



Portland Investment Counsel®  
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# PORTLAND FOCUSED PLUS FUNDS

**ANNUAL LETTERS  
TO INVESTORS  
2013-2025**

A history of intelligent management and  
outsized performance.

# PORTLAND FOCUSED PLUS FUNDS

As stated in the Fund’s Offering Memorandum (the “OM”), the Fund’s investment objective is “to achieve, over the long term, preservation of capital and a satisfactory return.”<sup>2</sup>

## JAMES COLE

James has over 40 years of investment experience including more than 30 years as a portfolio manager responsible for Canadian and U.S. equities.

Investment funds managed by James have received several national awards.

Prior to joining Portland, James was a portfolio manager with Gluskin Sheff + Associates Inc. and prior to this was Vice President and Portfolio Manager with Beutel, Goodman & Company Ltd. James also was a securities analyst for nine years culminating in 1992 with being ranked in the Brendan Wood survey of institutional investors as the #1 communications and media analyst in Canada.

James was formerly the treasurer of CFA Society Calgary and previously served for three years as a director of CFA Society Toronto and chairman of its accounting and disclosure committee. James holds a degree in Economics from Trent University and earned his Chartered Financial Analyst (CFA) designation in 1986.



James Cole, CFA  
Senior Vice President  
and Portfolio Manager

<p><b>Portland Focused Plus Fund LP</b> <b>Equity Focused</b> Best 1 Year Return <b>2nd Place</b><sup>3</sup></p>	<p><b>Portland Focused Plus Fund LP</b> <b>Equity Focused</b> Best 10 Year Return <b>2nd Place</b><sup>3</sup></p>
<p><b>Portland Focused Plus Fund LP</b> WINNER OF THE 2020 CANADIAN HF AWARDS <b>Equity Focused</b> Best 5 Year Return<sup>3</sup> 3rd Place</p>	<p><b>Portland Focused Plus Fund LP</b> WINNER OF THE 2019 CANADIAN HF AWARDS <b>Equity Focused</b> Best 1 Year Return<sup>3</sup> Best 3 Year Return<sup>3</sup> Best 5 Year Return<sup>3</sup> 2nd Place 3rd Place 1st Place</p>
<p><b>Portland Focused Plus Fund LP</b> WINNER OF THE 2018 CANADIAN HF AWARDS <b>Equity Focused - Best 5 Year Return</b> 3rd Place</p>	<p><b>2017 PCMA INVESTMENT FUND AWARD</b></p>

# Portland Focused Plus Funds

## ANNUAL LETTERS TO INVESTORS 2013-2025

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# **Portland Focused Plus Fund LP**

## **ANNUAL LETTER TO INVESTORS**

FOR THE YEAR ENDED DECEMBER 31, 2013

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return		
	Portland Focused Plus Fund LP	S&P/TSX Composite Index	S&P 500 Index (US\$)
2012 (from Oct. 31)	1.9%	0.6%	1.5%
2013	34.1%	13.0%	32.4%

Since Inception

Oct. 31, 2012 to Dec. 31, 2013

Compound annual return	30.8%	11.6%	28.8%
Cumulative return	36.7%	13.7%	34.4%

Notes:

Performance for the Portland Focused Plus Fund LP is for the class F units which is the highest fee class without embedded advisor compensation. Performance shown is the Fund's net return after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Fund generally hedges its U.S. dollar exposure.

Past performance is no guarantee of future results. This information is not to be construed as a public offering of securities in any jurisdiction of Canada. The offering of the Fund is made pursuant to an offering memorandum to eligible investors. Read the offering memorandum carefully before investing. For the Fund's offering memorandum which contains information including investment objectives, fees and expenses and risks, visit [www.portlandic.com/plusfund.html](http://www.portlandic.com/plusfund.html) or contact Lana Nicosia at 1-888-710-4242 ext.4539 or by email at [lnicosia@portlandic.com](mailto:lnicosia@portlandic.com).

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "Fund"):**

The inception date of the Fund was October 31, 2012 and, thus, 2013 was its first full year of operation. This letter describes how the Fund is managed (and why it is managed that way) and is intended to serve as a useful reference for current and prospective investors in the Fund.<sup>1</sup>

**Investment Objective**

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As stated in the Fund's Offering Memorandum (the "OM"), the Fund's investment objective is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> At the outset, it's important to consider what is meant by each aspect of the investment objective. Specifically:

- *Long term.* This means a measurement period long enough to encompass a full stock market cycle. These are often eight to 10 years in duration. The minimum period reasonable for measuring performance is five years and all investors in the Fund should have an investment horizon of at least that long. Further, to be fair, any measurement period should have start and end dates which are at similar points in the stock market cycle (i.e., high-to-high, as opposed to high-to-low or low-to-high).
- *Preservation of capital.* This means a return of not less than zero. For simplicity, I measure that in nominal terms (i.e., before consideration of changes in the purchasing power of money as a result of inflation or deflation). In practice, however, I strive to achieve preservation of capital in real terms (i.e., including the impact of changes in the purchasing power of money).
- *Satisfactory return.* This term is deliberately subjective. Assessment of an investment manager's performance should always be considered in light of the hand that he or she has been dealt; in the case of the Fund, equity markets provide the appropriate context. The OM states that the Fund's investments "will typically be equity securities issued by larger-capitalization companies domiciled in Canada, the United States and globally."<sup>3</sup> While the Fund may invest in securities of issuers domiciled in other countries (as was the case at the end of 2013), it is expected that investments in Canada and the U.S. will, on average, comprise the substantial majority of the Fund's investments. As a result, for those who wish to benchmark the performance of the Fund against equity indices, it is suggested that the two most relevant indices are the S&P/TSX Composite Index and the Standard & Poor's 500 Index (in U.S. dollars).<sup>4</sup> A 50%/50% weighting in those two indices would, in my view, be a reasonable benchmark against which to measure the long-term performance of the Fund.<sup>5</sup> Apart from the fact that the Fund draws its investments from multiple geographies, another reason for not choosing a single index against which to benchmark is that it would encourage benchmark sensitivity (i.e., closet indexing) which, in my opinion, is not in the best long-term interests of investors. Finally, the Fund is classified as an "alternative strategies" fund according to the definitions promulgated by the Canadian Investment Funds Standards Committee.<sup>6</sup> As a result, in assessing whether the Fund's returns have been satisfactory, from time to time it may be appropriate to compare its performance against the universe of alternative strategies funds.

Those of you acquainted with the literature of investment analysis may detect a familiar ring to the wording of the Fund's investment objective. That is because in creating the Fund, and in crafting its investment objective, the wisdom of the father of security analysis and the man known as the dean of Wall Street, Benjamin Graham, was deliberately invoked.<sup>7</sup> In his seminal work, *Security Analysis*, Graham discussed at length the difference between investment and speculation. After due consideration, he famously proposed

the following definition of investment: “[a]n investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.”<sup>8</sup> It is with tremendous respect and humility that I’ve chosen to paraphrase Graham’s definition. It is hoped that, over the long term, the Fund’s performance will serve to honour the man who was the inspiration for the Fund’s investment objective.

## Performance

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The performance of the Fund and the two benchmark stock market indices is shown in the table on page two of this letter. The Fund’s factsheet (“Fund Brief”), which shows performance updated to the latest available month-end, may be found at [www.portlandic.com/plusfund.html](http://www.portlandic.com/plusfund.html). A “Reasons to Invest” document, which summarizes the Fund’s value proposition to investors, may also be found at that web site.

For 2013, the Fund’s class F units achieved a return of 34.1% (net of fees and expenses). That compares to a total return of 13.0% for the S&P/TSX Composite Index and of 32.4% for the S&P 500 Index (in U.S. dollars). A 50%/50% blend of the two indices would have returned 22.7%.

For the entire period since inception of the Fund on October 31, 2012 to December 31, 2013, the Fund’s class F units achieved a cumulative return of 36.7%. That compares to a cumulative total return of 13.7% for the S&P/TSX Composite Index and of 34.4% for the S&P 500 Index (in U.S. dollars). A 50%/50% blend of the two indices would have returned 24.1%.

According to Lipper (one of the world’s leading fund performance measurement services), the median return of alternative strategies funds in 2013 was 10.9% compared to the Fund’s return of 34.1%.<sup>9</sup> For the period since inception of the Fund on October 31, 2012 to December 31, 2013, the median return of alternative strategies funds was an annualized rate of 11.2% compared to the Fund’s annualized return of 30.8%. The Fund ranked in the top decile among all alternative strategies funds in both periods.

Accordingly, in both 2013 and in the cumulative period since the Fund’s inception, the Fund has met its investment objective of preservation of capital and a satisfactory return.

## Investment Strategies

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The two core techniques which the Fund employs to achieve its investment objective are: 1) focused investing in a limited number of long securities positions; and 2) leverage (by purchasing securities on margin).<sup>10</sup> Given the importance of these two strategies to the success of the Fund, each is discussed below in greater detail.

### *Focus*

Focus refers to the Fund holding a limited number of long securities positions (typically four to six holdings in a normal range of zero to 10). It does not refer to a focus on a particular industry sector. As stated in the OM, the Fund “has no geographic, industry sector, asset class or market capitalization restrictions. There is no restriction on the percentage of the Net Asset Value of the Partnership which may be invested in the securities of a single issuer.”<sup>11</sup> The Fund’s manager, Portland Investment Counsel Inc. (“Portland”), has long espoused that one of the keys to wealth creation is to own a few high quality businesses. The Fund is

designed to enable it to pursue focused investing to the greatest extent possible.

It's worth noting that many of the world's greatest investors of the last century (and perhaps of all time) have been proponents of focused investing. Examples include Bernard Baruch,<sup>12</sup> Warren Buffett,<sup>13</sup> Phil Fisher,<sup>14</sup> John Maynard Keynes,<sup>15</sup> Charlie Munger,<sup>16</sup> Bill Ruane,<sup>17</sup> and of course Portland's own Michael Lee-Chin.<sup>18</sup> Also, a perusal of the lists of the world's wealthiest people shows that many (if not most) attained their wealth through ownership of one or a small number of high quality businesses held for a long period of time. The evidence in favour of focused investing is not confined to practitioners. The question of how many businesses one must hold in order to achieve the benefits of diversification, without unduly sacrificing return, has been the subject of considerable discussion in academic literature. Such studies have shown that the benefits of diversification can be achieved by holding as few as three businesses.<sup>19</sup>

There is an all-important rationale for focused investing and here again we turn for inspiration to Charlie Munger. He has often discussed the importance of having "multiple mental models" by knowing "the big ideas in the big disciplines."<sup>20</sup> Within the field of economics, one of the most important and powerful mental models is opportunity cost. The definition of opportunity cost is "the value of the best alternative forgone, in a situation in which a choice needs to be made between several mutually exclusive alternatives given limited resources."<sup>21</sup> Munger has repeatedly (and characteristically forcefully) stressed the importance of opportunity cost in making investment decisions.<sup>22</sup> Famed investor Sir John Templeton also invoked the concept of opportunity cost in his well-known saying that "the time to sell an asset is when you have found a much better bargain".<sup>23</sup>

The manner in which opportunity cost is employed in the management of the Fund is described as follows. If the Fund were starting from a position of being entirely in cash (as it was at inception), then the first company to be purchased in the Fund would be the one which, in my opinion, and among all of the businesses in my investment universe, offered the best combination of attractive total return prospects and limited downside risk. The Fund would take as large a position as deemed appropriate in said company, given investment alternatives. This is subject to the limit that we generally will not purchase any single investment to a weight greater than 50% of the Fund's net assets. There are two reasons for this limit. First, no matter how strongly one may feel about the merits of a particular security, one could be wrong, or adverse circumstances might arise subsequent to purchase. These undeniable facts are the reason for another expression of Templeton's: "the only investors who shouldn't diversify are those who are right 100 per cent of the time."<sup>24</sup> Second, the Fund's custodian may not extend loan value to any security that comprises more than 50% of the Fund's net assets. After purchasing the first company to the maximum percentage deemed appropriate, the Fund will purchase a second company to the maximum percentage deemed appropriate for it, then invest in a third company, etc., until the Fund's total assets have reached the maximum desired percentage of net assets (for more details, see the "Leverage" section below). This process will typically result in a portfolio of four to six holdings in a normal range of zero to 10. In the process of constructing and maintaining the portfolio, an effort is made to ensure that the holdings offer a reasonable level of diversification by sector and geography. Once the initial portfolio has been constructed, the concept of opportunity cost will continue to be employed (i.e., a new investment will only be bought if it is considered distinctly superior to one already held given that it would typically need to be sold to fund the new purchase).

### *Leverage*

Apart from focus, the second core strategy employed in the management of the Fund is leverage. Leverage refers to the use of borrowed money to acquire assets using the Fund's total assets as collateral for the borrowings. These borrowings are known as margin loans.

Many Canadians use leverage (i.e., mortgages) in the purchase of their homes. Data for 2011 show that 31% of Canadians live in an owned dwelling with a mortgage.<sup>25</sup> A further 36% of Canadians live in an owned dwelling without a mortgage.<sup>26</sup> No doubt many in the latter category once had mortgages on their homes. Despite this widespread use and apparent approval of using leverage for purchasing primary residences, many Canadians appear to be reluctant to employ leverage in the purchase of their investments. This reluctance is worth examining in light of the facts, as shown in the table below.

<b>Comparison in use of leverage to acquire:</b>	<b>Homes</b>	<b>Equities</b>
Maximum loan to value ratio	95% <sup>27</sup>	70% <sup>28</sup>
Interest rates – Canada	2.5% <sup>29</sup>	2.0% <sup>30</sup>
Interest rates – U.S.	n/a	1.1% <sup>31</sup>
Is interest expense tax-deductible?	No	Yes
Does asset generate income?	No	Yes
Ownership expenses per annum	2% <sup>32</sup>	None
Transaction costs to buy and sell	High	Negligible
Is capital gain (or loss) taxable?	No	Yes
Is a margin call possible?	No	Yes

In examining the table above, the facts favour the use of leverage to acquire equities rather than homes. Specifically:

- For large borrowers, interest rates on margin loans to invest in equities are lower than mortgage interest rates. For example, a large borrower can currently secure a floating rate margin loan to buy Canadian equities for an interest rate of 2.0% (and to buy U.S. equities for 1.1%) but would pay 2.5% for a floating rate mortgage. Admittedly, small borrowers would likely pay more for margin loans than for mortgages, perhaps 4.25% for a margin loan vs. 3.0% for a floating rate mortgage. Thus, the use of margin loans by smaller, non-professional investors is less compelling. Having said that, however, for larger, professionally-managed portfolios, such as the Fund, the ability to access low-cost financing can enhance investment returns provided that the total return (dividends and capital gains) on the assets acquired exceeds the borrowing cost. It follows that the Fund's ability to access margin loans on behalf of the Fund's investors at much lower cost than they likely could access on their own is one of the benefits of investing in the Fund.
- For most Canadians, mortgage interest is not tax-deductible.<sup>33</sup> Interest expense incurred to acquire income-producing assets, however, such as equities, is tax-deductible. If the investor is in an income tax bracket of 40%, the after-tax interest cost of a margin loan is only 60% of the pretax cost. This is a major benefit of margin loans as compared to traditional mortgages.
- A primary residence may provide intangible benefits but it does not produce income. Equities, on the other hand, may provide significant and growing income from dividends and distributions.
- The annual ownership costs of a home are about 2% of its market value per annum. Comparatively, there is no annual cost to owning equities.
- Transaction costs to buy and sell real estate are often punitive. These costs include real estate

brokerage, legal fees and, if applicable, land transfer taxes. Combined, these costs for a round-trip (i.e., a purchase followed by a sale) may amount to between 5% and 10% of the property value.<sup>34</sup> Conversely, the trading costs to buy and sell equities are negligible (see “Trading Costs” below).

While the comparisons in the table that are described above favour the use of leverage to acquire equities rather than homes, the final two lines of the table do not. Specifically:

- The penultimate line of the table indicates that the capital gain (or loss) on a principal residence is not taxable whereas gains (and losses) on equity investments are. Arguably, this advantage for home ownership is insignificant given the comparatively low tax rates that apply to capital gains and the substantial costs (as noted above) of acquiring, owning, operating and selling homes.
- The last line of the table indicates that, as long as mortgage payments are made when due, homeowners will generally keep their homes even if their market values have declined from their initial purchase price. Conversely, in the case of margin loans, a decline in the market value of an investment may result in a margin call which requires the borrower to sell an asset after it has declined in value. This distinction is somewhat misleading; if a home declines in value, that decline is real whether or not the homeowner is forced to sell. It appears that the fact that home prices are not easily determinable, whereas common stock prices are readily available throughout every business day, may result in complacency about home values compared to the anxiety sometimes associated with fluctuations in common stock prices, especially when using margin.

On balance, there are compelling reasons for the use of margin to enhance investment returns, including its low cost and tax-deductible interest. The primary drawback of using margin is the possibility of a margin call (hence the well-known expression that leverage works both ways). This possibility causes some to say that the use of any margin is speculative. There are valid reasons to disagree with that opinion. This subject is so important to the management of the Fund that a full discussion is merited.

### **Investment vs. Speculation**

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In his formulation of the definition of investment, Graham spent considerable time distinguishing investment from speculation. He proceeded to write, “[i]n our conservative view every nonprofessional who operates on margin should recognize that he is ipso facto speculating”.<sup>35</sup> Graham’s use of the word “nonprofessional” is significant (he repeated it elsewhere)<sup>36</sup> and strongly implies that Graham himself believed that it was possible for a professional to use margin and still be conducting an investment operation. That notion also accords with common sense. For example, it does not make sense to consider an investment fund (such as the Fund) with net assets of \$12 million as an investment operation if it uses no margin, and as speculative if it uses \$0.01 of margin. There is no practical difference between these two hypothetical portfolios. Thus, clearly, it is not the use of margin but the amount of margin which determines whether an operation should be considered as an investment or as a speculation. At what point in the use of margin would an investment operation flip over into being speculative? Can such speculation be intelligent?

In my opinion, at some point between having \$0.80 of margin per \$1.00 of net assets and \$1.00 of margin per \$1.00 of net assets, an operation becomes speculative. That conclusion is reached based on a consideration of the percentage decline that could be withstood before a margin call which would require that at least some stocks be sold (thus resulting in a permanent loss on that portion of the portfolio). A bear

market could happen at any time and such declines are typically in the range of (25%) to (40%) from the prior peak of equity markets. The use of \$0.80 and \$1.00 of margin per \$1.00 of net assets would permit declines of (36.5%) and (28.6%) (i.e., a typical bear market), respectively, in the market value of the total portfolio before a margin call.<sup>37</sup> For simplicity, we use as a rule the 1:1 ratio. In other words, if the Fund employs up to \$1.00 of margin per \$1.00 of net assets, we consider that the Fund is still being managed in accordance with Graham's definition of investment. If the Fund were to employ more than \$1.00 of margin (net of cash, if any)<sup>38</sup> per \$1.00 of net assets, we must concede that the use of margin would introduce a speculative element to the Fund's operation.

Since its inception to the end of 2013, the Fund has never used more than \$1.00 of margin per \$1.00 of net assets. Two conditions must be met before the Fund would consider doing so: first, the investments to be acquired would have to appear to offer an exceptionally attractive combination of superior return with limited downside risk; and second, equity markets would have to be attractive, as evidenced by such factors as low valuations, high volatility or both. To the end of 2013, I have not found these two conditions to be satisfied. If in the future that should change, the Fund may invest more on margin. As specified in the OM, "[m]argin borrowings may generally comprise up to 70% of the Partnership's total assets."<sup>39</sup>

If the Fund were ever to exceed \$1.00 of margin per \$1.00 of net assets (introducing a speculative element), the decision to do so would be intended to be considered intelligent in view of the then-prevailing facts. Graham himself noted that "there is a real difference between intelligent and unintelligent speculation".<sup>40</sup> Intelligent speculation is based on "an analysis of value"; it "presupposes at least that the mathematical possibilities are not against the speculation, basing the measurement of these odds on experience and the careful weighing of relevant facts."<sup>41</sup> Graham added, "I should greatly welcome an effort by security analysts to deal intelligently with speculative operations."<sup>42</sup> It is respectfully submitted that the possible use of margin by the Fund under the conditions outlined above would be in keeping with Graham's exhortation and constitute "intelligent speculation".

The Fund's investments and leverage will continue to be managed with a view, first and foremost, to preservation of capital. Having said that, there can be no assurance that the use of leverage will not be detrimental to the Fund's performance, particularly over short term periods. In my opinion, all investors in the Fund should have a minimum investment horizon of five years and be willing and able to tolerate high volatility.

## Investments

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As stated in the OM, investments in the Fund "will typically be equity securities issued by larger-capitalization companies domiciled in Canada, the United States and globally, which the Manager [Portland] believes have strong financial positions, superior track records and are undervalued. The Manager expects to place a particular emphasis on high-quality companies with above-average dividend yields and satisfactory historic and prospective dividend growth".<sup>43</sup>

With a view to giving investors more information regarding investments in the Fund, the following gives a more fulsome explanation of some of the key terms referenced above:

- *Larger-capitalization companies.* This means either large companies (market capitalizations of more than \$10 billion) or medium-sized companies (market capitalizations of \$3 billion to \$10 billion).

