com/2015-annual-partnership-letter/

8 http://www.advisor.ca/investments/market-insights/deep-value-investing-dispelling-the-ultimate-investing-misconceptions-220280

investment opportunity, and for the audience to gain insight into the thought process of six industry leaders. If you are interested in attending, tickets can be purchased directly through the Toronto CFA Society's website[9].

We have much to be thankful for at IBV. This past year produced excellent investment results. Further, our firm continued its considerable AUM growth trajectory, increasing our assets under management from $35 million to $59 million year over year. Since we began accepting outside investment partners in 2014, we have grown by over 83%! We're proud of these accomplishments and honored that you, our investment partners, continue to trust us with your hard-earned dollars.

Sincerely,

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[9] https://cfainstitute.force.com/eventapi__simple_event?id=a1Oj0000001UzWWEA0&site=a0Wj0000005liezEAA