There are four important reasons to prefer what Graham referred to as the “relatively unpopular large company.”<sup>44</sup> First, one can invest a meaningful amount into large businesses, even if they are very attractively valued only briefly. Second, trading costs to buy and sell shares of large companies are typically much lower than for small companies (see “Trading Costs” below). Third, larger companies usually have vastly greater resources (financial and access to capital, management and government) and diversification by product and geography than do small companies, better enabling them to see themselves through periods of temporary adversity which are often the cause of attractively low share prices. Fourth, when a large company’s fundamental performance and outlook improve, recognition through a higher stock price is typically very rapid (as opposed to valuations of small companies that can remain depressed for long periods). This quick valuation increase for large companies is because many portfolio managers are looking for undervalued large companies in which they can deploy a lot of capital and are also fearful, because of benchmark risk, of not being invested in a large business whose fortunes and stock price are on the mend. Thus, as soon as a large company’s fundamental performance shows signs of improving, its share price typically increases quickly. Since the portfolio rate of return is a function of how much one makes and over what time period, this faster recognition of undervaluation and fundamental improvement at larger companies enhances the Fund’s rate of return.

- *Strong financial positions.* In assessing a company’s financial position, a holistic approach is taken. For example, consideration is given to each of the income statement (to determine interest coverage), the balance sheet (for debt-to-equity and debt-to-capitalization ratios) and the statement of cash flows (to determine the business’s capital intensity and whether it’s generating free cash flow). The schedule of debt maturities and the company’s credit facilities and other possible sources of financing are evaluated. Industry-specific measures, such as, for banks, Basel III capital ratios and other custom measures, are also examined. Only those businesses that appear to have the financial means to weather a period of considerable adversity will be invested in. It should be noted that reliance is not placed on third-party credit ratings; the financial crisis of 2007-2008 made it clear that investors use such ratings at their peril.
- *Superior track records.* Consideration is given to a company’s long-term track record, such as its return on equity and its growth in sales, earnings, dividends, book value and tangible book value. Ideally, at least 10 years of data is examined (for many companies that I follow, models go back 25 years or more). Care is also taken to ensure that the measurement start and end dates fairly represent the company’s long-term performance. The cumulative impact of so-called “unusual” items is included. While the company’s historic track record is a very important part of the assessment, its estimated future business performance also merits consideration (while remaining suitably skeptical of any projection that suggests a material improvement from a company’s historic performance). In short, to paraphrase author Damon Runyon (who in turn was paraphrasing Ecclesiastes 9:11): the race is not always to the swift, nor the battle to the strong, but that is the way to bet.<sup>45</sup>
- *Undervalued.* John Burr Williams in his seminal work *The Theory of Investment Value* concluded that “a stock is worth the present value of all the dividends ever to be paid upon it, no more, no less.”<sup>46</sup> Keynes said much the same thing when he used the term “enterprise for the activity of forecasting the prospective yield of assets over their whole life”.<sup>47</sup> Finally, Buffett himself has echoed these views by stating that intrinsic value “is the discounted value of the cash that can be taken out of a business during its remaining life.”<sup>48</sup> The Fund is managed in accordance with these sentiments and thus utilizes dividend discount models for valuation. These models are supplemented with analysis based on traditional and objective measures of corporate performance such as earnings and book value. When the degree of undervaluation of a business suggests that investment in the business offers

both substantial total return potential and limited downside risk, the said business is an appropriate potential investment for the Fund.

- *High-quality.* This refers to companies with strong financial positions and superior track records (both terms as defined above) run by able and ethical managers. Ability may be judged by the long-term performance of the business. The ethics of a management team (and its governing board of directors) may be assessed by a variety of measures including the amount and type of executive compensation, use (and abuse) of stock options and its choice of accounting assumptions (such as the assumed rate of return on pensions). Ethics and honesty can also be assessed by noting how candid the company's communications are, particularly during times of adversity.
- *Dividend yield and growth.* Particular attention is paid to a company's dividend and to its historic and expected dividend growth (this is not surprising since intrinsic value is calculated using a dividend discount model). Not all investments are required to be dividend payors, however. Some companies are able to reinvest capital at consistently high rates of return and thus benefit their shareholders by retaining all earnings or by using retained cash flows for share repurchases. Perhaps the best example of a business that does not pay dividends but which has achieved extraordinary returns for shareholders is Berkshire Hathaway Inc.

Apart from paying dividends, the other way that companies return cash to shareholders is by common share repurchases. These are important enough to merit special discussion here. As Buffett has noted, there are two conditions that must be satisfied for share repurchases to be advisable. "First, the company has available funds – cash plus sensible borrowing capacity – beyond the near term needs of the business and, second, finds its stock selling below its intrinsic value, conservatively calculated."<sup>49</sup> Most companies that conduct share repurchases fail one or both of these two simple tests. Typically, by repurchasing shares, they imperil the company's financial position or reduce its intrinsic value per share or both. Companies that satisfy both tests and repurchase shares should be congratulated.

The Fund only discloses its investment portfolio annually, as of every December 31. The portfolio is disclosed infrequently for two reasons. The first is that, as behavioural studies have shown, people bombarded with data tend to make worse decisions than if they act knowing a smaller number of more important facts.<sup>50</sup> The second (and more important) reason is that disclosing the holdings more frequently would be distracting and would likely result in substantially worse investment performance. That is the same view reportedly expressed by Buffett when he used a golf analogy to explain that he didn't want to be second-guessed on every decision: "[a]ll I want to do is hand in a scorecard when I come off the golf course. I don't want you following me around and watching me shank a three-iron on this hole and leave a putt short on the next one."<sup>51</sup> For those who wish to get a more frequent sense of the Fund's holdings, reference may be made to the Portland Canadian Balanced Fund and the Portland Canadian Focused Fund. While these mutual funds have different objectives and constraints than the Fund, all three have enough similarity that they usually have at least some holdings in common. Holdings for the two mutual funds are disclosed monthly and are available at [www.portlandic.com](http://www.portlandic.com).

## Short Selling

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The section immediately above describes what the Fund seeks in long securities positions. The Fund, however, may also engage in short selling.<sup>52</sup> This strategy was included in the design of the Fund in order to give it flexibility. That said, there are two reasons to be wary of short selling. First, as it says in finance

textbooks, a long position can only go to zero whereas the theoretical loss on a short sale is unlimited. Second, a little-appreciated fact is that when a long position goes against you, its size gets progressively smaller, whereas when a short position goes against you, its size gets progressively larger. These two drawbacks of short sales can be both financially and emotionally debilitating. As a result, short selling in the Fund is likely to be limited in both amount and duration. To date, the Fund has not engaged in short sales.

## Foreign Currency

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The Fund is valued in Canadian dollars and all of its investors are Canadian. The Fund may, however, make investments in businesses whose share prices are denominated in foreign currencies, particularly the U.S. dollar. Further, many businesses in which the Fund may invest, including many Canadian businesses, derive revenues and income in multiple countries and multiple currencies. As a result, the Fund is exposed to the fluctuations in the value of such foreign currencies in relation to the Canadian dollar.

The primary foreign currency to which the Fund is exposed is the U.S. dollar. It is also the currency whose real value many people are particularly concerned with because of its historic and prospective decline in real terms. In order to mitigate the Fund's currency risk, its "look-through" U.S. dollar exposure is calculated: the dollar amount invested in each business is multiplied by the business's proportion of income earned in the U.S., and these products are summed across the Fund's entire portfolio. This number is added to the amount of U.S. dollar cash and then the amount of U.S. dollar margin debt is subtracted in order to determine net look-through exposure. The objective is to keep the amount of the net look-through exposure to the U.S. dollar at minimal levels (unless there are compelling investment reasons to do otherwise). At the end of 2013, net look-through U.S. dollar exposure was minimal. Other ways to keep net look-through exposure to the U.S. dollar at low levels would be the use of margin debt denominated in currencies other than the U.S. dollar, or the use of currency forwards; to date, the Fund has not used either of these techniques.

There are two noteworthy consequences of the Fund's foreign currency management.

- First, as a result of currency hedging, the Fund generally does not benefit when the U.S. dollar appreciates in terms of the Canadian dollar (as it did in 2013). Similarly, the Fund generally does not suffer if the U.S. dollar declines in terms of the Canadian dollar (as it did from 2002 to 2007 and, again, from 2008 to 2011). In other words, the performance of the Fund's U.S. dollar-denominated securities will be whatever it is in U.S. dollars, with little impact from foreign currency translation. As a result, I believe that it's appropriate to use the S&P 500 Index in U.S. dollars, rather than in Canadian dollars, as one of the Fund's comparison indices.
- The second consequence of the Fund's foreign currency management is that the Fund may, from time to time, hold Canadian dollar cash even while it also has U.S. dollar margin debt. One might ask, why not convert the Canadian dollar cash into U.S. dollars in order to repay or reduce the U.S. dollar margin debt? There are three reasons for not doing so. First, there is nothing to be gained in terms of net interest expense as, at the end of 2013, the interest rate being earned on Canadian dollar cash was slightly higher than the interest rate being incurred on U.S. dollar margin debt. Second, to convert Canadian dollars into U.S. dollars and eventually convert those U.S. dollars back to Canadian dollars, the Fund would incur round-trip transaction costs (i.e., the foreign exchange bid-ask spread). Finally, as described above, the Fund uses U.S. dollar margin debt to mitigate its look-through exposure to the U.S. dollar. If the Fund were to convert Canadian dollars to U.S.

dollars in order to reduce the U.S. margin debt, it would increase the Fund's look-through U.S. dollar exposure, undermining the Fund's objective to keep look-through U.S. dollar exposure at a low level. Thus, from time to time (as it did at times in 2013), the Fund may hold Canadian dollar cash even while it has U.S. dollar margin debt.

## Volatility vs. Risk

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What constitutes risk is a subject of considerable discussion and disagreement in academic and professional circles. The proponents of Modern Portfolio Theory (MPT) would have us believe that risk is volatility (i.e., the standard deviation of returns).<sup>53</sup> In my opinion, this theory is illogical and absurd. It has, in fact, been rejected by many of the best investors of all time. For example, Munger, in typically colourful language, has described MPT as "asinine".<sup>54</sup> Buffett has stated that "volatility does not measure risk. Risk comes from the economics of the business and from not knowing what you're doing."<sup>55</sup> Graham himself weighed in on the subject and noted that beta (the ratio of the volatility of a particular stock or portfolio to that of the overall market)

*"is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of 'risk.' Price variability yes; risk no...[t]he idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business."*<sup>56</sup>

Acclaimed investor David Swensen, Yale University's chief investment officer, has expressed a similar sentiment. He has written

*"Standard deviation of returns, the measure of dispersion most commonly used to assess risk, fails to capture much of what concerns fiduciaries. Simply understanding the historical volatility of returns provides little useful information regarding the efficacy of a particular investment strategy. The fundamental risk of the underlying investment matters, not the security price fluctuation."*<sup>57</sup>

MPT is based in part on the Efficient Market Hypothesis (EMH) to which it is closely allied.<sup>58</sup> Renowned investor Jeremy Grantham, co-founder of one of the world's leading investment management firms, recently described EMH as "laughable".<sup>59</sup> On an anecdotal level, many university foundations and hospital wings have been endowed by focused investors; none appear to have been endowed by efficient market theorists. In words attributed to hedge fund manager Larry Hite, "I've noticed that everyone who has ever tried to tell me that markets are efficient is poor."<sup>60</sup>

So if risk isn't volatility, then what is it? Perhaps the best definition was formulated by venerable investor Howard Marks: "[r]isk means uncertainty about which outcome will occur and about the possibility of loss when the unfavorable ones do."<sup>61</sup> To this might be added that risk is about not only the possibility of loss, but also the likely amount of the loss when it does occur. That is what a bond manager or insurance company would call "loss given default".

Investor Frank Martin segregates investment risk into three inter-related components: business risk, financial risk and valuation risk.<sup>62</sup> *Business risk* refers to the potential deterioration of a business's earnings

or financial position (often the two are related) subsequent to purchase. In the Fund, as discussed under “Investments” above, business risk is mitigated by investing only in businesses of reasonably large size in strong financial positions with good track records run by honest, able management. *Financial risk* refers to the downside of excessive use of borrowed money either in the businesses in which the Fund invests or in the Fund itself. Financial risk is mitigated by investing only in businesses in strong financial positions and by managing the Fund’s borrowings in the manner described under “Leverage” and “Investment vs. Speculation” above. *Valuation risk* refers to overpaying for a business and having its market price later decline. Valuation risk is mitigated by being careful about the prices that the Fund pays and, in particular, using Graham’s twin principles that: 1) every stock purchase should be considered as though one were buying the whole business; and 2) one should invest only at a margin of safety price below a fair business valuation.<sup>63</sup> As an adjunct to the above, it is important to understand that quotational loss is unavoidable. That is to say, it’s certain that from time to time some or all of the Fund’s investments will have market prices below its purchase cost. What the Fund strives to avoid, however, is permanent loss arising from any of business, financial or valuation risk.

Occasionally one will see a financial news headline or hear a commentator describing the recent stock market as “volatile”. Nothing could be further from the truth. The best and most widely accepted measure of stock market volatility is the VIX index which measures the implied volatility of S&P 500 index options.<sup>64</sup> In 2013, the average level of the VIX index was the lowest it had been in seven years. Similarly, the year’s range between the high and low levels of the VIX index (i.e., the volatility of the volatility) was the lowest it had been in eight years. Moreover, for many individual businesses, this simple measure of volatility (the high-low range) was the lowest it had been since they went public or for at least 25 years. Although it is impossible to predict when stock market volatility will increase, it is certain to do so. When that happens, two other things are likely to happen at the same time: the Fund’s net asset value per unit is likely to decline in the short term; and there will likely be many opportunities to acquire excellent long-term investments at bargain prices. Increased volatility should not be feared, it should be embraced. In the words of Warren Buffett, “volatility is the friend of the long-term investor.”<sup>65</sup>

## Trading Costs

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Trading costs refers to the total costs incurred to effect an equity trade and consists of three elements: 1) brokerage commissions and fees (which are the most easily measured); 2) bid-ask spread; and 3) market impact. *Brokerage commissions* may be about \$0.02 per share for transactions done through the Fund’s custodian and \$0.01 per share or less if done through a trading-only platform such as Instinet or Interactive Brokers. Retail clients of self-directed brokerage firms pay even lower commission rates since those firms also earn substantial revenues through asset management fees, mutual fund trailing commissions and margin lending and they use those revenues to subsidize their well-publicized commission rates. The *bid-ask spread* refers to the fact that if one pays the lowest asking price, and simultaneously sells the same security at the highest bid price, one will have lost money (many people would have experienced this phenomenon through the purchase of foreign currency for trips and the subsequent sale of leftover currency at a lower price, for a net loss on the round-trip transaction). *Market impact* is the effect that a market participant has when it buys or sells an asset.<sup>66</sup> In other words, transacting in large volumes (or in thinly-traded securities) is likely to push up the price as one tries to buy, and is likely to push down the price as one tries to sell.

The following table is illustrative of the Fund's typical trading costs for an equity trade of \$5 million (the approximate size of a large single position in the Fund). Estimates are used, but the figures are consistent with third-party studies.<sup>67</sup>

<b>Equity transaction costs for a company of size:</b>	<b>Small cap.</b>	<b>Large cap.</b>
Transaction amount (A)	\$5,000,000	\$5,000,000
Stock price (B)	\$20.00	\$50.00
Shares to be bought (C, = A/B)	250,000	100,000
Commissions per share (D)	\$0.02	\$0.02
Commissions, % (E, = D/B)	0.10%	0.04%
Commissions, \$ (F, = C x D)	\$5,000	\$2,000
Bid-ask spread, \$ per share (G)	\$0.02	\$0.02
Bid-ask spread, each way, % (H, = G/B/2)	0.05%	0.02%
Bid-ask spread, each way, \$ (I, = C x G/2)	\$2,500	\$1,000
Market impact, each way, \$ per share (J)	\$0.02	\$0.01
Market impact, each way, % (K, = J/B)	0.10%	0.02%
Market impact, each way, \$ (L, = C x J)	\$5,000	\$1,000
Transaction costs, each way, % (E + H + K)	0.25%	0.08%
Transaction costs, each way, \$ (F + I + L)	\$12,500	\$4,000

As indicated, trading costs are much lower for large capitalization companies than for small capitalization companies. A review of each element of the above hypothetical trade further specifies the following:

- The stock price of a small capitalization company is typically only about \$20 per share while that for a large capitalization, well-established company (such as are favoured in the Fund) is typically more like \$50 per share. Since brokerage commissions will be about \$0.02 per share in either case, commissions as a percentage of market value will be about 0.10% for the small company but only about 0.04% for the large company.
- The bid-ask spread may be about \$0.02 per share for a small capitalization company (say, bid \$19.99 per share and ask \$20.01 per share) and the same \$0.02 per share for a large capitalization company (say, bid \$49.99 per share and ask \$50.01 per share). Thus, in either case, one may expect to lose about \$0.01 per share each way (or \$0.02 in total for a buy and a sell combined). This equates to 0.05% for a small company but only 0.02% for a large company. As indicated, the spread (or what Graham referred to as the turn of the market) is typically much lower in percentage terms for large companies than for small companies.
- The market impact to effect a trade of identical size is likely to be much greater for a small company than for a large company. For example, the market impact of a \$5 million trade may be about 0.10% for a small company and only 0.02% for a large company. In fact, since price is a paramount consideration in the Fund's investment strategy and the Fund almost always uses limit orders, its market impact is very close to zero. Limit prices are only varied when the opportunity cost of not executing a trade far outweighs the incremental cost of changing the limit price.

In summary, the trading costs to effect a \$5 million trade are about \$12,500 or 0.25% for a small company and \$4,000 or 0.08% for a large company. As noted under “Investments” above, lower trading cost is one of the important reasons that larger businesses are favoured in the Fund.

## Portfolio Turnover

For an unleveraged fund, portfolio turnover is typically defined as the lesser of equity purchases and sales divided by average fund net assets.<sup>68</sup> For a fund which uses leverage (such as the Fund), it makes more sense to define portfolio turnover as the lesser of equity purchases and sales divided by average total assets (i.e., including assets financed with margin borrowings). Regardless of how one calculates it, the Fund does not target a particular rate of portfolio turnover. As previously indicated, the overarching goal is to meet the Fund’s investment objective: preservation of capital and a satisfactory return. The Fund’s trading costs are low (see “Trading Costs” immediately above) and, in any event, it is not prudent to allow the turnover “tail” to wag the investment “dog”.

Given the seemingly unrelenting increase in equity markets in 2013, would the Fund’s performance have been even stronger if no investments had been sold? Almost certainly. Portfolio sales may leave some money on the table if share prices continue to rise. At the same time, paying down margin debt will always reduce portfolio risk. The words attributed to both Baruch and to Baron Rothschild are appropriate. When asked how they made their fortunes, they replied “I always sell too soon.”<sup>69</sup>

## Taxes

The Fund is a limited partnership and, as such, does not pay taxes. Instead, the income and expenses of the Fund are allocated annually to the Fund’s investors for inclusion in their respective income tax returns. Tax considerations regarding investing in Fund units are described in the OM.<sup>70</sup> As noted therein, each investor should seek independent advice based upon the investor’s own particular circumstances.

Although every investor’s tax situation is unique, taxes are such an important factor in long-term investment returns that it’s worth making some general observations here. All investors in the Fund are Canadian; in fact, the Fund is a limited partnership and tax law does not permit non-Canadian investors. Further, at the end of 2013, all of the Fund’s investors were resident in the provinces of either Alberta or Ontario. Tax rates applicable (in 2013) to residents of those two provinces are shown in the table below. For simplicity, the table only shows the marginal tax rates (i.e., the tax rate that would apply to one more dollar of income) applicable to someone with taxable income of \$150,000 (which falls in the highest tax bracket in Alberta and the second-highest tax bracket in Ontario).<sup>71</sup>

<b>Marginal tax rate on taxable income of \$150,000 - 2013</b>	<b>Alberta</b>	<b>Ontario</b>
Income and foreign dividends	39.0%	46.4%
Eligible Canadian dividends	19.3%	29.5%
Capital gains	19.5%	23.2%

Income in the Fund consists of foreign dividends, real estate investment trust distributions (both of which are

taxed like regular income), eligible Canadian dividends and capital gains. Most investments will be expected to have substantial long-term total return potential and limited downside risk. Fundamental merits such as these will be of paramount importance in the Fund's choice of investments. The tax consequences of each investment's source of income are a secondary consideration (and, as noted, will vary with each investor in any event).

As shown in the table, a comparatively low tax rate applies to capital gains. This is a critical factor in the management of the Fund. As discussed under "Portfolio Turnover" immediately above, if the sale of a security is warranted (e.g., to reduce portfolio leverage or for fundamental or valuation reasons), then the security will be sold regardless of tax considerations. As a result, particularly in years when investment returns are strong (such as in 2013), investors in the Fund should expect to be allocated capital gains and other income for inclusion in their income tax returns. The sting of paying taxes on those gains should be soothed by the comparatively low tax rate applicable to capital gains and by the knowledge that the best way to maximize after-tax returns is to maximize pretax returns. To again quote Munger: "I would say that trying to minimize taxes too much is one of the great standard causes of really dumb mistakes."<sup>72</sup>

## **Inflation**

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For reasons of convenience and objectivity, all rate of return data included in this letter is in nominal terms (i.e., before the impact of inflation). This does not take into account the impact of inflation in eroding the value of assets and returns in real (i.e., inflation-adjusted) terms. For example, over the 25 years from 1988 to 2013, the compound annual rate of inflation (as measured by the Canadian consumer price index) was 2.14%.<sup>73</sup> This is consistent with the Bank of Canada's "inflation-control target" (adopted in 1991) of 2%.<sup>74</sup> In the United States, the results are even worse: the compound annual rate of increase in its consumer price index over the same 25-year period was 2.75%.<sup>75</sup>

While an inflation rate of 2.14% (such as Canada has experienced in recent times) may not sound like much, the magic of compound interest can cause even a low rate of inflation to inflict a terrible toll over the long term. Using the mathematical rule of 72 (i.e., dividing 72 by the growth rate calculates approximately how long it will take something to double), an annual inflation rate of 2.14% will result in a doubling of the price level in just 33 years. Thus, a person aged 52 who lives to be 85 should expect prices by that time to double.

Nor should we be complacent about future rates of inflation. Inflation has often been much higher than 2% in the past and it may be again. Indeed, it is well known that, for centuries, governments have overspent their means with the inevitable result being currency debasement and default.<sup>76</sup>

The toll that inflation takes on rates of return is dramatic. Assume, for the purposes of this discussion, an average annual total return on an unleveraged equity portfolio of 8.0% (consistent with historic long-term stock market returns).<sup>77</sup> Further assume that the weighted average tax rate on the various forms of income comprising the 8.0% return for an Alberta resident is 20% (see "Taxes" immediately above). With these assumptions, the after-tax return on the portfolio would be 8.0% times (1 - .20) or 6.4%. From this must be subtracted the rate of inflation; assume that is equal to the Bank of Canada's inflation target of 2%. The after-tax real rate of return is thus only 6.4% - 2% or 4.4%. The seemingly small rate of inflation of 2% eats up two percentage points of the after-tax return of 6.4%, for a staggering reduction in real return of (31%). The results for an Ontario resident are worse. For Ontarians in the second-highest tax bracket, taxes will consume about 25% of the pretax return of 8.0%, reducing the after-tax return to 8.0% times (1 - .25) or

6.0%. The same rate of inflation of 2% reduces the after-tax real rate of return to 4.0%, a reduction in real return of (33%).

The above analysis compels the following conclusion: a pretax, nominal return that might appear satisfactory may, in fact, be unsatisfactory after the impact of taxes and inflation are taken into account. As a result, the Fund must use every tool at its disposal to enhance its performance in order to meet its objective of a satisfactory return. Everything done in terms of the management of the Fund, from the careful implementation of purchase and sale decisions, to zealousness about achieving low fees and operating expenses (see "Fund Fees and Expenses" below), to having the Fund based in Alberta (which has the lowest tax rates in Canada on the Fund's management and performance fees), is aimed at enhancing the after-tax real rates of return for the Fund's investors.

## **Fund Fees and Expenses**

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Most of this letter has described how the Fund strives to meet its investment objective through management of its portfolio. The Fund also endeavours to meet its investment objective through control of its fees and expenses.

### *Management Fees*

The Fund's class A management fee is 2% per annum which includes a trailing commission of 1% payable to distributing investment dealers.<sup>78</sup> The Fund's class F management fee is 1% (this class is generally intended for fee-based accounts of investment dealers). These are industry standard fees. For investments of at least \$1 million, the Fund offers two additional classes of units: class B, with a management fee of only 0.75%; and class BN, with a management fee of 1.75%. Portland believes that the Fund, with its class B and class BN units, is the only alternative strategies fund which has published discounted management fees for larger investments.

### *Performance Fees*

The Fund's class A, class F and class B units have a performance fee of 10% of the amount by which each class's net asset value per unit exceeds its respective high water mark (i.e., its highest-ever net asset value per unit).<sup>79</sup> This fee is half of that typically charged by other alternative strategies funds.<sup>80</sup> Furthermore, unlike many other funds, the Fund charges its performance fee at the fund level, not at the unitholder level. Apart from being simple to administer, this means that no investor will incur a performance fee unless the particular Fund class surpasses its highest-ever net asset value per unit.

### *Operating Expenses*

The Fund incurs operating expenses for such items as administration, audit and legal fees.<sup>81</sup> From the inception of the Fund to December 31, 2013, the Fund's operating expenses have been 0.50% per annum plus applicable taxes. While there can be no assurance that the Fund's operating expenses will remain at 0.50% per annum, the commitment to expense discipline will continue so as to maximize the Fund's returns to its investors.

## **Future Value Formula**

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Portland has long advised investors to consider and take to heart the future value formula. If FV stands

for future value, PV for present value, r for rate of return and n for the number of years an investment is held, then FV equals PV times  $(1+r)^n$ . One of the interesting things about this equation is that the investor completely controls two of the three variables including the very powerful exponent. In simple terms, what this means is that an investor who wants a larger nest egg in the future (FV) must invest the largest possible amount today (PV) and hold it for a long time (n). This may sound self-serving but it's true. The Fund will try to do its part to maximize the rate of return (r) given equity market conditions and consistent with preservation of capital.

### Outlook

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I want to take this opportunity to thank all investors for your investment and confidence. While I must and will avoid specific forecasts, I sincerely believe that by continuing to follow the principles and procedures outlined in this letter, the Fund will continue to meet its investment objective: to achieve, over the long term, preservation of capital and a satisfactory return.



March 18, 2014

James Cole  
Senior Vice President and Portfolio Manager  
Portland Investment Counsel Inc.

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## Notes

1. Financial analysts are required by the CFA Institute's Code of Ethics and Standards of Professional Conduct to "distinguish between fact and opinion in the presentation of investment analysis" (see [http://www.cfainstitute.org/Translations%20of%20Code%20of%20Ethics%20and%20Standards%20of%20Pr/english\\_code.pdf](http://www.cfainstitute.org/Translations%20of%20Code%20of%20Ethics%20and%20Standards%20of%20Pr/english_code.pdf), Standard V.B.3). In this letter, all opinions are those of, and the words "I", "me", "my" and "mine" refer to, the Fund's portfolio manager, James H. Cole.
2. Portland Focused Plus Fund LP Confidential Offering Memorandum, October 22, 2012, p. 2. The OM is available at <http://www.portlandic.com/plusfund.html>.
3. OM, p. 2.
4. I show as one of the benchmark indices the S&P 500 Index in U.S. dollars rather than in Canadian dollars since the Fund generally hedges its U.S. dollar exposure. For a fuller discussion, see the "Foreign Currency" section of this letter.
5. Reasons for weighting Canada at 50% when it is a much smaller percentage of the combined Canadian and U.S. market capitalizations include the facts that: 1) I'm based in Canada and have home country knowledge which is likely to manifest itself in my selection of investments; 2) in my opinion, Canadian companies have, on average, superior corporate governance (such as separation of chairman and chief executive officer and less egregious executive compensation) compared to U.S. firms; and 3) in the case of one large sector, financial services, innate Canadian conservatism has served domestic companies particularly well compared to their U.S. peers. Finally, the 50%/50% division, while undeniably arbitrary, has the overarching virtue of simplicity.
6. <http://www.cifsc.org/en/CIFSC%20Category%20Definitions%202013.pdf>, p. 13.
7. Janet Lowe, *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (John Wiley & Sons, 1999), pp. 249-250 and Benjamin Graham, *The Memoirs of the Dean of Wall Street* (McGraw-Hill, 1996).
8. Benjamin Graham and David L. Dodd, *Security Analysis* (McGraw-Hill, 1934 first edition), p. 54.
9. The median return is that return which divides the universe of funds in half such that half of funds have a performance above the median and half of funds have a performance below the median. A top decile return is one which is in the top 10% of funds in the category.
10. OM, p. 2.
11. *Ibid.*, p. 10.
12. Bernard Baruch, *My Own Story* (Buccaneer Books, 1957). See especially pp. 101-102 and p. 131, which detail Baruch's successful speculations in sugar and copper, respectively, and p. 254 where Baruch writes "[d]on't buy too many different securities. Better have only a few investments which can be watched."
13. Warren Buffett is widely regarded as the greatest investor of all time. His commitment to focused investing is so well known that little elaboration is needed here. For example, at the end of 2012, Berkshire Hathaway Inc., of which Buffett is chairman, held 59% of its common equity portfolio in just four issuers, despite the large US\$88 billion size of the portfolio. See Berkshire's 2012 annual report at <http://www.berkshirehathaway.com/2012ar/linksannual12.html>, p. 15. Also, when Buffett was managing investment partnerships in the 1960s, he had an unwritten rule that he would not put more than 25% of the partnership's money into any one security (although he broke the rule for American Express, committing 40%). See Carol Loomis, "The Inside Story of Warren Buffett," *Fortune* (April 11, 1988), p. 4.
14. Philip Fisher, *Common Stocks and Uncommon Profits* (PSR Publications, 1984 revised edition (originally published in 1958)), pp. 116-127. Fisher suggests as a rough guide that adequate diversification can be attained with as few as five stocks and concludes by stating, "[i]n the field of common stocks, a little bit of a great many

can never be more than a poor substitute for a few of the outstanding.”

15. It's a little-appreciated fact that Keynes, the world-renowned economist, was also a great investor. From 1928 to 1945, Keynes nearly quintupled the value of the Chest Fund of King's College, Cambridge from capital appreciation alone in a period in which the general British stock market declined. See “J.M. Keynes's Investment Performance: A Note,” *The Journal of Finance* vol. XXXVIII (March 1983) pp. 232-235. In 1934, Keynes wrote “[a]s time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence...One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence.” See <http://www.maynardkeynes.org/keynes-the-investor.html>.
16. Charles Munger is vice chairman of Berkshire Hathaway and Buffett's long-time business partner. In September 2013 *Forbes* estimated his net worth at US\$1.2 billion (see <http://www.forbes.com/profile/charles-munger/>). Munger has long espoused and practiced focusing investing. For example, it's been said of Munger, “[i]n his view, a portfolio of three companies is plenty of diversification. Accordingly, Charlie is willing to commit uncommonly high percentages of his investment capital to individual ‘focused’ opportunities.” Peter D. Kaufman, editor, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger* (PCA Publication, 2005), p. 48. In his own words, Munger states “[o]ur investment style has been given a name – focus investing – which implies ten holdings, not one hundred or four hundred.” *Ibid.*, p. 88. He adds, “[t]he idea of excessive diversification is madness.” *Ibid.*, p. 90. In comments at Berkshire Hathaway's annual general meetings, Munger has summed up his investment approach by saying “make fewer decisions, make better decisions” (May 2002) and “you don't need a ton of good ideas; you need a couple of good ideas that make a ton” (May 2006).
17. William Ruane founded and managed the Sequoia Fund. In 1999, *Forbes* noted that an investment of \$10,000 in the fund at its inception in 1970 would have been worth \$1.1 million that year (see <http://www.washingtonpost.com/wp-dyn/content/article/2005/10/05/AR2005100502298.html?sub=new>). Ruane was an ardent believer and practitioner of focused investing in larger capitalization companies. For example, the Sequoia Fund's annual report for 1999 (the oldest available on the fund's web site) shows that at the end of 1999, 97% of the fund's common equities was invested in only nine businesses (see <http://www.sequoiafund.com/Reports/Annual/Ann99.pdf>).
18. See, for example, the chairman's message to the semi-annual report of AIC Funds dated June 30, 1997, reprinted in *Messages: The Writings of Michael Lee-Chin* (AIC, 2002), pp. 29-32.
19. E.g., John Evans and Stephen Archer, “Diversification and the Reduction of Dispersion – An Empirical Analysis,” *The Journal of Finance* vol. XXIII (December 1968) pp. 761-767; Henry A. Latané and William E. Young, “Test of Portfolio Building Rules,” *The Journal of Finance* vol. XXIV (September 1969) pp. 595-611; and K.H. Johnson and D.S. Shannon, “A Note on Diversification and the Reduction of Dispersion,” *Journal of Financial Economics* 1 (1974) pp. 365-372. The pioneering Evans and Archer study concluded that the “results also raise doubts concerning the economic justification of increasing portfolio sizes beyond 10 or so securities”.
20. Kaufman, op. cit., p. 53 and p. 121.
21. [http://en.wikipedia.org/wiki/Opportunity\\_cost](http://en.wikipedia.org/wiki/Opportunity_cost).
22. E.g., Kaufman, op. cit., p. 92, pp. 95-96 and p. 353.

23. [http://www.franklintempleton.ca/ca/retail/en/pdf/products/sales\\_tools/16\\_rules.pdf](http://www.franklintempleton.ca/ca/retail/en/pdf/products/sales_tools/16_rules.pdf).
24. William Proctor, *The Templeton Touch* (Templeton Press, 2012 revised edition), p. 91.
25. Statistics Canada, CANSIM table 203-0027, <http://www.statcan.gc.ca/pub/12-581-x/2013000/h-l-eng.htm>.
26. Ibid.
27. Homes may be purchased with loan-to-value (LTV) ratios up to 95% although homes with LTVs exceeding 80% require mortgage insurance. See [http://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/hopr/hopr\\_001.cfm](http://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/hopr/hopr_001.cfm).
28. The Investment Industry Regulatory Organization of Canada (IIROC) is the self-regulatory organization of broker-dealers. Every quarter, it publishes a list of securities eligible for reduced margin which generally comprises the largest and most liquid stocks in Canada (see, for example, [http://www.iiroc.ca/Documents/2012/c4f887a0-35d6-4a43-a093-b39c169e4563\\_en.pdf](http://www.iiroc.ca/Documents/2012/c4f887a0-35d6-4a43-a093-b39c169e4563_en.pdf)). The maximum that brokers are permitted to lend against such securities is 70% of their value.
29. We assume a significant loan so that the borrower is able to negotiate a 0.50% reduction from the Canadian prime rate, which as of February 19, 2014 was 3.0%. The lowest mortgage rate posted by Royal Bank of Canada (Canada's largest bank) as of February 19, 2014 was 3.0% (for a five-year closed variable rate mortgage).
30. The average Canadian dollar debit interest rate offered to the Fund by three custodians as of February 19, 2014 was approximately 2.0%.
31. The average U.S. dollar debit interest rate offered to the Fund by three custodians as of February 19, 2014 was approximately 1.1%.
32. As of 2013, annual property taxes on residential homes are often in the range of 0.4% to 0.9% or more of assessed value (as per the web sites of a sample of major Canadian cities). To this must be added the expenses to operate the home (such as for heat, electricity and water), perform regular maintenance (such as yard work, snow removal and minor repairs) and a depreciation reserve for occasional major items (such as painting or a new roof). In my estimation, all of these ownership expenses combine to at least 2% of fair market value per annum.
33. The exception is if the property is held free and clear (i.e., debt-free) and a mortgage is then taken out on the property with the proceeds of the mortgage used to acquire income-producing assets. In that case, the interest on the mortgage would generally be tax-deductible. This technique (which has been popularized as the "Smith Manoeuvre"), however, appears to be beyond the means of many Canadians.
34. For example, in Toronto, real estate commissions are often 2.5%, the Government of Ontario levies a land transfer tax of up to 2% on purchases and the city levies a similar land transfer tax on sales. These expenses thus amount to 4.5% each way, or a total of 9.0% for a round trip, to which must be added other costs such as legal fees and property inspection fees.
35. Benjamin Graham, *The Intelligent Investor* (Harper & Row, 1973 fourth revised edition), p. 4.
36. Lowe, op. cit., p. 146.
37. For the mathematically inclined, if N = net assets and M = amount of margin and if all securities held are eligible for 70% margin, then the percentage decline in the total portfolio that must occur to trigger a margin call is  $M/7/(N+M) - 1$ .
38. Note that for the reasons discussed in the "Foreign Currency" section of this letter, the Fund may, from time to time, hold cash in one currency even while it holds margin loans in another currency. I would then net cash, if any, against margin loans in calculating the amount of leverage. Another way to measure the Fund's use of leverage which yields the same result is simply to divide total equities by net assets.
39. OM, p. 2.
40. Lowe, op. cit., p. 215.
41. Ibid., p. 216 and p. 223.
42. Ibid., p. 228.

43. OM, p. 2.
44. Graham, op. cit., pp. 79-82 and p. 211.
45. [http://en.wikipedia.org/wiki/Damon\\_Runyon](http://en.wikipedia.org/wiki/Damon_Runyon)
46. John Burr Williams, *The Theory of Investment Value* (Harvard University Press, 1938), p. 80. See also pp. 57-58 and p. 474.
47. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Harcourt, 1964; originally published in 1936), p. 158 and pp. 154-155.
48. Berkshire Hathaway Inc. 1999 annual report, p. 60.
49. Ibid., p. 16.
50. James Montier, *Behavioural Investing: A practitioner's guide to applying behavioural finance* (John Wiley & Sons, 2007), pp. 133-140.
51. Carol Loomis, *Tap Dancing to Work: Warren Buffett on practically everything, 1966-2012* (Penguin, 2012), p. 102.
52. OM, p. 3. Short selling is the practice of selling shares that one doesn't own (and borrows for delivery). A common intention is to buy the shares back at a lower price at a future date and profit from the difference between the sale and purchase prices. Alternatively, short sales may be used to hedge long positions.
53. [http://en.wikipedia.org/wiki/Modern\\_portfolio\\_theory](http://en.wikipedia.org/wiki/Modern_portfolio_theory)
54. Berkshire Hathaway Inc. annual meeting, May 2006.
55. Berkshire Hathaway Inc. annual meeting, May 2007.
56. Lowe, op. cit., p. 67.
57. David Swensen, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (Free Press, revised 2009 edition), p. 335.
58. <http://www.investopedia.com/articles/investing/041213/modern-portfolio-theory-vs-behavioral-finance.asp>
59. GMO LLC Quarterly Letter, November 2013, pp. 6-9.
60. My notes attribute this quotation to Larry Hite although the source is unknown.
61. Howard Marks, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor* (Columbia University Press, 2011), p. 46.
62. Frank Martin, *Speculative Contagion: An Antidote for Speculative Epidemics* (AuthorHouse, 2006), pp. 74-76, cited in Montier, op. cit., pp. 448-452.
63. These are two of the three central messages of Graham's *Intelligent Investor*. The third is that the market is there to serve you, not to guide you.
64. <http://www.cboe.com/micro/VIX/vixintro.aspx>
65. I wish to give proper attribution to Buffett as I'm certain that he has used those exact words although I've been unable to find the source to reference.
66. [http://en.wikipedia.org/wiki/Market\\_impact](http://en.wikipedia.org/wiki/Market_impact)
67. See, e.g., estimates by Elkins McSherry LLC that in the second quarter of 2012, total trading costs (commissions plus fees plus "implementation shortfall") for U.S. equities were 0.40%. See [https://www.elkinsmcscherry.com/EM/pdfs/Newsletters/Aug\\_2012\\_newsletter.pdf](https://www.elkinsmcscherry.com/EM/pdfs/Newsletters/Aug_2012_newsletter.pdf), p. 4. An earlier study by the same firm found that in January 2010 trading costs for a mega-cap company were 5 basis points (i.e., 0.05%), for a large-cap company were 35 basis points and for a small cap company were 125 basis points. See [https://www.elkinsmcscherry.com/EM/pdfs/Newsletters/Feb\\_2010\\_newsletter.pdf](https://www.elkinsmcscherry.com/EM/pdfs/Newsletters/Feb_2010_newsletter.pdf), p. 4.
68. <http://www.investopedia.com/terms/p/portfolioturnover.asp>
69. <http://www.aquotes.net/bernard-baruch/bernard-baruch-i-made-my-money-by-selling-too-soon/> and <http://www.asxmarketwatch.com/2011/11/trading-and-investment-quotes-i-never-buy-at-the-bottom-and-i-always-sell-too-soon/>. See also Baruch, op. cit., pp. 241-242.
70. OM, pp. 17-22.

71. <http://taxtips.ca/marginaltaxrates.htm>
72. Kaufman, op. cit., p. 195.
73. <http://www.bankofcanada.ca/rates/related/inflation-calculator/>. Results using the GDP deflator are similar; see <http://www.indexmundi.com/facts/canada/gdp-deflator>
74. <http://www.bankofcanada.ca/rates/indicators/key-variables/inflation-control-target/>
75. <http://www.usinflationcalculator.com/>. Results using the GDP deflator are similar; see <http://www.indexmundi.com/facts/united-states/gdp-deflator>
76. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009). The recent controversy over at what point a country's debt-to-GDP ratio begins to affect its economic growth does not diminish the book's central message, demonstrated very clearly, that government overspending results in debasement and default.
77. According to Bloomberg data, the compound annual total returns for the 50-year period from the end of 1963 to the end of 2013 for the S&P/TSX Composite Index and the S&P 500 Index were 6.9% and 8.6%, respectively. Similarly, data compiled by John Bogle show that the average annual total return on U.S. stocks for the 100 years ended 2009 was 9.1%. See John F. Wasik, *Keynes's Way to Wealth: Timeless Investment Lessons from the Great Economist* (McGraw-Hill, 2014), p. xv.
78. OM, pages 6, 12 and 14.
79. OM, p. 13.
80. [http://www.investopedia.com/terms/t/two\\_and\\_twenty.asp](http://www.investopedia.com/terms/t/two_and_twenty.asp). I believe that all of the Fund's major competitors have a typical "2% and 20%" fee structure which includes a performance fee of 20% whereas the Fund's performance fee is half of that, i.e., 10%.
81. OM, pp. 13-14.

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The PORTLAND FOCUSED PLUS FUND LP (the “Partnership”) is not publicly offered. It is only available under offering memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as “accredited investors”. Information herein pertaining to the Partnership is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Partnership is made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

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Enquiries can be directed to: Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7

Tel.: 1-888-710-4242 • Fax: 1-866-722-4242

Email: [info@portlandic.com](mailto:info@portlandic.com) • Web site: [www.portlandic.com](http://www.portlandic.com)

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# Portland Focused Plus Fund LP

## ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2014

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return		
	Portland Focused Plus Fund LP	S&P/TSX Composite Index	S&P 500 Index (US\$)
2012 (from Oct. 31)	1.9%	0.6%	1.5%
2013	34.1%	13.0%	32.4%
2014	16.8%	10.6%	13.7%

Since Inception (Oct. 31, 2012)

Compound annual return	24.1%	11.1%	21.6%
Cumulative return	59.7%	25.7%	52.8%

Notes:

Performance for the Portland Focused Plus Fund LP is for the class F units which is the highest fee class without embedded advisor compensation. Performance shown is the Fund's net return after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Fund generally hedges its U.S. dollar exposure.

Past performance is no guarantee of future results. This information is not to be construed as a public offering of securities in any jurisdiction of Canada. The offering of the Fund is made pursuant to an offering memorandum to eligible investors. Read the offering memorandum carefully before investing. For the Fund's offering memorandum which contains information including investment objectives, fees and expenses and risks, visit [www.portlandic.com/plusfund.html](http://www.portlandic.com/plusfund.html) or contact Lana Nicosia at 1-888-710-4242 or by email at [lnicosia@portlandic.com](mailto:lnicosia@portlandic.com).

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "Fund"):**

This letter describes how the Fund is managed and why it is managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Fund.<sup>1</sup>

**2013 Letter**

The 2013 annual letter to investors in the Fund ("2013 Letter") is available on the web site of Portland Investment Counsel Inc. ("PIC") at <http://www.portlandinvestmentcounsel.com/plusfund.html>. The major subject areas covered in the 2013 Letter are: investment objective; performance; investment strategies (focus and leverage); investment vs. speculation; investments; short selling; foreign currency; volatility vs. risk; trading costs; portfolio turnover; taxes; inflation; fund fees and expenses; and future value formula. As those subject areas were discussed in detail in the 2013 Letter, this letter provides concise references to those subjects only as necessary. Investors are strongly encouraged to read the 2013 Letter before reading this letter.

**Investment Objective**

As stated in the Fund's Offering Memorandum (the "OM"), the Fund's investment objective is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Fund has been satisfactory, investors should compare the long-term performance of the Fund to a 50%/50% average of the returns of the S&P/TSX Composite Index and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance**

The performance of the Fund and that of the two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Fund's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end, may be found at [www.portlandic.com/plusfund.html](http://www.portlandic.com/plusfund.html).

In 2014, the Fund's class F units achieved a return of 16.8% (net of fees and expenses). That compares to a total return of 10.6% for the S&P/TSX Composite Index and 13.7% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 12.1%. For the entire period since inception of the Fund on October 31, 2012 to December 31, 2014 the Fund's class F units achieved a cumulative return of 59.7%. That compares to a cumulative total return of 25.7% for the S&P/TSX Composite Index and 52.8% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 39.2%. Accordingly, in both 2014 and for the cumulative period since the Fund's inception, the Fund met its investment objective of preservation of capital and a satisfactory return.

**Operating Expenses**

The Fund incurs operating expenses for such items as fund administration, audit and legal fees.<sup>4</sup> From the inception of the Fund to December 31, 2014, the Fund's operating expenses were 0.50% per annum plus applicable taxes. While there can be no assurance that the Fund's operating expenses will remain at 0.50% per annum, PIC remains committed to tight control of fees and expenses so as to maximize the Fund's returns.

## Management Fee Reductions

Effective July 1, 2014, PIC reduced the management fee on each of the class B and class BN units by 0.75% per annum to nil and 1.0% per annum, respectively.<sup>5</sup> To my knowledge, the Fund's class B units are the only class of any investment fund in Canada with no management fee.

## Fund Classes

The Fund has four classes of units. The features of each are outlined below:<sup>6</sup>

- *Class A units* have a minimum initial subscription amount of \$5,000 for accredited investors (\$150,000 for all others). Class A units have a management fee of 2% per annum and a performance fee of 10% of the amount above the class's highest ever net asset value per unit ("High Water Mark"). A trailing commission of 1% per annum is paid to financial advisors whose clients invest in class A units;
- *Class B units* have a minimum initial subscription amount of \$1,000,000. Class B units do not have a management fee; they have a performance fee of 10% of the amount above the class's High Water Mark;
- *Class BN units* have a minimum initial subscription amount of \$1,000,000. Class BN units have a management fee of 1% per annum; they do not have a performance fee; and
- *Class F units* have a minimum initial subscription amount of \$5,000 for accredited investors (\$150,000 for all others). Class F units have a management fee of 1% per annum and a performance fee of 10% of the amount above the class's High Water Mark.

The performance of the class F units, which is the highest fee class without embedded advisor compensation, is shown in the table on the inside front cover of this letter. The performance of all of the Fund's four classes is shown in the table below.

Year	Annual Total Return			
	Class A	Class B	Class BN	Class F
2012 (from Oct. 31)	1.7%	2.0%	2.0%	1.9%
2013	33.0%	34.4%	37.7%	34.1%
2014	15.6%	17.5%	18.8%	16.8%

### Since Inception (Oct. 31, 2012)

Compound annual return	22.9%	24.6%	26.7%	24.1%
Cumulative return	56.4%	61.0%	66.9%	59.7%

As can be seen in the last line of the table, for the period from October 31, 2012 to December 31, 2014, the Fund's class F units had a cumulative return of 59.7% while the Fund's class B and class BN units had higher cumulative returns of 61.0% and 66.9%, respectively. Going forward, the class B units are certain to continue to have returns greater than the class F units since

the class B units have no management fee. Similarly, the class BN units will have a performance greater than the class F units to the extent that the Fund earns performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the class B and class BN units are encouraged to do so in order to take advantage of the lower fees applicable to those classes which will continue to enhance their long term performance.

### **Oil Prices**

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One of the major economic events of 2014 was the dramatic decline in oil prices. This had a significant impact on the Fund's performance. As a result, a discussion of world oil markets is merited.

For the three and a half years ended June 30, 2014, the world price of oil, as represented by the price for Brent crude, traded in a narrow range and averaged US\$110 per barrel.<sup>7</sup> By the end of 2014, Brent had fallen below US\$60 per barrel. To date in 2015, Brent has averaged less than US\$60 per barrel, a decline from its average for the three and a half years ended June 30, 2014 of more than (US\$50) per barrel or (45%).<sup>8</sup> The world consumes 92.4 million barrels per day or 33.7 billion barrels per year.<sup>9</sup> As a result, if the price of Brent crude oil were to remain at US\$60 per barrel then as compared to the prior several years the world's oil consumers would save US\$1.7 *trillion* per year. This would be, in effect, an enormous tax cut which would benefit the world's largest net oil consuming countries. That list includes almost all of the world's major economies: the United States ("U.S."), China, Japan, India and most of continental Europe. Conversely, the tax cut will be paid by the world's net oil producing countries: the 12 member states of the Organization of the Petroleum Exporting Countries ("OPEC"), Russia, Mexico and a few other smaller countries (including, alas, Canada). On balance, the decline of crude oil prices in the second half of 2014 and early 2015, if sustained, can be expected to be hugely beneficial to the world economy.

Beginning in 2004, I became a believer in the Peak Oil Theory. This theory asserts that global crude oil production is at or near a peak, after which production will begin to decline. The world is critically dependent on crude oil, particularly for transportation fuels consumed by planes, trains and automobiles. Alternative energy sources for those consumption needs are either unavailable or are uneconomic. In the absence of alternatives, the world will continue to rely on crude oil which, once used, is gone forever. Given the increasing difficulty of maintaining and increasing oil supply, the price mechanism must serve to balance supply and demand. In other words, based on the Peak Oil Theory, oil prices will average much higher levels than previously in order to make it economic to find and produce increasingly expensive sources of crude oil and to encourage greater efficiency in energy consumption. For the 10 years ended in mid-2014, this theory was an accurate predictor of world oil markets as prices rose to previously unheard-of levels yet there was limited increase in either oil production or the profitability of energy companies (because of the difficulty and high cost of bringing on new reserves).

Beginning in mid-2014, the seeming stability in world oil prices began to unravel. Two technological developments, horizontal drilling and hydraulic fracturing (fracking), have been applied

to known deposits of light, tight oil in shale formations that prior extraction methods had been unable to exploit. Oil production in the U.S. has experienced a dramatic renaissance, increasing from 7.4 million barrels per day in 2009 to 11.7 million barrels per day in 2014.<sup>10</sup> At the same time, three OPEC countries, Iran, Iraq and Libya, began to restore production that had been curtailed by geopolitical events.<sup>11</sup> World oil production began to exceed consumption and prices began to fall. On November 27, 2014 that price decline accelerated sharply after OPEC decided to maintain its production when financial markets had expected an OPEC production cut.<sup>12</sup> Prices went into freefall and, as noted, Brent crude fell below US\$60 per barrel by the end of 2014 and has averaged less than US\$60 per barrel in 2015 to date.

For investors, it's important to attempt to predict what oil prices will be in the future. The laws of economics suggest that the long-term equilibrium price will be one which balances supply and demand and which covers oil's total production costs including a satisfactory return on the equity capital deployed in oil-producing companies. In terms of demand, one often reads that world oil demand has fallen. Almost invariably, the writer means to say that the *growth* of demand has fallen. In data going back more than 40 years, other than in times of recession or in response to a sudden major increase in oil prices (neither of which factor exists now), oil demand has never declined. In fact, over the past decade (ending in 2014), world oil demand grew by a cumulative amount of 9.4 million barrels per day (i.e., at about 1.0% per annum).<sup>13</sup>

In terms of supply, it's important to distinguish between marginal cost and total cost. Marginal costs are the cash costs required to produce and deliver one more barrel of oil from existing facilities, such as cash costs for production, transportation and royalties. Total costs (i.e., full-cycle costs), include marginal costs as well as exploration, development, depreciation, depletion and amortization, general and administrative expenses, interest expense and income taxes. While oil prices are currently higher than the marginal cost of all but the highest-cost sources of supply, they are far below total costs as well as the excess required above total costs to provide a satisfactory return on the shareholders' equity invested in oil producing companies.

In my estimation, the world oil price required to cover total costs and provide an adequate return on investment is at least US\$80 per barrel. Since oil prices are currently far below that level, investment in new oil production will decline which will eventually tighten up the supply/demand balance. Think of oil production as a pipeline: money goes in one end and, a year or more later, oil comes out the other end. Once the money tap is turned sharply down, which has been happening since December, oil production will inevitably decline. That is the basis for the timeless expression that "the best cure for low oil prices is low oil prices." The natural decline rate of existing production means that when spending on new production dries up, total production will soon begin to decline, thus causing prices to increase back to a level at which investment in new production is economic.

It should be noted that changes in oil prices have a leveraged effect on the profitability of oil-producing companies. For example, if oil were \$100 per barrel and a company's total costs were

\$60 per barrel, a decline of (40%) in the oil price would result in a decline in the company's net income of (100%). That explains why the fall in oil prices in 2014 had a materially negative impact on the share prices of energy companies. In 2014, for example, the S&P/TSX Oil & Gas Exploration and Production sub-index fell (24.8%) while the S&P/TSX Oil & Gas Drilling sub-index declined by (39.2%).<sup>14</sup> The share prices of global energy service companies such as offshore drillers also fell sharply. This had a material negative effect on the performance of the Fund, as is more fully discussed in the next two sections of this letter.

### **Sell Discipline**

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An important aspect of any portfolio manager's style is sell discipline. In other words, under what circumstances would an investment already held be sold? Apart from special circumstances such as takeovers, the factors that would give rise to security sales in the Fund are as follows:

- *Material adverse change.* This refers to circumstances when a business, subsequent to purchase, experiences a significant deterioration in its fundamental attributes such as earnings, financial position, operations or management;
- *Mistakes.* These are instances in which candour demands the recognition that there may not have been material adverse change. Instead, the merits of the business or the attractiveness of its valuation were misunderstood at the time of purchase; and
- *High valuation / opportunity cost.* This is the happy circumstance in which an investment in a company has performed so well (such as when its share price has risen much faster than its earnings, dividends and intrinsic value) that it no longer represents an attractive combination of high potential return with limited downside risk compared to investment alternatives. When this occurs, the investment becomes a candidate for sale with the proceeds to be re-allocated to superior investment opportunities.

From time to time, despite the fact that the Fund's investments do not meet the criteria for sale listed above, I may choose to sell securities in order to *reduce portfolio leverage*. In that instance, the Fund may sell all or part of its investment portfolio, considering such factors as valuation, fundamental performance and industry diversification. As noted in the 2013 Letter, paying down margin debt reduces portfolio risk.<sup>15</sup>

Most of the security sales in the Fund since its inception have been effected in order to reduce portfolio leverage or after strong performance has diminished a stock's prospective return and increased its downside risk. The Fund has experienced only a small number of security sales due to material adverse change or mistakes. One of those instances is reviewed immediately below.

### **The Biggest Loser**

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Some readers may be familiar with the reality television show, "The Biggest Loser". The show depicts obese contestants who compete to lose weight. The contestant who loses the most weight wins a cash prize. In investing, by contrast, the biggest loser is not anything to celebrate. Reviewing losers can, however, be useful and serve to improve future investment decision-making. In that spirit, below is the tale of the Fund's investment in Ensco plc ("Ensco").

As noted above, I believe in the Peak Oil Theory and the conclusion that flows from it: oil prices will, on average, be higher than they've been historically. As a result, I have been open to investing in oil-related businesses which meet our typical investment criteria (i.e., larger-capitalization companies with strong financial positions and superior track records that are undervalued, with a particular emphasis on companies with above-average dividend yields and satisfactory historic and prospective dividend growth).<sup>16</sup> In late 2013, I decided that one company that met those criteria was the world's second-largest offshore oil & gas driller, Enesco.

At the end of 2013, at about the time the Fund made its investment in the company, Enesco traded at: a price to book value of 1.0 times; a dividend yield of 5.3%; and a trailing price/earnings ("P/E") ratio of 9.3 times.<sup>17</sup> These are all levels which had historically indicated attractive investment value for this major business.

In light of what transpired in 2014, it's clear that I didn't appreciate how fat Enesco was or how much market value it would have to shed to become lean. The investment was acquired in the Fund in December 2013 and January 2014 at a total cost of US\$4.87 million. When the Fund finished selling Enesco in December 2014, the total proceeds from the investment, including dividends received during the Fund's period of ownership, totaled US\$3.55 million. The loss on the investment was thus (US\$1.32) million or (27.1%). I did sell almost half of the original holding in March at a modest loss when I began to believe that the fundamental outlook for the business constituted material adverse change as compared to the original investment thesis. Yet, presented with several warnings over the balance of 2014, I hung onto the remaining shares (at their ever-increasing dividend yield as the stock price went down). Those warnings included Enesco's announcement in its results for the second quarter of 2014, its first under its new chief executive officer ("CEO"), that it was taking an impairment charge of (US\$1.5) billion related to its drilling rigs. I too readily accepted this as the "big bath" often taken by new CEOs which writes off old assets and enhances future earnings. The impairment charge substantially reduced the previous average earnings which had underpinned part of the original investment thesis. Also, the OPEC decision of November 27 clearly marked a sea change in at least the near-term outlook for oil prices. Only with the end of 2014 looming, and the Fund having substantial realized capital gains on other positions while still holding Enesco at an unrealized loss, did I sell the remaining shares of Enesco.

I believe that I have become better over the years at not averaging down in positions that have gone awry (i.e., not throwing good money after bad). I believe that I have also become somewhat better at selling positions for which there has been material adverse change or when I recognize that I have made a mistake (i.e., cutting losses short). The tale of Enesco described above, however, shows that in that aspect of investing I still have room for improvement.

### **The One That Got Away**

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The tale of Fortis Inc. ("Fortis") is one which is much happier and yet still bittersweet.

Fortis is a leader in the North American electric and gas utility business, with total assets of more than \$26 billion and fiscal 2014 revenue of \$5.4 billion.<sup>18</sup> It serves customers across Canada and in the U.S. and Caribbean. In December 2013, Fortis announced that it had agreed to acquire UNS Energy Corporation (“UNS”), a utility company in Arizona, for US\$4.3 billion. Simultaneously, Fortis announced that it would finance the acquisition of UNS partly by the issuance of \$1.8 billion of convertible debentures (“Debentures”). The Debentures were sold on an instalment basis at a price of \$1,000 per Debenture, with \$333 due on closing (evidenced by instalment receipts) and \$667 due on the final instalment date (after closing of the UNS acquisition). The Debentures were sold on a “bought deal” basis, meaning that the offering’s underwriters (certain major brokerage firms) agreed to acquire the Debentures in the event that there was insufficient public demand.

As sometimes happens with bought deals, the underwriters misjudged the market. There were not enough buyers for the Debentures at their original issue price so the underwriters were forced to buy the Debentures and take them into their own securities inventory. As often happens in such situations, the underwriters (rather than tie up their own capital for long periods in ownership of a security that they had clearly misjudged) soon reduced the price to sell the securities out of their inventory. In January 2014, the underwriters cut the price from \$333 (the price that they had paid on closing) to \$305. I determined that the Debentures met the Fund’s investment criteria and that at their reduced price they offered an exceptionally attractive combination of high expected return with limited downside risk. The Fund therefore acquired \$4.30 million principal amount of Debentures for an initial outlay of \$1.31 million. So far, so good.

After placing the initial Debenture order, I contacted the Fund’s custodian because I proposed to take a much larger position in the Debentures but before doing so I needed to determine what the custodian would provide in loan value (i.e., in a margin loan) against the Debentures as security. The custodian’s answer was “zero.” I argued strenuously against that position. I pointed out that since the volatility of Fortis common shares was about one-third that of the overall stock market, even though the Debentures were triple-leveraged (since they were only partially paid), their volatility could be expected to be no greater than that of the overall stock market. Further, I considered it illogical that the custodian would readily extend 70% loan-to-value against Fortis common shares but nothing against the Debentures which ranked higher in the company’s capital structure. While I argued these points vociferously, the custodian was unmoved. To be fair, at least one major competing prime broker (and one of the deal’s *underwriters*) would, similarly, offer no loan value on the Debentures.

I was thus faced with a difficult choice. Either I could simply keep the Fund’s initial investment in the Debentures or, to increase it significantly as I had proposed, I would have to sell many other of the Fund’s investments at the low prices then prevailing in late January. Had the custodian been willing to lend against the Debentures, this choice would not have been necessary as the Fund could have financed the purchase of additional Debentures with a margin loan. In the end, I reluctantly chose simply to keep the initial investment in the Debentures, rather than sell other investments at low prices so as to buy more Debentures which would have tied up more capital

in an unmarginable security.

The Debentures have proved to be the Fund's biggest winner to date. Compared to the purchase price of the Debenture instalment receipts of \$305.00, the total return on the instalment receipts, achieved in just nine months, was 75.3%. This is summarized in the following table:

#### Rate of return on Fortis convertible debentures

Fortis common stock price on Oct. 27, 2014	\$35.75
Times: # of Fortis shares per \$1,000 principal amount	32.5521
Equals: conversion value per \$1,000 principal amount	<u>\$1,163.74</u>
Subtract: final instalment payment	<u>(\$667.00)</u>
Equals: conversion value of instalment receipt	\$496.74
Add: interest coupon paid on instalment receipt	\$40.00
Subtract: accrued interest paid on purchase	<u>(\$2.19)</u>
Equals: total value of instalment receipt	\$534.55
Divided by: instalment receipt cost, Jan. 24, 2014 per \$1,000	\$305.00
Equals: simple rate of return on instalment receipts	75.3%

The following points explain the items in the table:

- The final instalment of the Debentures became due and was made on October 27, 2014 and the Debentures were converted into common shares on that date;
- Each \$1,000 principal amount of Debentures was convertible into 32.5521 Fortis common shares. At the closing price of the common shares on October 27 of \$35.75 per share, the market value of the shares (into which each \$1,000 principal amount of Debentures was converted) was therefore \$1,163.74;
- From this must be deducted the \$667 final instalment paid on the Debentures, so that the terminal value of the instalment receipts was \$496.74;
- To this must be added the coupon (i.e., interest) received on the Debentures of \$40.00. The accrued interest of \$2.19 that was paid upon the purchase of the Debentures in January, however, must be deducted; and
- Summing up all of the above items, the total value received for each Debenture instalment receipt was \$534.55. Compared to the purchase price of the Debenture instalment receipts of \$305.00, the total return on the instalment receipts, achieved in just nine months, was 75.3%.

The story got even better after October 27 when the Fortis common shares continued to appreciate. The total impact of the Fortis investment on the Fund in 2014 was as follows: the Fund sold some Fortis shares in late 2014 for realized capital gains of \$710,000 (as compared to their acquisition cost by means of the Debentures); held the remaining shares at December 31, 2014

which at their price then of \$38.96 per share had an unrealized gain of \$414,000; and the Fund had received Debenture coupon payments (net of accrued interest paid) of \$163,000. The realized gains, unrealized gains and coupon payments arising from the Fund's investment in the Debentures thus totaled \$1,287,000.

As good as the Fortis gains were, they could have been significantly larger. It was my intention (provided only that the instalment receipts had been given a normal loan value of 50% to 70%) to have the Fund purchase almost four times as much of the Debentures as it did. Woulda, coulda, shoulda are the useless pleas of investors, usually when they're employing 20/20 hindsight. Indeed, a favourite expression of PIC's chairman, Michael Lee-Chin, underscores the importance of taking action as he notes that "ideas are a dime a dozen; those who implement them are priceless." To have the Fortis idea and to take action, only to have that action severely limited by a supplier (in this case, the Fund's custodian), is a hard pill to swallow. It's not unlike hooking a huge fish only to be told by the captain to cut the line. While the performance of the Fund to date has certainly been satisfactory, its cumulative returns are and will always be less than they would have been were it not for the one that got away.

### **Income Taxes**

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In describing the Fund, I often mention the tax-efficiency of the Fund's legal form as a limited partnership ("LP"). I'm sometimes asked to explain how an LP works and what the benefits are to

investors. My explanation follows.

LPs are flow-through entities. The LP itself is not subject to income tax; all of its income and expenses are allocated to its investors for inclusion in their tax returns. Such income and expense items retain their tax character as though they had been received or paid by the investors directly. For example, as stipulated for individuals under the *Income Tax Act*, only 50% of the Fund's capital gains are included in investors' taxable incomes.

An additional example may prove instructive. Assume a hypothetical investment fund which is an LP. Further assume that it has the following portfolio and returns (the portfolio, while hypothetical, is not unlike how the Fund was invested at the end of 2014):

- Net assets of \$15 million;
- Margin loan of \$15 million, for a debt: equity ratio of 1:1 and a total portfolio size of \$30 million;
- The margin loan is entirely in U.S. dollars at an interest rate of 1.2%;
- The LP is invested \$15 million in Canadian equities and \$15 million in U.S. equities;
- The Canadian equities earn an annual total return of 8%, consisting of a dividend yield of 4% and capital gains of 4%;
- The U.S. equities also earn an annual total return of 8%, consisting of a dividend yield of 3% and capital gains of 5%;
- The foreign withholding tax on the LP's U.S. dividends received is 15%;
- The LP incurs operating expenses of 0.5% of net assets;
- The LP has a management fee of 1% and a performance fee of 10% of any return in excess of all of its expenses (i.e., the combined amount of interest expense, foreign withholding taxes, operating expenses and management fee); and
- For simplicity, the management fee and operating expenses are based on beginning of year net assets (rather than average net assets); there is no change in foreign exchange rates; and the goods and services tax ("GST") and/or harmonized sales tax ("HST") applicable to the LP's fees and expenses are ignored.

Given the above assumptions, the following table shows the income statement of the hypothetical LP and how its income and expenses would be recorded for tax purposes by the LP's limited partners (the results are shown for residents of both Alberta and Ontario, where, to date, all of the Fund's investors are located).

Hypothetical LP income statement	Alberta	Ontario
<b>LP income:</b>		
Canadian dividends	\$600,000	\$600,000
Foreign dividends	\$450,000	\$450,000
Capital gains	\$1,350,000	\$1,350,000
Fund total income	\$2,400,000	\$2,400,000
<b>LP expenses:</b>		
Margin loan interest expense	\$180,000	\$180,000
Foreign withholding taxes	\$67,500	\$67,500
Operating expenses	\$75,000	\$75,000
Management fee	\$150,000	\$150,000
Performance fee	\$192,750	\$192,750
Fund total expenses	\$665,250	\$665,250
LP income as reported	\$1,734,750	\$1,734,750
Add back: foreign withholding taxes	\$67,500	\$67,500
LP income before taxes	\$1,802,250	\$1,802,250

#### Limited partner tax rates

Marginal income tax rates (2014, assuming taxable income of \$150,000):<sup>19</sup>

Income (including foreign dividends)	39.00%	47.97%
Gross-up rate for Canadian dividends	38.00%	38.00%
Federal dividend tax credit	15.02%	15.02%
Provincial dividend tax credit	13.80%	13.80%

#### Limited partner allocations & taxes

<b>Income:</b>		
Canadian dividends (grossed-up)	\$828,000	\$828,000
Foreign dividends	\$450,000	\$450,000
Capital gains (50% inclusion)	\$675,000	\$675,000
Total income	\$1,953,000	\$1,953,000
Carrying charges (ex foreign withholding taxes)	(\$597,750)	(\$597,750)
Income before taxes	\$1,355,250	\$1,355,250
Income taxes before credits	\$528,548	\$650,113
Federal dividend tax credit	(\$124,364)	(\$124,364)
Provincial dividend tax credit	(\$114,264)	(\$114,264)
Foreign tax credit	(\$67,500)	(\$67,500)
Income taxes after credits	\$222,420	\$343,985
Add: foreign taxes withheld from LP	\$67,500	\$67,500
Total income taxes paid by investors	\$289,920	\$411,485

<b>Income taxes paid by investors as a % of LP income before taxes</b>	<b>16.1%</b>	<b>22.8%</b>
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Under the assumptions stated above, the LP would report income to its partners of \$1,734,750 after foreign withholding taxes of \$67,500. As a result, the LP's income before taxes, adding back the foreign withholding taxes paid, would be \$1,802,250. When the LP's income and expenses are allocated to investors, however, the investors' income before taxes would be only \$1,355,250. That is because under Canadian tax law dividends are grossed-up by 38%, which increases income, but that is more than offset by the fact that here is only a 50% inclusion rate for capital gains, which decreases income. *After accounting for the federal dividend tax credit, the provincial dividend tax credit and the foreign tax credit (which simply offsets the foreign taxes withheld from the LP at source), the taxes payable for residents of Alberta and Ontario on their allocations of the LP's income and expenses would represent only 16.1% and 22.8%, respectively, of the LP's income before taxes.* These comparatively low tax rates are achieved because two types of the LP's income (Canadian dividends and all capital gains) are taxed at preferential rates, whereas all of the LP's expenses are deductible from income at the highest marginal tax rates.

In addition, a potentially important benefit of the Fund's structure as an LP is that an LP may flow through capital losses to its investors. Conversely, a trust, which is the legal form of most investment funds, may not allocate capital losses to its investors. The Fund realized substantial capital gains in each of 2013 and 2014 and had further unrealized capital gains at the end of 2014. It is good to know, however, that if in the future the Fund should ever have net realized capital losses, it would be able to allocate such capital losses to investors rather than have them stranded at the Fund level.

Notwithstanding these positives, there is one important drawback of the LP structure. The *Income Tax Act* does not permit limited partnerships to be held in registered plans. Therefore, the target market for the Fund is non-registered assets of investors who are Canadian residents and who meet the accredited investor or minimum investment amount criteria.

### **Compound Interest**

One of the most powerful forces that may be put to work for investors is compound interest. That is the process by which the sum initially invested first earns investment income and in each subsequent period income is earned not only on the original sum invested, but also on the accumulated investment income. The brilliant Albert Einstein spoke several times regarding compound interest. He stated that "compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't, pays it."<sup>20</sup> Einstein also stated that compound interest is "the greatest mathematical discovery of all time"<sup>21</sup> and "the most powerful force in the universe."<sup>22</sup>

Compound interest may be illustrated using the mathematical rule of 72 (as an aside, Einstein also stated that the rule of 72 is the *ninth* wonder of the world). Dividing 72 by the growth rate calculates approximately how long it will take something to double. Thus, for example, if an investment provided a total return of 8% per annum, and all dividends or interest were reinvest-

ed, then the amount of the investment would double in nine years. If one held such an investment for 45 years, the investment would double in value five times, for a value at the end of the period of  $2^5$  or 32 times the original investment.

In order for compound interest to work its wonders for creating wealth, investors must: 1) maximize both the initial amount invested and subsequent contributions to the original investment; 2) find investments which will compound for a very long period of time *without being interrupted by permanent losses*; 3) find investments which will compound at a satisfactory rate over an investor's lifetime (or longer); and 4) provide such investments with a long period of time (measured in decades, not years or months) within which to grow.

In my opinion, the most difficult of these four elements to get right is to select investments that will compound for a long time without interruption by permanent losses. Indeed, it is that element that caused renowned economist and investor John Maynard Keynes to state, "I am sure that one of the reasons why in practice we are not influenced to set more money aside by reflecting on the magical consequences of compound interest over a long period is to be found in the fact that we do not rely on the accumulation continuing uninterrupted. And indeed we are justified, on the basis of past experience, in expecting that something would happen to interrupt it."<sup>23</sup> Later sections of this letter discuss two investments that I believe will continue to meet the objective of being able to compound for a long period of time without interruption by permanent losses, namely equity indices and common shares of the largest Canadian banks.

I find many examples of compound interest to be unrealistic and unsatisfying because not only do they fail to account for the likelihood of interruption in the growth rate and use unsustainably high growth rates, but also they fail to account for the real-world effects of trading costs, fees, expenses, taxes and inflation. The example of compound interest with which this letter concludes is inclusive of all of these effects and shows the magical power of long-term compounding in a realistic illustration.<sup>24</sup>

### **Exchange-Traded Funds**

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An exchange-traded fund ("ETF") is a fund that tracks the performance of an equity index (or bond index, commodity or other underlying investment) and that is traded on a stock exchange. The first ETF, tracking the S&P 500 Index, began trading in 1993.<sup>25</sup> Since then, ETFs have grown explosively. For example, in 2014, U.S.-based ETFs attracted \$243 billion in net new assets and total assets surpassed \$2 trillion.<sup>26</sup> In Canada, where the ETF industry is much less mature, in 2014 ETFs attracted \$10 billion in net new assets and total assets reached \$77 billion.<sup>27</sup>

One of the reasons for the popularity of ETFs is that some of them offer very low fees and expenses. As Jack Bogle (the founder and retired CEO of The Vanguard Group) and others have argued, the long-term performance of most investors has been and will continue to be lower than that of market indices.<sup>28</sup> Many investors may thus be better off investing passively (i.e., by investing in low-cost ETFs that track broad market indices).

In my opinion, one of the reasons that ETFs have not attained higher asset levels in Canada is

that their fees have been too high. That changed in 2014, in what may be regarded as a coming of age year for the Canadian ETF industry. In March, industry leader iShares (owned by the world's largest asset manager, BlackRock Inc.) announced significant fee cuts for ETFs tracking core asset classes, including Canadian equities and bonds as well as U.S. and international equities.<sup>29</sup> In April, the Canadian ETF industry's second-largest firm, Bank of Montreal, responded by announcing fee cuts of its own.<sup>30</sup> In October, Vanguard Canada also announced ETF fee reductions.<sup>31</sup> Not surprisingly, these three firms led the Canadian industry in 2014 net sales.<sup>32</sup> With these three large, long-established firms which are leaders in total ETF assets, Canadians now have a range of choices for low-cost investing in core asset classes.

I believe that the most compelling feature of ETFs is not the low fees and expenses now available on core asset classes, although that is certainly beneficial. Nor is it that investors can access a diversified portfolio in a single security, although that, too, is advantageous. I believe that the most compelling feature of ETFs is that *they provide investors with the opportunity to achieve satisfactory compound returns for a long period of time without interruption by permanent losses*. After all, any individual business could go to zero; stock markets overall, however, do not. Similarly, any individual asset management firm could cease to exist; all active portfolio managers are certain to grow old and die. Conversely, it is reasonable to believe that an ETF sponsored by a very large and established asset manager investing in a core asset class could carry on forever. In fact, the first ETF, the Standard & Poor's Depository Receipt S&P 500 ETF launched in 1993, is still going strong and now has a net asset value of \$194 billion.<sup>33</sup>

I consider ETFs to be particularly appropriate for fixed income investing. As one experienced observer stated, Canada's bond market "is a very small market and it's very hard to trade and it's got very poor liquidity and very poor transparency."<sup>34</sup> I agree with those sentiments. As a result, smaller investors are likely to be better off using ETFs for their fixed income allocation rather than trying to buy bonds directly. In fact, the Portland Canadian Balanced Fund uses ETFs for its fixed income component. Later sections of this letter discuss some of the opportunities and difficulties in using ETFs for equity investing.

### Historic Asset Class Returns

The total returns of some major asset classes in Canadian dollars ("C\$") for the 25 years ended December 31, 2014 are shown in the table below. I have chosen this period because it is both long-term and it represents a fair peak-to-peak measurement period. By coincidence, the exchange rate between the C\$ and the US\$ was C\$1.00 = US\$0.86 at the end of both 1989 and 2014. As a result, US\$ returns would have been the same as the C\$ returns shown in the table.

Total returns, 25 years ended 2014 (in C\$ unless otherwise indicated) <sup>35</sup>	
S&P/TSX Banks Index	14.2%
S&P 500 Index	9.6%
S&P/TSX 60 Index	8.7%
S&P/TSX Composite Index	8.0%

Scotia Universe Bond Index	7.8%
MSCI World Index	6.9%
MSCI World ex-USA Index	4.9%
Canada Treasury bills	4.1%
Annual inflation rate - U.S.	2.6%
Annual inflation rate – Canada	2.1%

What the table shows is that over the last 25 years, U.S. and Canadian equity market returns have been much higher than the returns of fixed income and cash. The highest returns shown in the table, by far, are for Canadian banks: the S&P/TSX Banks Index had a compound annual return for the 25-year period of 14.2% per annum. The next highest compound annual return was for the S&P 500 Index which was 9.6%. Next in performance was the S&P/TSX 60 Index (generally the 60 largest, high quality companies listed on the TSX) with a return of 8.7%. That was followed by the S&P/TSX Composite Index (with a normal number of about 220 to 300 companies, including the constituents of the S&P/TSX 60 Index plus many other generally smaller companies), with a return of 8.0%. What this shows is that during this period the shares of large capitalization companies outperformed their small cap brethren. As for fixed income, this period covered most of the greatest bull market for bonds in history. Nevertheless, fixed income (as represented by the Scotia Universe Bond Index) underperformed equities and had a return of 7.8%. The compound annual return on cash (as measured by Canada Treasury bills) was 4.1%. The inflation rates during the 25-year period in the U.S. and Canada averaged 2.6% and 2.1%, respectively. Of particular interest, the return of the MSCI World Index (which includes the U.S.) was 6.9% while the return of the MSCI World ex-USA Index was 4.9%. Thus, the returns in the U.S. far exceeded those in the rest of the world. This was not just a function of the collapse of the Japanese equity market during this period; the U.S. also outperformed Europe.

### Asset Mix

I do not mean to suggest that over the next 25 years, equities will perform as well as they have in the last 25. I do believe, however, that equities will continue to outperform bonds and cash over the long term. I have some very good company in that belief. Investing luminaries Charley Ellis, David Swensen and Warren Buffett all favour equities for long-term investors. For investors who plan to leave most of their wealth in bequests, Ellis, a leading American investment consultant, warns against the conventional wisdom of owning a greater proportion of assets in bonds as investors get older: “the wiser, better decision for you and your family might be to invest 100 percent in equities because your ‘investing horizon’ is far longer than your ‘living horizon.’”<sup>36</sup> Swensen, chief investment officer of Yale University since 1985, states that effective investment portfolios should be built on “the philosophical principles of equity orientation and diversification”.<sup>37</sup> He adds that investment portfolios should have an “equity bias” as “over reasonably long periods of time stock returns exceed those of bonds and cash.”<sup>38</sup> Swensen concludes his argument for an equity bias by stating that “historical evidence clearly points to a strong equity orientation for long-term investment programs.”<sup>39</sup> Buffett, chairman of Berkshire Hathaway Inc. and

considered by many to be the greatest investor of all time, simply states that in his will, his advice to the trustee for his wife is: “Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 Index Fund. (I suggest Vanguard’s.)”<sup>40</sup>

These views may be summarized as follows:

- Investors with a long (or maybe perpetual) investment horizon should be invested primarily, perhaps exclusively, in equities;
- Among the three major asset classes (equities, fixed income and cash), equities have historically earned the highest returns over the long term; and
- Prospectively, a reasonable base-case forecast suggests that over the long term, equities will continue to provide higher returns than fixed income or cash, probably by a wide margin.

### **50-Year Asset Class Return Forecasts**

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The 2013 Letter scrupulously avoided any asset class return predictions. World-famous financier J.P. Morgan, when asked what would happen to stock prices, gave the following legendary response: “they will fluctuate.”<sup>41</sup> I would like to defy his wise example and venture to predict the returns of selected major asset classes that might be realized over the next 50 years, from 2014 to 2064. The purpose of this seemingly foolhardy exercise is to provide some guidance to a young adult, just turned 18, who thus has an investing horizon of at least 50 years before he begins to draw on his savings to fund his retirement. Actual results will differ from these forecasts and the differences could be material. Planning for the financial success of this hypothetical young adult, however, demands that we make some reasonable predictions so as to guide long-term investment selection. The predictions contained in this letter do not account for major, low probability, outlier events which have come to be known as “black swans”. These could include, for example, a nuclear terrorist attack on the U.S. or a global pandemic which could dramatically affect investment returns. I’ve assumed, instead, that the world will muddle through as that is the high-probability scenario for which one should plan (while remaining mindful of downside risk in extreme scenarios).

#### *S&P 500 Index: 50-Year Forecast*<sup>42</sup>

I believe that over the long term, investors are likely to continue to achieve higher returns with S&P 500 Index ETFs than with world index ETFs. As noted above, in the last 25 years the S&P 500 Index has strongly outperformed the S&P/TSX Composite Index and the MSCI World ex-USA Index. Certainly, some reasons for that outperformance are that the U.S. is the world’s largest economy, and one of its most dynamic and free, governed by the rule of law. In fact, the U.S. represents over 58% of the MSCI World Index.<sup>43</sup> Also, in 2013 (the latest year for which data is available), foreign sales accounted for 33% of aggregate revenue of the S&P 500 Index companies.<sup>44</sup> Thus, the S&P 500 Index is actually very international in scope. Many ETFs now permit one to invest in the S&P 500 Index with fees that are both very low and much lower than the fees for world indices (of which U.S. companies comprise the majority percentage, anyway). As a result, for purposes of the 50-year asset class forecast, I use the S&P 500 Index as the leading large capitalization equity index.

According to the Gordon Equation, the real (i.e., inflation-adjusted) return of an equity asset such as the S&P 500 Index will equal: 1) the initial dividend yield plus 2) the real growth rate of dividends plus 3) the annualized change in valuation.<sup>45</sup> *One author has estimated that for U.S. stocks for the 200-year period 1802 to 2002, the initial dividend yield accounted for 78% of the real return with the growth of dividends and annualized change in valuation accounting for only 13% and 9%, respectively.*<sup>46</sup> To these three real factors one must add another factor: 4) the expected rate of inflation, in order to determine the expected nominal rate of return.

*Initial dividend yield.* One of the four factors stated above is known: at December 31, 2014, the indicated dividend rate on the S&P 500 Index was \$41.18 which, on the index level at that time of 2,059, provided an initial dividend yield of exactly 2.0%.

*Real growth rate of dividends.* This could be higher or lower than the real growth rate of earnings because of changes in the dividend payout ratio. Over the very long term, however, the growth rate of dividends should be similar to the growth rate of earnings. In fact, the dividend on the S&P 500 Index at the end of 2014 of \$41.18 was equal to a payout ratio of estimated 2014 “operating” earnings (i.e., earnings excluding specified items) of \$113.05 of 36.4%, similar to the 25-year average dividend payout ratio of operating earnings of 34.7%.<sup>47</sup> Similarly, the year-end 2014 dividend was equal to a payout ratio of estimated 2014 as-reported earnings (i.e., earnings according to generally accepted accounting principles (“GAAP”)) of \$102.32 of 40.2%, not much different than the 25-year average dividend payout ratio of GAAP earnings of 42.4%. Thus, it’s reasonable to expect that for the next 50-year period there will be no change in the dividend payout ratio. As a result, in order to estimate the expected real growth rate of dividends (one of the factors in the Gordon Equation) of the S&P 500 Index, one must simply estimate the expected real growth rate of earnings.

The real earnings growth rate of the S&P 500 Index will be derived in part from the following factors:

- *Population growth in the U.S. and, to a lesser extent, the rest of the world.* Over the last 25 years, U.S. population has grown at a compound annual rate of 1.0%.<sup>48</sup> In the same period, world population has grown at a compound annual rate of 1.3%.<sup>49</sup> It seems likely that population growth rates in the U.S. and world will continue to gradually decline, to 0.5% per annum or less. In fact, over the very long term, the only sustainable rate of population growth is zero; and
- *Gross domestic product (“GDP”) growth per capita in the U.S. and, to a lesser extent, the rest of the world, in real terms.* For the eight years from 2006 (just prior to the global financial crisis) to 2014, U.S. real GDP per capita increased at a compound annual rate of 0.4%.<sup>50</sup> From 2006 to 2013 (the most recent data available), world GDP per capita increased at a rate of approximately 2.2%.<sup>51</sup> It seems reasonable to believe that as the world gets richer and the base of world GDP gets larger, economic growth rates will slow down, just as they have in the major developed countries in recent years. For our 50-year horizon, I assume growth in world real GDP per capita of 1.0% per annum.

Combining the above two assumptions of world population growth of 0.5% per annum with growth in world real GDP per capita of 1.0% per annum suggests a forecast for world real GDP growth over the 50-year period from 2014 to 2064 of 1.5% per annum. Other factors which will also influence the real earnings growth of the S&P 500 Index will be:

- *Corporate profits as a percentage of GDP.* These will always fluctuate. In 2014, U.S. after-tax corporate profits as a percentage of GDP were approximately 8.9% compared to their average since 1950 of 6.3%.<sup>52</sup> Naysayers who have long predicted a decline in the ratio of corporate profits to GDP have proven to be wrong (at least so far). In particular, corporate tax rates have trended down over time which has boosted profitability. It may be that in a modern economy which is increasingly based on services and intellectual property, corporations are better able to reduce taxes by flowing income through lower-tax jurisdictions than they were in the past. It seems reasonable to assume that over our 50-year horizon, the ratio of after-tax corporate profits to GDP will remain at the 2014 level so that real corporate profits will grow in line with estimated world real GDP growth of 1.5% per annum; and
- *Variance in earnings per share ("EPS") growth of the S&P 500 Index compared to the growth rate of corporate profits.* The growth rates of these two items do not necessarily match. That is partly because public companies do not pay out all of their earnings as dividends. Instead, a significant portion of earnings are retained and used for such purposes as acquisitions, internal growth and share repurchases. Companies also issue shares to finance acquisitions, pay down debt and for equity-based compensation. Determining how much the reinvestment of retained earnings and net share repurchases (or issuances) will add (or subtract) from future earnings per share growth of the S&P 500 Index is impossible. *My best guess, however, for the next 50 years is that these factors will result in a net increase in EPS growth of 0.5% above the growth rate of real corporate profits of 1.5%, so that S&P 500 Index EPS growth in real terms will be 2.0%.*

*Given the assumption of an unchanged dividend payout ratio, the real growth rate of dividends is also expected to be 2.0%.* That would be meaningfully lower than the compound annual growth rates in S&P 500 Index real operating EPS and real dividends per share for the 17 years ended 2014 of 3.4% and 3.3%, respectively.<sup>53</sup> The reason to refer to this seemingly odd 17-year period is that growth rates can be easily distorted by using start dates or end dates which are unrepresentative. There is nothing wrong with an end date of 2014; it is several years into an economic growth cycle and was the highest ever level to date of S&P 500 Index earnings and dividends. The base year with which to compare 2014 should be one which: is long enough in the past that the results since then would be considered long-term; was at a similar high point in the economic cycle; and had a dividend payout ratio of operating EPS similar to 2014's level of 34.9% (so that dividend growth rates are not distorted by a material change in the dividend payout ratio).<sup>54</sup> In my opinion, the base year which best meets those criteria, and that therefore serves as the best base year with which to compare 2014, is 1997. It was 17 years before 2014, so the results are long-term; it was several years into an economic growth cycle and had the highest-ever S&P 500 Index operating EPS and dividends to that time; and the 1997 dividend payout ratio of operating EPS of 35.2% was very similar to the 2014 dividend payout ratio of 34.9%.

*Expected rate of inflation.* When companies report their financial results, they do so not in real (constant currency) terms but instead in nominal terms. As a result, in order to facilitate com-

parison of these predictions with future reported results, the U.S. inflation rate must also be estimated. As noted above, for the 25 years ended in 2014, the compound annual U.S. inflation rate was 2.6%. In the most recent cycle (i.e., from 2006 to 2014), the compound annual U.S. inflation rate was 2.0%. While the U.S. does not have an explicit inflation target, the Federal Reserve (the U.S. central bank) has an objective of price stability which it interprets as a low rate of inflation. For the 50-year forecast, I assume that U.S. inflation will be at a compound annual rate of 2.0%.

*Combining the above factors, my base case forecast for the compound annual growth rate ("CAGR") of S&P 500 Index EPS and dividends per share for the 50-year period 2014 to 2064 is 2.0% real plus an inflation factor of 2.0% for a total nominal growth rate of 4.0%. The forecast nominal operating EPS CAGR of 4.0% compares with the operating EPS CAGR during the 25-year and eight-year periods ended 2014 of 6.3% and 3.2%, respectively.*

The enormous increases in money supplies in recent years, as various central banks have pursued loose money policies known as quantitative easing, may someday end badly in a substantial increase in the rate of inflation or even hyperinflation. Such predictions made in recent years have proven to be wrong (at least so far). If the high-inflation scenario were to arise, it would certainly throw off many of the predictions contained in this letter although it would only serve to underscore the letter's central theme which is that long-term investors should favour equities over fixed income and cash.

*Annualized change in valuation.* Given the prediction above of a CAGR in nominal dividends per share of 4.0%, there is only one factor remaining to consider in our 50-year forecast for the S&P 500 Index in US\$ which is the annualized change in valuation. At the end of 2014, the S&P 500 Index's level of 2,059 divided by its 2014 estimated operating EPS of \$113.05 resulted in a trailing operating P/E ratio of 18.2 times. That level is very similar to the average operating P/E ratio for the 25 years ended 2014 of 17.7 times. Most of the time, the P/E ratio of the S&P 500 is between 15 times and 20 times and at the end of 2014 it was about in the middle of that range. In general, the P/E ratio tends to be lower during periods of high interest rates and inflation (such as during the 1970s and 1980s) and higher during periods of low interest rates and inflation (such as during the last 15 years or so). On balance, I see no reason to expect the operating P/E ratio of the S&P 500 Index to be materially different fifty years' hence than it was at the end of 2014.

Putting it all together, the *S&P 500 Index dividend yield at the end of 2014 was 2.0%. To this must be added the forecasts above for real operating EPS growth of 2.0% and no change in valuation (i.e., no change in the ratio of price to earnings or dividends) so that the expected real rate of return for the S&P 500 Index for the 50 years ended 2064 is 4.0%. Adding in the expected rate of inflation of 2.0% yields an expected nominal rate of return of the S&P 500 Index in US\$ of 6.0%.*

Unfortunately, we're not done yet since we're Canadians and we're interested in what the return of the S&P 500 Index will be not in US\$ but in C\$. For the 15 years ended in 2014, the average exchange rate between the two currencies was C\$1.00 = US\$0.85.<sup>55</sup> Foreign exchange rates have a tendency to fluctuate around measures of the relative purchasing power of the two currencies, an item known as purchasing power parity ("PPP"). The Organisation for Economic Co-operation and Development estimates that in 2013 (the latest year for which data is available), the PPP of the C\$ was US\$0.80.<sup>56</sup> The Big Mac Index, invented and popularized by *The Economist*, estimates the PPPs of currencies based on the prices of the popular hamburger. According to the Big Mac Index, in January 2015 (the last time the index was published) the PPP of the C\$ was US\$0.84.<sup>57</sup> One might also expect that foreign exchange rates would change over time based on differences in various countries' rates of inflation (by definition, a higher rate of inflation means that a currency is losing real purchasing power at a faster rate). This letter has already stated an expectation for the future U.S. inflation rate of 2.0%. The Bank of Canada has an explicit "inflation-control target" of 2.0% and it has been pretty good at hitting it.<sup>58</sup> From 1991 (when the target was adopted) through 2014, Canada's rate of inflation averaged 1.8%.<sup>59</sup> My forecast for Canada's average rate of inflation for the next 50 years (with the same caveats as stated above for the U.S. rate of inflation) is thus 2.0%, the same as the forecast for the U.S. rate of inflation. In conclusion, it seems reasonable to expect that there will be no change in the foreign exchange rate by the end of the full period so that at the end of 2064 the rate is expected to remain as it was at the end of 2014 (i.e., C\$1.00 = US\$0.86). As a result, the nominal rate of return of the S&P 500 Index over the 50-year period from 2014 to 2064 is estimated to be the same in C\$ as in US\$ (i.e., 6.0%).

For this section's final point (I promise), it must be noted that there is no way in the real world for an investor to replicate exactly the performance of the S&P 500 Index. For example, investors in ETFs will incur management fees, expenses, taxes thereon, brokerage commissions and tracking error (i.e., the variance of the performance of the ETF compared to the performance of the underlying index which is not explained by fees and expenses). In addition, investors in Canadian-based ETFs will incur foreign withholding tax on U.S. dividends at a rate of 15%. Considering the dividend yield of the S&P 500 Index at the end of 2014 of 2.0%, for example, Canadian-based ETFs will pay foreign withholding taxes which will diminish the ETF's annual performance by 0.3% per annum as compared to the performance of the S&P 500 Index itself. Depending upon the type of account in which the ETF is held, there may be no means for the investor to recover the foreign withholding taxes paid. If the investor chose to buy U.S.-based ETFs instead, however, she would avoid the foreign withholding tax but would have to convert her C\$ into US\$ and, eventually, back again. Given that retail foreign currency transaction spreads (compared to the spot exchange rates) can be as high as 2.0%, it might take many years for an investor to recover round-trip foreign exchange spreads through savings in foreign withholding taxes at a rate of 0.3% per annum. Furthermore, U.S.-based ETFs are considered by the U.S. Internal Revenue Service to be "situs property" which could result in a liability upon death for U.S. estate tax. For these reasons, the rest of this letter assumes that if an investor chooses to

buy ETFs, they are based in Canada.

### *Canadian Banks: Historic Performance*<sup>60</sup>

As noted above, the S&P/TSX Banks Index has achieved outstanding total returns over the last 25 (and more) years. There are many reasons for that. For example, unlike the commodity companies which are so prominent in the S&P/TSX Composite Index, banks have very low capital expenditure requirements. As a result, bank earnings tend to be very good proxies for their free cash flows (i.e., what you see is what you get). The banks also provide services for which there are universal and perpetual needs, such as: personal and commercial banking services; investment banking; insurance; and wealth management. The banks also have enormous barriers to entry, including the need to be very large in order to be able to profitably meet the costs of information technology and the ever-increasing regulatory burden. Bank brands and scale also serve as barriers to entry (customers are reluctant to place their deposits into small, little-known financial institutions with short track records and history has proven such reluctance to have merit). These are some of the reasons why the six largest banks today are the same companies which were the six largest banks 25 years ago. Indeed, there has been no entry or exit from the ranks of the top six Canadian banks in the last 25 years. To my knowledge, that is a fact which is unique to the banks; it can't be said of any other industry.

In view of the positive attributes of the Canadian banks, they are often favourites of retail investors and rightly so. Perhaps the best true-life example of this is found in the book *Millionaire Down the Road* which chronicles the extraordinary story of a remarkable man, Rankin Hodgins.<sup>61</sup> During his working career as a small-town insurance broker, Hodgins' yearly income was never more than \$65,000. He started his investment portfolio in 1978, at the age of 56, with an investment loan of \$200,000. By 2013, 35 years later, the portfolio had grown to \$9 million. How did Hodgins do it? With four key elements: leverage; Canadian bank stocks; compound interest; and time.<sup>62</sup>

These four elements are central to how the Fund was invested at the end of 2014. Regarding the first two elements (i.e., leverage and bank stocks), at December 31, 2014, before giving effect to subscriptions receivable and redemptions payable, the Fund's equities represented 192% of its net assets (i.e., it had \$0.92 of margin loans for every dollar of net assets).<sup>63</sup> Furthermore, bank stocks alone represented 130% of the Fund's net assets, consisting of 103% of net assets in four of the six largest Canadian banks and 27% in the second-largest U.S. bank. Why does the Fund have so much in banks? When Willie Sutton was asked why he robbed banks, he allegedly replied "because that's where the money is."<sup>64</sup> I believe that for investors, also, banks are where the money is. The rest of this section details my expectations for Canadian bank stocks and how the Fund intends to combine them with the third and fourth elements (i.e., compound interest and time) to continue to deliver satisfactory long-term returns.

Before we consider the prospects for the Canadian banks, it's worth considering their historic performance. The table below shows a number of performance indicators for the six largest Canadian banks over two time periods: the long-term period from 1988 to 2014 and the most

recent eight-year cycle from 2006 to 2014 (the table uses a 26-year period ending in 2014 rather than the more conventional 25-year period since the latter would have a base year of 1989 when bank earnings were already adversely affected by the impact of the early 1990s recession so it would distort calculated growth rates). The banks are sorted from left to right based on their CAGR in EPS for the 26 years from 1988 to 2014, highest to lowest. For space reasons, the columns show the banks by their stock symbol: Royal Bank of Canada, RY; Bank of Nova Scotia, BNS; Toronto-Dominion Bank, TD; Bank of Montreal, BMO; Canadian Imperial Bank of Commerce, CM; and National Bank of Canada, NA. The rightmost column also shows simple averages of the performance items for the six banks. Unless otherwise indicated, all data is for periods ending with the bank fiscal year which ended October 31, 2014 (“FY’14”). The rows for the 26-year data section show the following items (in descending order):

- *FD EPS ex items* refers to the CAGR in fully diluted earnings per share excluding certain specified items deemed to be unusual, non-cash or non-recurring;
- *Dividends per share* is the CAGR in dividends per share;
- *Book value per share* is the CAGR in book value (i.e., common equity) per share;
- *Return on equity, GAAP* refers to the average return on equity as reported (i.e., according to GAAP);
- *Return on equity, ex items* refers to the return on equity excluding specified items;
- *Earnings purity* refers to the ratio of GAAP earnings to earnings excluding items. If there were no items, the ratio would be 100%. A lower figure, e.g., 95%, indicates that on average GAAP earnings were 5% lower than earnings excluding items;
- *Dividend payout* shows, in three rows, the beginning of period, end of period and period average, respectively, dividends as a percentage of earnings excluding items;
- *Basel III CET1 capital ratio* shows the Common Equity Tier 1 (“CET1”) capital ratio, computed in accordance with Basel III banking regulations, as of the end of the fourth quarter of FY’14;
- *% chg in common shares o/s, FY’14* shows the percentage change in common shares outstanding during FY’14;
- *Stock options as % of shares o/s* shows the number of stock options outstanding at the end of FY’14 as a percentage of common shares outstanding;
- *Market cap* shows the market capitalization (i.e., common shares outstanding times share price) in billions of dollars at December 31, 2014;
- *Trailing P/E ex items* shows the trailing price/earnings ratio (i.e., the stock price at December 31, 2014 divided by FD EPS ex items for FY’14); and
- *Indicated div. yield* shows the dividend yield (i.e., the annualized dividend at its most recent indicated rate as of December 31, 2014 divided by the stock price on that date).

## Canadian big six banks fundamental performance

	RY	BNS	TD	BMO	CM	NA	Simple Average
26-year data, 1988-2014							
FD EPS ex items	9.2%	8.3%	8.3%	7.1%	6.7%	6.2%	7.6%
Dividends per share	9.6%	10.5%	10.8%	7.2%	7.7%	7.0%	8.8%
Book value per share	8.7%	9.2%	9.3%	7.3%	5.3%	6.0%	7.6%
Return on equity, GAAP	16.0%	16.5%	14.0%	14.5%	13.6%	14.0%	14.8%
Return on equity, ex items	16.4%	16.5%	13.5%	14.8%	14.3%	14.4%	15.0%
Earnings purity	94%	101%	93%	97%	95%	96%	96%
Dividend payout, beg. of period	41%	28%	24%	46%	34%	34%	34%
Dividend payout, end of period	46%	47%	43%	46%	44%	42%	45%
Dividend payout (average)	45%	44%	41%	47%	52%	40%	45%
Basel III CET1 capital ratio, Q4/ FY'14	9.9%	10.7%	9.4%	10.1%	10.3%	9.2%	10.0%
% chg in common shares o/s, FY'14	0.1%	0.7%	0.5%	0.8%	-0.6%	1.0%	0.4%
Stock options as % of shares o/s	0.6%	2.1%	1.1%	2.1%	1.0%	4.5%	1.9%
Market cap (\$bln, Dec. 31, 2014)	\$115.8						
Trailing P/E ex items (Dec. 31, 2014)	13.0	12.1	13.0	12.5	11.2	11.0	12.1
Indicated div. yield (Dec. 31, 2014)	3.7%	4.0%	3.4%	3.9%	4.1%	4.0%	3.9%

	RY	BNS	TD	BMO	CM	NA	Simple Average
Eight-year data, 2006-2014							
FD EPS ex items	7.0%	5.6%	7.9%	3.1%	3.3%	7.4%	5.7%
Dividends per share	8.9%	6.9%	9.5%	4.5%	4.5%	8.5%	7.1%
Book value per share	9.3%	10.1%	9.9%	6.6%	5.2%	8.3%	8.2%
Return on equity, GAAP	17.5%	18.1%	14.1%	13.7%	15.0%	17.5%	16.0%
Return on equity, ex items	18.9%	17.9%	13.4%	14.9%	15.0%	19.0%	16.5%
Earnings purity	91%	103%	91%	93%	100%	93%	95%
Dividend payout, beg. of period	40%	42%	38%	41%	40%	39%	40%
Dividend payout, end of period	46%	47%	43%	46%	44%	42%	45%
Dividend payout (average)	48%	49%	42%	53%	66%	40%	50%

As you will note, the second section of the table shows only the first nine of the data items (all the rest are the same for both periods) for the most recent cycle (i.e., 2006 to 2014). In the 26 years ended 2014, using a simple average of the six banks, earnings per share grew at a CAGR of 7.6% while dividends grew at a faster rate of 8.8% as the banks raised their dividend payout ratios between the beginning and the end of the period. For the eight years ended 2014, the growth rates of earnings and dividends slowed down to 5.7% and 7.1%, respectively.

An important item shown in the table above is the CET1 regulatory capital ratio. The ratio is calculated by dividing common equity by risk-weighted assets, both as defined by Basel III regulations. Under those regulations, the largest Canadian banks are required by 2019 to have a minimum CET1 ratio of 7.0% plus a “domestic systemically important bank” surcharge of 1.0% for a total CET1 ratio of 8.0%.<sup>65</sup> It appears that the Canadian banks, at least partly in order to demonstrate their financial strength, are actually targeting a CET1 ratio of 10.0%. The banks achieved that threshold at the end of FY’14 (the average shown in the table for this item is on a weighted-average basis). Rules have changed so much over the years that it is not possible to make long term capital comparisons on an apples-to-apples basis. What is clear, however, is that ever since the global financial crisis of 2008-2009, which is considered by many to have been the worst financial crisis since the Great Depression, bank regulators have demanded ever-higher capital ratios. For example, from the end of FY’08 (at the apex of the crisis) to FY’14, the big six banks’ weighted-average ratio of tangible common equity to risk-weighted assets increased from 6.4% to 10.1%, an increase of 58%.

In my opinion, the primary results of these much higher capital ratios is that: banks will likely have lower (but still satisfactory) returns on equity and growth rates of earnings and dividends; and they will be safer and less volatile investments than they’ve been in the past. *That makes investments in the banks well-suited for long-term compounding.*

### *Canadian Banks: 50-Year Forecast*<sup>66</sup>

With their historic performance as a preamble, it’s now time to estimate the future 50-year total returns over the period 2014 to 2064 for the large Canadian banks, as was done above for the S&P 500 Index. To reiterate, the expected real (i.e., inflation-adjusted) return of equities such as the banks should equal the initial dividend yield plus the real growth rate of dividends plus the annualized change in valuation. To this must be added the expected rate of inflation in order to determine expected bank nominal total returns. Estimates for these factors are outlined below.

*Initial dividend yield.* At the end of 2014, the banks had an average indicated dividend yield of 3.9%. One of the banks, however, has adopted a practice of increasing its dividends annually (the other banks all tend to increase dividends semi-annually) and was expected to announce a dividend increase in February 2015 (which it did). *As a result, adjusted for that one dividend increase, I believe that it’s fair to say that the initial dividend yield of the Canadian banks at December 31, 2014 closely approximated 4.0%.*

*Real growth rate of dividends.* Future dividend growth could be higher or lower than earnings growth because of changes in the dividend payout ratio. That ratio for the big six banks in 2014 was an average of 45% which was equal to its 26-year average. I assume that over the 50-year forecast horizon there will be no change in the dividend payout ratio from the 2014 level. As a result, the real growth rate of dividends should equal the real growth rate of earnings, which will be derived from:

- *World real GDP growth, as estimated earlier in this letter, of 1.5%.* I estimate that in order to fund this real increase in their risk-weighted assets, plus an inflation factor, banks will have to devote about 15% of their annual net income to increasing their regulatory capital; and
- *Capital deployment.* The banks also pay out about 45% of their earnings as dividends. That still leaves about 40% of their annual net income available for further internal growth, acquisitions and share repurchases. Banks are often able to realize better returns through share repurchases than are other companies since bank stocks tend to trade at lower P/E multiples (i.e., higher earnings yields) than do shares of companies in other industries. Banks also tend to dilute their shareholders less (i.e., their use of stock-based compensation is lower) than many other industries. *On balance, I believe it's reasonable to estimate that, over the next 50 years, internal growth, acquisitions and net share repurchases will result in bank EPS growth of 1.0% above the growth rate of world GDP of 1.5%, so that Canadian bank EPS growth in real terms will be 2.5%.*

Given the assumption of an unchanged dividend payout ratio, *the real growth rate of dividends is also expected to be 2.5%.* The forecast real growth rate of 2.5% per annum would compare with the real growth in the most recent cycle (2006 to 2014) of bank EPS and dividends of 4.0% and 5.4%, respectively.

The final two factors that need to be considered in order to estimate future bank nominal total returns are:

*Expected rate of inflation.* In order to convert the expected real EPS growth to a nominal figure, the estimated Canadian inflation rate must be added. Earlier in this letter, that was estimated at 2.0%. *As a result, my base case forecast for the CAGR of Canadian banks' EPS and dividends per share for the 50-year period 2014 to 2064 is 2.5% real plus an inflation factor of 2.0% for a total nominal growth rate of 4.5%.* The forecast nominal EPS growth rate of 4.5% per annum would compare with the CAGR in nominal EPS excluding items for the eight years from 2006 to 2014 of 5.7%; and

*Annualized change in valuation.* At December 31, 2014, the banks traded at an average trailing P/E ratio of 12.1 times. I consider this to be somewhat low given the continuing low-growth, low-inflation, low-interest rate scenario that is envisaged, especially given the banks' strong capital ratios. I believe that the primary reasons that the banks are not trading at higher P/E levels are fears of higher loan losses and lower capital markets-related revenue that might arise in a normalized economic environment. These fears have some merit but I believe that, say, a (10%)

decline in bank earnings that might result from those factors would be offset by 10% higher P/E ratios, with no net change in the share prices of Canadian banks. As a result, it seems reasonable to forecast no change in the P/E ratios of the Canadian banks from those prevailing at the end of 2014.

*Putting it all together, the dividend yields of the banks at the end of 2014 were 4.0%. To this must be added the forecasts above for real operating EPS growth of 2.5% and no change in valuation (i.e., no change in the ratio of price to earnings or dividends) so that the expected real rate of return for the banks for the 50 years ended 2064 is 6.5%. Adding in the expected rate of inflation of 2.0% yields an expected nominal rate of return for the banks of 8.5% per annum.*

### *Summary of 50-Year Asset Class Return Forecasts*

The following table summarizes my views on expected asset class returns for the next 50 years. Bank stocks and cash, which an investor could easily purchase and hold himself at little or no cost, are assumed to be bought and held directly by investors. The S&P 500 Index and the FTSE TMX Canada Universe Bond Index, which an investor could not replicate directly other than at great cost (if at all), are assumed to be bought and held using ETFs. The ETFs are assumed to have no tracking error (i.e., there is no difference in expected returns between the ETFs and their underlying indices other than that accounted for by fees, expenses and taxes payable by the ETFs).

#### **Asset class total returns Base case forecast - 50 years 2014-2064**

Canadian banks	
Initial dividend yield	4.00%
Real growth of dividend	2.50%
Change in valuation	0.00%
Expected real total return	6.50%
Expected rate of inflation	2.00%
<b>Expected nominal total return of Canadian banks</b>	<b>8.50%</b>

S&P 500 Index (Canada-based ETF)	
Initial dividend yield	2.00%
Real growth of dividend	2.00%
Change in valuation	0.00%
Expected real total return of S&P 500 Index	4.00%
Expected rate of inflation	2.00%
Expected nominal total return of S&P 500 Index	6.00%
Foreign withholding taxes	-0.30%
ETF management expense ratio	-0.11%
Impact of change in C\$/US\$ exchange rate	0.00%
<b>Expected nominal total return of S&amp;P 500 Index ETF</b>	<b>5.59%</b>
Bonds	
Expected long-term real return on bonds	1.00%
Expected rate of inflation	2.00%
Nominal return of FTSE TMX Canada Universe Bond Index	3.00%
ETF management expense ratio	-0.33%
<b>Expected nominal total return of bond index ETF</b>	<b>2.67%</b>
Cash	
Expected long-term real return on cash	0.50%
Expected rate of inflation	2.00%
<b>Expected nominal return on cash</b>	<b>2.50%</b>
Inflation	
25-year CAGR of Canadian CPI inflation, 1989-2014	1.99%
Bank of Canada inflation-control target (adopted in 1991)	2.00%
<b>Expected rate of inflation</b>	<b>2.00%</b>

For ease of reference, the nominal returns for each asset class in the table above are in **bold**. In order to convert these figures to real returns, readers must subtract the expected rate of inflation of 2.00%. The following explains the basis for the forecasts shown in the table (from top to bottom):

- *Canadian Banks*. Expected returns are as outlined in the earlier “Canadian Banks: 50-Year Forecast” section of this letter. To the initial dividend yield of 4.00% is added the real growth rate of dividends of 2.50% and the change in valuation of 0.00% to reach an expected real return of 6.50%. To this is added the expected rate of inflation of 2.00% to reach an expected nominal return of 8.50%;

- *S&P 500 Index.* Expected returns are as outlined in the earlier “S&P 500 Index: 50-Year Forecast” section of this letter. To the initial dividend yield of 2.00% is added the real growth of dividends of 2.00% and the change in valuation of 0.00% to reach an expected real return of 4.00%. To this is added the expected rate of inflation of 2.00% to reach an expected nominal return of 6.00%. From this is subtracted the foreign withholding taxes for a Canada-based ETF of (0.30%) (i.e., 15% of the dividends received), and the ETF management expense ratio of (0.11%) to reach the expected nominal total return of an S&P 500 Index ETF of 5.59%. After deducting inflation of 2.00%, this would result in a real return on the S&P 500 Index ETF of 3.59%;
- *Bonds.* The real total return on bonds, as represented by the FTSE TMX Canada Universe Bond Index, is expected to be 1.00%. To this must be added the expected rate of inflation of 2.00% to derive an expected nominal return on bonds of 3.00%. That compares with the bond index yield to maturity at the end of 2014 of 2.23%.<sup>67</sup> The forecast implicitly assumes that the yield curve (i.e., the graphical representation of fixed income yields by maturity) will shift up from its level at the end of 2014 by at least one percentage point. If that were to occur, reinvestment rates for bond coupons and maturities would be higher than current rates, allowing the weighted average yield to maturity over the period to 2064 to be 3.00%. Implicitly, the forecast assumes that the capital losses that would initially be suffered by bondholders as interest rates rose would be more than offset over the 50-year investment horizon by the higher interest rates then available for reinvesting bond coupons and maturities. The nominal return forecast of 3.00%, after deducting inflation of 2.00%, would result in a real return on bonds of 1.00%. Also, the bond ETF management expense ratio is estimated at 0.33% (consisting of a management fee of 0.30% plus a blended tax rate for GST and/or HST applicable to the management fee of 10%). That would reduce the bond returns to a nominal return of 2.67% and to a real return of 0.67%;
- *Cash.* The return on cash is expected to be 0.50% in real terms (i.e., 2.50% in nominal terms). That compares with the returns currently available on investment savings accounts offered by the big six Canadian banks of 1.00%.<sup>68</sup> The forecast thus implicitly assumes that, on average over the next 50 years, returns on cash will be 1.50% higher than they are today; and
- *Inflation.* The inflation rate of 2.00% is assumed to be equal to the Bank of Canada’s inflation-control target of 2.00% and is in line with the 25-year CAGR in Canadian inflation for the period from 1989 to 2014 of 1.99%.

Given the prospective returns outlined above, it will not surprise readers to learn that for long-term investment performance I strongly favour equities, particularly common shares of Canadian banks, over bonds and cash. That is because I believe equities will both deliver superior long-term returns and offer far better inflation protection.<sup>69</sup>

### **Stock Market Seasonality**

A soothsayer told Julius Caesar to “beware the ides of March.”<sup>70</sup> Given what happened in 2014, when October 15 proved to be the low of a brief but tumultuous stock market decline, perhaps better advice to minimize financial bloodshed would be to “beware the ides of October.” Mark Twain commented on stock market seasonality when he wrote: “October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”<sup>71</sup>

Twain notwithstanding, over the long term, September has actually been the worst calendar month for the S&P 500 Index.<sup>72</sup> October, while it has much better returns on average than September, is justly famous for selling climaxes. Many of the largest stock market declines in history have occurred in September and October. Some recent September examples include: September 2002, when the S&P 500 Index fell (11.0%) immediately before the bottom of the technology meltdown; September 2008, when the S&P 500 Index fell (9.6%) in the first terrible month of the 2008-2009 global financial crisis; and September 2011, when it fell (7.2%) over concerns about slowing global growth and the ratings downgrade of U.S. government debt. These all provided what proved to be excellent buying opportunities.

Examples of historic sell-offs in October include: October 29, 1929 (“Black Tuesday”), which heralded the onset of the Great Depression and punctuated a month in which the S&P 500 Index fell (26.5%); October 19, 1987 (“Black Monday”), the largest single-day decline in history, resulting in a loss for the S&P 500 Index that month of (21.8%); and October 2008, when stocks continued their rout during the global financial crisis and fell (16.8%). 2014 added another minor moment to that list when on October 15 the S&P 500 Index experienced its largest intra-day decline and its highest volatility in almost three years. The decline was very short-lived, however, lasting the better part of an hour. Nevertheless, I certainly felt like my bowel had been eviscerated. Of course, that could be because, as fate would have it, that afternoon I had a colonoscopy.

Knowing that many declines occur in September and October still begs the question, “Why?” I believe that there are three important reasons why declines tend to occur in the early fall. One is ingrained, primordial behaviour. As summer turns to fall, North American investors, not unlike squirrels, begin to put aside their frivolous ways and gather their nuts around them for the winter ahead. Loss aversion increases and investors become like Twain himself: “I’m more concerned about the return of my money than with the return on my money.”<sup>73</sup> Investors have a tendency to sell stocks to increase their cash holdings, and this selling pressure results in stock market lows in the fall. A second reason for declines in the early fall is that most U.S. mutual funds have fiscal years that end on October 31.<sup>74</sup> U.S. mutual funds thus have a tendency to sell stocks with unrealized losses in October so as to offset realized gains. A third reason for declines in early fall is behavioural psychology. Even casual market participants know that market declines have often happened in September and October. Thus, when those months roll around on the calendar, investors become weak-kneed and sell at the first sign of lower stock prices. Declines in September and October therefore feed on themselves and become self-fulfilling prophecies.

The well-known habit of stocks being weak in early fall is the basis for two common expressions: “sell in May and go away” and “buy when it snows, sell when it goes”. In fact, one recent academic study found that the benefits to “sell in May” were both significant and persistent.<sup>75</sup> I have done my own research on this topic in an effort to answer the following questions:

- Is it better for passive (i.e., equity index) investors to remain fully invested throughout the year or is there a period in the year in which it is consistently better to be out of equities (when equity returns

are consistently negative)? And,

- What is the shortest period of time that one could be out of equities, and which period is it, so as to avoid the worst periods for equities and yet still be invested most of the time so as to capture the long-term superior returns?

In my view, there is no one period which can be relied upon to be consistently negative (that would be too easy). On average, however, September has historically had the most negative returns. October, while its returns are positive on average, has recorded many of the worst declines in history (as noted above). Accordingly, if I were forced to pick months in which I would be out of equities every year, I'd say September and October. The historical results of doing so are shown in the tables below (using the data I have available for: the S&P/TSX Composite Index since October 31, 1977; and the S&P 500 Index since October 31, 1988).

**Value of \$10,000 invested in S&P/TSX Composite Index**  
Years ended October 31

Period	Decade	# of years	Oct. 31 to Aug. 31	Aug. 31 to Oct. 31	Year
Oct. 31, 1977 to Oct. 31, 1979	1970s	2	\$19,198	\$9,308	\$17,870
Oct. 31, 1979 to Oct. 31, 1989	1980s	10	\$53,259	\$6,775	\$36,083
Oct. 31, 1989 to Oct. 31, 1999	1990s	10	\$19,311	\$12,386	\$23,918
Oct. 31, 1999 to Oct. 31, 2009	2000s	10	\$28,577	\$6,488	\$18,540
Oct. 31, 2009 to Oct. 31, 2014	2010s	5	\$14,366	\$10,764	\$15,463
Total		37	\$810,660	\$5,454	\$442,158

**Value of \$10,000 invested in S&P 500 Index**  
Years ended October 31

Period	Decade	# of years	Oct. 31 to Aug. 31	Aug. 31 to Oct. 31	Year
Oct. 31, 1988 to Oct. 31, 1989	1980s	1	\$12,993	\$9,728	\$12,640
Oct. 31, 1989 to Oct. 31, 1999	1990s	10	\$38,918	\$13,239	\$51,526
Oct. 31, 1999 to Oct. 31, 2009	2000s	10	\$11,581	\$7,849	\$9,090

Oct. 31, 2009 to Oct. 31, 2014	2010s	5	\$16,913	\$12,794	\$21,638
Total		26	\$99,052	\$12,933	\$128,102

Some of the highlights of these tables are noted below:

- For the full 37 years of data for the S&P/TSX Composite Index, \$10,000 invested on October 31, 1977 would have increased by October 31, 2014 to over \$442,000 (a testament to the wonders of compound interest over a long period of time);
- If one had sold every August 31 and gone to cash, however, and repurchased every October 31, the portfolio would have grown to \$810,000. The example excludes the trading costs for the buy and the sell and excludes interest on the cash for the two-month period. The reason for the much higher results with a market timing strategy is that results for September and October for the full 37-year period were negative. If one had invested on every August 31 and sold stocks and converted to cash on every October 31, \$10,000 would have shrunk in value to only \$5,454, a decline of (45.5%);
- Results have varied over time and this market timing strategy would not have worked in the current decade to date. In the five years 2010 to 2014 inclusive, if a market participant had sold every August 31 and repurchased every October 31, he would have missed out on a cumulative return of 7.6% (as \$10,000 turned into \$10,764);
- The results of the same market timing strategy for the S&P 500 Index would have been much worse. For example, for the 26 years shown in the table (1988 to 2014), \$10,000 invested under a “buy and hold” approach would have grown to \$128,102. If the investor had been in cash in September and October, however, the \$10,000 would have grown to only \$99,052;
- One feature that has been persistent is that Canadian stocks have performed worse than U.S. stocks in September and October: Canadian stocks rose less than U.S. ones during the 1990s; declined more during the 2000s; and rose less in the 2010s to date. Perhaps our colder climate accentuates the “gather your nuts” effect...; and
- As an adjunct to the above, it’s worth noting the dramatic differences in performance, and changes in relative performance, of the equity markets of the two countries. In the 1990s, a period of generally low commodity prices, \$10,000 invested in the S&P/TSX Composite Index turned into \$23,918. That badly trailed the S&P 500 Index which turned \$10,000 into \$51,526 (fuelled by the technology bubble). In the 2000s, as commodity prices rose in tandem with demand from China, Canadian stocks turned \$10,000 into \$18,540. U.S. stocks, however, experienced a lost decade and actually declined, turning \$10,000 into only \$9,090. In the 2010s to date, relative performance has reversed again. In the first five years of the current decade, the S&P/TSX Composite Index, struggling once more with lower commodity prices, turned \$10,000 into \$15,463. In the same period, the S&P 500 Index has more than doubled that rate of gain, turning \$10,000 into \$21,638.

Based on the foregoing analysis, I can offer no comfort to those who wish to time equity markets other than to caution wariness of September and the first few weeks of October, particularly in Canada. Investors who seek to benefit from stock market seasonality have the alluring prospect of dramatically enhancing their long-term returns, but to do so they must face the Scylla and

Charybdis which threaten all investors: fear and greed. If an investor goes to cash at the end of August, and stock markets decline in September and October, he may be fearful of buying back into equities and experiencing further declines, or greedy that if he only waits stocks may become even cheaper. Conversely, if an investor goes to cash and stock markets rise, she may be fearful of buying back into equities at higher prices only to have them subsequently decline, or greedy to wait until a pullback before buying back in. In either case, the investor faces the real risk that he or she will remain in cash, not buy back into equities and miss out on their long-term returns which historically and prospectively are much higher than the returns on cash.

If one wishes to play the game of attempting to use stock market seasonality to enhance returns, I suggest the following simple annual rule: go to cash not earlier than August 31 and get back into a full equity weighting not later than October 31. In that way, the maximum amount of time that one would be out of equities would be two months of every calendar year. Like Odysseus, you must lash yourself to the mast of this strategy and stay on course despite the siren calls of emotions and market soothsayers. All other ways lie peril.

Of course, even with a clear and disciplined market timing strategy as described above, trying to benefit from stock market seasonality may not work over the long run and certainly won't work in some years. In 2010, I had reason to reorganize my family's financial affairs. To do so, I had to sell equities and, for a short while, be all in cash. Being a student of stock market history, I thought "Aha! If I have to be briefly all in cash, I'll do it in September, so that I miss what has historically been the worst month for equities!" In September 2010 the S&P 500 Index rose 8.9%, its best September since Hitler invaded Poland.<sup>76</sup>

### **Registered Plans vs. Non-registered Investment Accounts**

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In Canada, individuals may generally invest in two types of accounts: registered plans and non-registered accounts. *Registered plans* are certain types of plans (see "Types of Registered Plans" below) that are registered with the Government of Canada and which operate according to laws and regulations created by the federal government. *Non-registered assets* are any assets that are not held in a registered plan.

Certain types of investment income earned on non-registered assets are taxed at lower rates than ordinary income. For example, to mitigate double taxation (whereby corporations pay income tax then pay out their after-tax income to shareholders as dividends which are also taxed), eligible Canadian dividends earn dividend tax credits which reduce the effective tax rate on dividends to levels far below the tax rates applicable to ordinary income. Similarly, in order to encourage investment and entrepreneurship, capital gains are taxed at only half of the rates applicable to ordinary income. In addition to these favourable tax treatments, non-registered investment accounts can be leveraged (i.e., assets held in non-registered accounts may be pledged as collateral for margin borrowings which may be used to increase the amount of investments). For all of these reasons, I believe that non-registered assets should form a key part of most investors' wealth creation plans. As noted above under "Income Taxes", the Fund is structured as a limited partnership partly in order to preserve and flow through to investors' non-registered accounts the

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Fund’s portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Fund LP Confidential Offering Memorandum, October 22, 2012, p. 2. The OM is available at <http://www.portlandinvestmentcounsel.com/plusfund.html>
3. 2013 Letter, p. 3.
4. OM pp.13-14.
5. Amendment No. 1 dated July 2, 2014 to the OM (the “Amendment”), p. 2.
6. OM p. 6 and p. 13 and Amendment p. 2.
7. Bloomberg L.P.
8. Ibid.
9. International Energy Agency. “Oil Market Report” (“OMR”), December 12, 2014, table 1, p. 52.
10. Ibid., table 3, p. 57 and OMR, December 10, 2010, table 3, p. 65.
11. Ibid.
12. [http://www.opec.org/opec\\_web/en/press\\_room/2938.htm](http://www.opec.org/opec_web/en/press_room/2938.htm)
13. OMR, December 12, 2014, table 1, p. 52 and archived issues.
14. TD Securities Inc.
15. 2013 Letter, p. 15.
16. OM, p. 2.
17. Calculations are derived from the following data: the Fund’s cost of its investment in Ensco was US\$56.68 per share; Ensco’s book value per share at December 31, 2013 was US\$54.80 per share; its dividend at the time of purchase was US\$3.00 per share; and its earnings per share in 2013 were US\$6.07. Fundamental data is from company reports.
18. <https://www.fortisinc.com/Pages/default.aspx>
19. <http://www.taxtips.ca/>
20. <http://www.goodreads.com/quotes/76863-compound-interest-is-the-eighth-wonder-of-the-world-he>
21. <http://www.investopedia.com/university/beginner/beginner2.asp>
22. <http://www.quotesonfinance.com/quote/79/Albert-Einstein-Compound-interest>
23. Keynes, John Maynard. *The Collected Writings of John Maynard Keynes, vol. XII, Economic Articles and Correspondence: Investment and Editorial* (Cambridge University Press, 2013), p. 785; from a letter in 1928.
24. See the “Using Tax-Free Savings Accounts for Long-Term Wealth Creation” section of this letter.
25. <http://www.investopedia.com/articles/exchangetradedfunds/12/brief-history-exchange-traded-funds.asp>
26. Straus, Daniel. “U.S. ETF Flows: Full Year 2014 A Strong Finish to the Year.” National Bank Financial, January 2, 2015.
27. Straus, Daniel. “Canadian ETF Flows: December and Full Year 2014 Biggest Month Ever.” National Bank Financial, January 2, 2015.
28. John C. Bogle has written many books and articles in favour of passive investing using ETFs. See, for example, *The Little Book of Common Sense Investing* (John Wiley & Sons, Inc., 2007).
29. <http://www.blackrock.com/ca/individual/en/literature/press-release/pr-2014-03-24-en-ca.pdf>
30. <http://newsroom.bmo.com/press-releases/bmo-asset-management-inc-cuts-management-fees-on-tsx-bmo-201404210940767001>
31. <https://www.vanguardcanada.ca/individual/articles/vanguard-news/news-from-vanguard/lower-management-fees.htm>
32. “Canadian ETF Flows”, op. cit.
33. <https://www.spdrs.com/product/fund.seam?ticker=SPY>
34. Devlin, Ed. Quoted in “Canada, world’s ‘worst’ bond market, needs transparency: Pimco.” *The Globe and Mail*, July 8, 2014, p. B12.
35. The data for the Scotia Universe Bond Index and Canadian Treasury bills are from Bank of Nova Scotia. All other data is from TD Securities Inc. except for the Canadian and U.S. inflation rates which are from the Bank of Canada at <http://www.bankofcanada.ca/rates/related/inflation-calculator/> and the Bureau of Labor Statistics at <http://www.bls.gov/cpi/cpid1412.pdf>, table 24, respectively.

36. Ellis, Charles. *Winning the Loser's Game: Timeless Strategies for Successful Investing* (McGraw Hill, 2013 sixth edition), p. 169.
37. Swensen, David. *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (Free Press, 2009 edition, originally published 2000), p. 128.
38. Swensen, David. *Unconventional Success: A Fundamental Approach to Personal Investment* (Free Press, 2005), p. 14.
39. *Ibid.*, p. 16.
40. Berkshire Hathaway 2013 annual report, p. 20.
41. [http://en.wikiquote.org/wiki/J.\\_P.\\_Morgan](http://en.wikiquote.org/wiki/J._P._Morgan)
42. Throughout this section of the letter, for the S&P 500 Index, all price data is from Thomson Reuters Corporation and all fundamental data (i.e., operating earnings, as-reported earnings and dividends) is from Standard & Poor's Financial Services LLC ("Standard & Poor's") as of Mar. 6, 2015 (the latest data published before going to press) available at <http://ca.spindices.com/indices/equity/sp-500>. Where applicable, to convert historical nominal returns to real returns I have adjusted nominal returns using inflation figures sourced from the Bureau of Labor Statistics.
43. [http://www.msci.com/resources/factsheets/index\\_fact\\_sheet/msci-world-index.pdf](http://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf)
44. <http://www.businessinsider.com/foreign-revenues-by-region-2014-10>
45. Bernstein, William J. *The Investor's Manifesto: Preparing for Prosperity, Armageddon and Everything In Between* (John Wiley & Sons, Inc., 2010), pp. 25-35, esp. p. 32.
46. Arnott, Robert D. "Dividends and the Three Dwarfs," *Financial Analysts Journal*, March/April 2003, vol. 59, no. 2: 4-6.
47. The indicated dividend rate at the end of 2014 of \$41.18 was slightly higher than the dividends paid in 2014 which were \$39.44. As a result, the 2014 dividend payout ratio using the year-end indicated dividend rate was 36.4% whereas using the dividends paid in 2014 it was 34.9%. The latter is the figure which should properly be compared to long-term average dividend payout ratios. Since there is little difference, however, the impact to the analysis is immaterial.
48. [http://en.wikipedia.org/wiki/Demographics\\_of\\_the\\_United\\_States](http://en.wikipedia.org/wiki/Demographics_of_the_United_States)
49. [http://www.census.gov/population/international/data/worldpop/table\\_population.php](http://www.census.gov/population/international/data/worldpop/table_population.php)
50. <http://www.tradingeconomics.com/united-states/gdp-per-capita>
51. Data for world GDP growth is at [http://en.wikipedia.org/wiki/Gross\\_world\\_product](http://en.wikipedia.org/wiki/Gross_world_product). From the world GDP growth of 3.3% from 2006 to 2014 I have subtracted population growth in that period of 1.1% per annum to derive estimated world GDP growth per capita of 2.2%.
52. Thomson Reuters Datastream.
53. Earnings and dividends are provided by Standard & Poor's in nominal terms; I have adjusted them for inflation as calculated by the Bureau of Labor Statistics.
54. For this purpose, the cited 2014 dividend payout ratio of 34.9% is dividends paid in 2014 divided by 2014 operating earnings per share. See the discussion in note 47 above.
55. Bloomberg L.P.
56. [http://stats.oecd.org/Index.aspx?DataSetCode=SNA\\_Table4](http://stats.oecd.org/Index.aspx?DataSetCode=SNA_Table4)
57. <http://www.economist.com/content/big-mac-index>
58. <http://www.bankofcanada.ca/rates/indicators/key-variables/inflation-control-target/>
59. <http://www.bankofcanada.ca/rates/related/inflation-calculator/>
60. Throughout this section of the letter, for the Canadian banks, all price data is from Thomson Reuters Corporation and all fundamental data (e.g., earnings, dividends, book value and return on equity) is from company reports. Where applicable, to convert historical nominal returns to real returns I have adjusted nominal returns using inflation figures provided by the Bank of Canada's inflation calculator.
61. Hodgins, Douglas R. *Millionaire Down the Road: Secrets of the ultimate tax-efficient investor* (Millionaire Down the Road Media Inc., 2013).
62. The book does not provide Hodgins' portfolio as of any date although it's clear that the majority of his portfolio was consistently comprised of the largest Canadian banks. See *ibid.*, p. 57, 70, 79-80, 88, 111-112, 115, 120, 129 and 150-151.

63. The Fund's 2014 financial statements are available at <http://www.portlandic.com/plusfund.html>.
64. Sutton denied that he said those exact words but the world, not wanting to let the facts get in the way of a good story, attributes the phrase to him, anyway. See [http://en.wikipedia.org/wiki/Willie\\_Sutton](http://en.wikipedia.org/wiki/Willie_Sutton).
65. See, for example, Royal Bank of Canada 2014 annual report, p. 86, available at [http://www.rbc.com/investorrelations/pdf/ar\\_2014\\_e.pdf](http://www.rbc.com/investorrelations/pdf/ar_2014_e.pdf)
66. See note 60 above.
67. PC Bond Index Team.
68. See, for example, <http://www.rbcroyalbank.com/products/isa/>.
69. The prospective asset class returns discussed in this letter appear reasonable based on the assumptions contained herein and on market conditions prevailing at the end of 2014. It's hoped that the prospective returns will help illuminate the remainder of this letter. Actual 50-year asset class returns for the period 2014 to 2064 are certain to vary from those stated herein, however, and the variances could be material.
70. Shakespeare, William. *Julius Caesar*, Act 1, scene 2, 15-19, quoted at <http://www.phrases.org.uk/meanings/beware-the-ides-of-march.html>
71. Twain, Mark. *Pudd'nhead Wilson*, quoted at [http://en.wikipedia.org/wiki/Mark\\_Twain\\_effect](http://en.wikipedia.org/wiki/Mark_Twain_effect)
72. [http://www.moneychimp.com/features/monthly\\_returns.htm](http://www.moneychimp.com/features/monthly_returns.htm)
73. Twain, Mark. Quoted at <http://www.foxbusiness.com/personal-finance/2013/04/01/it-is-return-my-money/>. As the article states, the quotation has also been attributed to Will Rogers although he appears to have been quoting Twain.
74. <http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2011/11/15/when-are-capital-gains-distributions-a-bad-thing>
75. Andrade, Sandro C., Vidhi Chhaochharia and Michael E. Fuerst. "'Sell in May' Just Won't Go Away," *Financial Analysts Journal*, July/August 2013, vol. 69, no. 4: 94-106.
76. <http://data.okfn.org/data/core/s-and-p-500> and [http://www.moneychimp.com/features/monthly\\_returns.htm](http://www.moneychimp.com/features/monthly_returns.htm)
77. <http://www.rbcroyalbank.com/products/rrsp/contribution-limits.html>
78. <http://www.cra-arc.gc.ca/E/pub/tg/t4040/t4040-13e.pdf>, pp. 5-6.
79. <http://www.cra-arc.gc.ca/E/pub/tg/rc4092/rc4092-13e.pdf>, p. 2.
80. <http://www.cra-arc.gc.ca/E/pub/tg/rc4466/rc4466-13-11e.pdf>, p. 7. There have been media reports that if the federal government balances its budget it may increase the annual TFSA contribution limit to \$10,000 but at time of writing no such increase has been announced.

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**Enquiries can be directed to: Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7**

**Tel: 1-888-710-4242 • Fax: 1-866-722-4242**

**Email: [info@portlandic.com](mailto:info@portlandic.com) • Web site: [www.portlandic.com](http://www.portlandic.com)**

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# Portland Focused Plus Fund LP

## ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2015

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return		
	Portland Focused Plus Fund LP	S&P/TSX Composite Index	S&P 500 Index (US\$)
2012 (from Oct. 31)	1.9%	0.6%	1.5%
2013	34.1%	13.0%	32.4%
2014	16.8%	10.6%	13.7%
2015	7.5%	(8.3%)	1.4%

Since Inception (Oct. 31, 2012)

Compound annual return	18.6%	4.6%	14.8%
Cumulative return	71.6%	15.3%	54.9%

Notes:

Performance for the Portland Focused Plus Fund LP is for the series F units which is the highest fee series without embedded advisor compensation. Performance shown is the Fund's net return after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Fund generally hedges its U.S. dollar exposure.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "Fund"):**

This letter describes how the Fund is managed and why it is managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Fund.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Fund regarding 2013 ("2013 Letter") and 2014 ("2014 Letter") are available on the web site of Portland Investment Counsel Inc. ("PIC") at <http://www.portlandic.com/focusedplusfundLP.html>. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read the 2013 Letter and 2014 Letter (which are incorporated herein by reference).

**Investment Objective**

As stated in the Fund's Offering Memorandum ("OM"), the Fund's investment objective is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Fund has been satisfactory, investors should compare the long-term performance of the Fund to a 50%/50% average of the returns of the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance**

The performance of the Fund and that of the two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Fund's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end, may be found at <http://www.portlandic.com/focusedplusfundLP.html>.

In 2015, the Fund's series F units achieved a return of 7.5% (net of fees and expenses). That compares to a loss of (8.3%) for the S&P/TSX Index and to a total return of 1.4% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a loss of (3.4%). For the entire period since inception of the Fund on October 31, 2012 to December 31, 2015, the Fund's series F units achieved a cumulative return of 71.6%. That compares to a cumulative total return of 15.3% for the S&P/TSX Index and 54.9% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 35.1%. Accordingly, in both 2015 and for the cumulative period since the Fund's inception, the Fund met its investment objective of preservation of capital and a satisfactory return.

**Operating Expenses**

The Fund incurs operating expenses for such items as fund administration, audit and legal fees.<sup>4</sup> From the inception of the Fund on October 31, 2012 to December 31, 2015, the Fund's operating expenses as a percentage of its net asset value have been 0.50% per annum plus applicable taxes. While there can be no assurance that the Fund's operating expenses will remain at 0.50%

per annum, PIC remains committed to tight management of fees and expenses so as to maximize the Fund's returns.

### Offering Memorandum

On March 1, 2016, PIC renewed the Fund's OM. This is the first complete refresh of the Fund's offering memorandum since the inception of the Fund on October 31, 2012. The purpose of amending and restating the Fund's offering memorandum was three-fold, namely to: i) incorporate two previous amendments to the Fund's offering memorandum directly into the body of the OM; ii) add text regarding the proposed launch, planned for March 31, 2016, of a new trust fund similar to the Fund which, unlike the Fund, will be eligible for investment by registered plans; and iii) make such other minor changes and updates to the OM as were deemed necessary or advisable. As part of these minor changes, the Fund's former "classes" have been renamed "series" and the Fund's former class BN units and class B units have been renamed series M units and series P units, respectively.

### Fund Series

The Fund has four series of units. The features of each are outlined below:<sup>5</sup>

- **Series A units** have: a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit ("High Water Mark") of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have: a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have: a minimum initial subscription amount of \$1,000,000; and a management fee of 1% per annum. Series M units do not have a performance fee; and
- **Series P units** have: a minimum initial subscription amount of \$1,000,000; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee.

The performance of the series F units, which is the highest fee class without embedded advisor compensation, is shown in the table on the inside front cover of this letter. The performance of all of the Fund's four series is shown in the table below.

Year	Annual Total Return			
	Series A	Series F	Series M	Series P
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%
2013	33.0%	34.1%	37.7%	34.4%
2014	15.6%	16.8%	18.8%	17.5%
2015	6.5%	7.5%	8.3%	8.5%

Since Inception (Oct. 31, 2012)

Compound annual return	17.5%	18.6%	20.5%	19.3%
Cumulative return	66.6%	71.6%	80.7%	74.7%

As can be seen in the last line of the table, for the period from October 31, 2012 to December 31, 2015, the Fund's series F units had a cumulative return of 71.6% while the Fund's series M units and series P units had higher cumulative returns of 80.7% and 74.7%, respectively. Going forward, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Fund earns performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long term performance.

### **Time-Weighted vs. Money-Weighted Rates of Return**

Calculating the rate of return on an investment portfolio is not as simple as it might appear.

If there are never any cash flows in or out of a portfolio between its inception and its termination, then calculating performance is a relatively simple matter. In such an instance, the percentage return (R) is the ending portfolio value ( $V_1$ ) divided by the beginning portfolio value ( $V_0$ ) minus one times 100 (i.e.,  $R = (V_1/V_0 - 1) \times 100$ ). For example, if a portfolio started with \$100,000, had no cash flows in or out and ended with \$121,000, its percentage return would be 21% (i.e.,  $(\$121,000/\$100,000 - 1) \times 100$ ). This calculation shows the cumulative return without any consideration of how much time elapsed. More commonly, in order to facilitate comparison of various investments, cumulative returns are converted to annualized returns. To calculate annualized returns (AR), one would modify the above equation by applying to the first term an exponent whose numerator is one and whose denominator is the number of years (Y) for which the portfolio existed (i.e.,  $AR = ((V_1/V_0)^{1/Y} - 1) \times 100$ ). In the above example, assuming that the cumulative return occurred over a period of two years ( $Y=2$ ), the annualized rate of return would be 10% per annum (i.e.,  $((\$121,000/\$100,000)^{1/2} - 1) \times 100$ ).

In the real world, there are very few portfolios that have no cash flows in or out during their lifetimes. As soon as cash flows in (through deposits or subscriptions) or out (through withdrawals or redemptions) are introduced, the method of calculating rate of return becomes more complicated. In the case of portfolios with cash flows, there are two primary methods of calculating performance: i) the *time-weighted* method; and ii) the *money-weighted* method (this is also known as the *asset-weighted* method or *dollar-weighted* method, if dollars are the portfolio's reporting currency). As we will see, understanding the difference between the two methods of calculating rate of return is crucial to successful investing over a lifetime.

*Time-weighted* rate of return is the standard method of calculating return used in the investment management industry. Indeed, all of the return figures for the Fund cited earlier in this letter have been calculated on a time-weighted basis. In order to perform time-weighted calculations, the

portfolio must be unitized. For example, an investment fund might start by issuing 1,000 units at \$100 per unit for a total initial portfolio of \$100,000. Even if it was one person's portfolio (i.e., no units were issued), we would pick an arbitrary initial value per unit (say, \$100) and calculate the number of units issued (in this example, 1,000). Thereafter, immediately prior to every cash flow, the portfolio is valued and its value per unit is calculated. The cash flow is then added to (or subtracted from) the portfolio value and the number of units outstanding is correspondingly increased (or decreased) at the then-prevailing net asset value per unit. The time-weighted rate of return is then calculated by dividing the terminal value per unit by the initial value per unit. An illustration will follow shortly. First, however, it would be beneficial to describe the money-weighted method of calculating return.

*Money-weighted* rate of return is, in essence, an internal rate of return calculation.<sup>6</sup> Money-weighted returns are calculated using an iterative function. The function determines the rate of return (i.e., the discount rate) which equates the net present value of all of the positive cash flows (in our example to follow, that is the ending portfolio value) with the net present value of all of the negative cash flows (in our example to follow, the initial and subsequent contributions). Iterative functions involve repeating similar calculations over and over again, using a trial and error process with diminishing errors, until the correct result is found to a specified degree of accuracy. Iterative functions are too difficult to do by hand as they could involve thousands of computations. Fortunately, the Microsoft Excel spreadsheet application does the calculation for us using its XIRR function.

It's now time to illustrate the difference between time-weighted and money-weighted returns with two examples. For both examples, let's assume that: a portfolio was started on December 31, 2014 with \$5,000; another \$5,000 was contributed on April 30, 2015; and the portfolio ended on December 31, 2015 with a value of \$10,000. In Example 1, however, the first \$5,000 grew to a value of \$6,000 before the additional contribution of \$5,000. The combined amount of \$11,000 then declined in value by year-end to \$10,000. In Example 2, the first \$5,000 declined to a value of \$4,000 before the additional contribution of \$5,000. The combined amount of \$9,000 then increased in value by year-end to \$10,000. The table below shows these two examples. As can be seen, there is a striking difference between the time-weighted and money-weighted rates of return.

<u>Example 1:</u>	<u>Date</u>	<u>Value</u>	<u>Units</u>	<u>Value per Unit</u>
Initial portfolio value	31-Dec-14	\$5,000	5,000	\$1.000
Income and gains		\$1,000		
Portfolio value before contribution	30-Apr-15	\$6,000	5,000	\$1.200
Contribution	30-Apr-15	\$5,000	4,167	\$1.200
Portfolio value after contribution	30-Apr-15	\$11,000	9,167	\$1.200
Income and (losses)		(\$1,000)		
Portfolio value at end of year	31-Dec-15	\$10,000	9,167	\$1.091
Time-weighted rate of return				9.1%
Money-weighted rate of return				0.0%

<u>Example 2:</u>	<u>Date</u>	<u>Value</u>	<u>Units</u>	<u>Value per Unit</u>
Initial portfolio value	31-Dec-14	\$5,000	5,000	\$1.000
Income and (losses)		(\$1,000)		
Portfolio value before contribution	30-Apr-15	\$4,000	5,000	\$0.800
Contribution	30-Apr-15	\$5,000	6,250	\$0.800
Portfolio value after contribution	30-Apr-15	\$9,000	11,250	\$0.800
Income and gains		\$1,000		
Portfolio value at end of year	31-Dec-15	\$10,000	11,250	\$0.889
Time-weighted rate of return				-11.1%
Money-weighted rate of return				0.0%

Given the dramatic differences in rates of return shown in the table, it's worth exploring this matter further.

### **Example 1**

In Example 1, the investor starts on December 31, 2014 with \$5,000. The table shows the unitization of this sum by assuming that the investor has subscribed for 5,000 units with a value per unit of exactly \$1.00. In the first four months of 2015, he achieves an increase in the value of his portfolio of \$1,000 or 20.0%, reaching a total value of \$6,000. Each of the 5,000 units is now worth \$1.20. He then adds another \$5,000 to his portfolio. At the deemed unit issue price of \$1.20, his number of units increases by 4,167 to reach a total of 9,167 units with a market value of \$11,000. Alas, the portfolio declines in value over the remaining eight months of 2015, falling by \$1,000 to a value of \$10,000. Dividing this amount by his 9,167 units yields a value at the end of 2015 of \$1.091 per unit. Given that the value per unit a year earlier had been exactly \$1.000, Example 1's *time-weighted* rate of return (using the formula described above) is  $(1.091/1.000 - 1) \times 100$  for a positive performance of 9.1%.

To calculate Example 1's *money-weighted* rate of return all that is needed is to input the portfolio's cash flows, and the date of every cash flow, into Excel's XIRR function. In the case of Example 1, there is an outlay of (\$5,000) at the inception of the portfolio on December 31, 2014; another outlay of (\$5,000) on April 30, 2015; and a terminal value on December 31, 2015 of \$10,000. The portfolio's resulting money-weighted rate of return in 2015 is 0.0%. In effect, the money-weighted calculation says "the investor invested a total of \$10,000 (\$5,000 on each of December 31, 2014 and April 30, 2015), and also ended with \$10,000, so his rate of return is zero."

### **Example 2**

In Example 2, the investor also starts on December 31, 2014 with \$5,000. The table shows the unitization of this sum by assuming that the investor has subscribed for 5,000 units with a value per

unit of exactly \$1.00. In the first four months of 2015, her portfolio decreases in value by (\$1,000) or (20.0%), declining to a value of \$4,000. Each of the 5,000 units is now worth \$0.80. She then adds another \$5,000 to her portfolio. At the deemed unit issue price of \$0.80, her number of units increases by 6,250 to reach a total of 11,250 units with a market value of \$9,000. The portfolio then increases in value over the remaining eight months of 2015, rising by \$1,000 to a value of \$10,000. Dividing this amount by her 11,250 units yields a value at the end of 2015 of \$0.889 per unit. Given that the value per unit a year earlier had been exactly \$1.000, Example 2's *time-weighted* rate of return (using the formula described above) is  $(0.889/1.000 - 1) \times 100$  for a negative performance of (11.1%).

The *money-weighted* rate of return in Example 2 is exactly the same as was calculated for Example 1 (i.e., 0.0%). That is because in both examples the inputs are the same (i.e., there is an outlay of (\$5,000) at the inception of the portfolio on December 31, 2014; another outlay of (\$5,000) on April 30, 2015; and a terminal value on December 31, 2015 of \$10,000). In both examples, the investor contributes \$10,000 and ends with \$10,000. The portfolio's resulting money-weighted rate of return in 2015 in both Example 1 and Example 2 is zero.

### **Comparison**

The time-weighted rate of return in Example 1 was 9.1% while the money-weighted return was 0.0%. The time-weighted rate of return in Example 2 was negative (11.1%) while the money-weighted return was 0.0%. Which of the two methods of measuring performance, time-weighted or money-weighted, is correct? *The answer is that they're both correct but they're measuring different things.*

Time-weighted rate of return is the method universally used to measure the performance of portfolio managers, investment funds and asset class indices (such as stock market indices). That is because the portfolio manager, investment fund or asset class generally has no control over, and often no knowledge of, when an investor chooses to add (or withdraw) funds to (or from) the portfolio, fund or index in question.

Money-weighted rate of return, by contrast, measures an investor's own experience. That is because the money-weighted rate of return, as its name implies, is calculated by using the amount of the investor's money actually invested during each sub-period of investment performance.

*Understanding the difference between time-weighted and money-weighted rates of return, and the resulting portfolio management implications, is crucial to an investor's success over his or her lifetime.* The next section of this letter discusses the implications.

### **Temporal Diversification**

In order to determine the cumulative *time-weighted* performance of a portfolio over a multi-year period, one simply multiplies together the performances for the individual years. The product is the cumulative result over the multi-year period. It's important to note that, as with all multiplications,

the order in which the numbers occur is irrelevant. In other words, if one multiplies a bunch of numbers together, the result is always the same regardless of the sequence in which the numbers appear. In the vernacular of finance, the cumulative result of a series of *time-weighted* returns is not path dependent.

By contrast, the cumulative *money-weighted* performance of a portfolio over a multi-year period is, in fact, path dependent. In other words, it matters a great deal to the cumulative result of a real portfolio how much money is invested in each sub-period. In Example 1 above, the money-weighted return of 0.0% was much *worse* than the time-weighted return of 9.1% because more than twice as much money (\$11,000 vs. \$5,000) was invested during the down period than during the up period. Conversely, in Example 2 above, the money-weighted return of 0.0% was much *better* than the time-weighted return of (11.1%) because 80% more money (\$9,000 vs. \$5,000) was invested during the up period.

This distinction is extremely important to long-term wealth creation. For example, as was discussed in the 2014 Letter, an investor who starts saving at age 18 and steadily builds up his investments over the next 50 years until retirement might have a portfolio amount 100 (or more) times greater in his later years than in his early years.<sup>7</sup> As a result, the performance achieved by the investor in his later years is much more important than the performance achieved in his early years. Many baby boomers (the huge demographic cohort of those born from 1946 to 1964) have experienced the negative impact of this very phenomenon. They have been, in effect, real world, unwitting participants in Example 1 above. Many baby boomers had comparatively small investment portfolios in the 1980s and 1990s, when real (after-inflation) returns in the three major asset classes (stocks, bonds and cash) were very strong. Conversely, boomers have had their largest portfolios since 2000, just before their planned retirements, when real asset class returns have been relatively poor. This phenomenon has been described in a recent article aptly titled “Who Ate Joe’s Retirement Money? Sequence Risk and its Insidious Drag on Retirement Wealth”.<sup>8</sup> The result (combined with rising life expectancies and, in my opinion, low prospective asset class returns) is that the largest population segment in Canada and the U.S. may be ill-prepared for its long retirement.

What can be done to address this problem and to prevent it from happening to future generations of investors? Unfortunately, with regard to the oldest boomers (who turn 70 this year), there is not much that can be done. In many cases, boomers, given their advanced years, limited ability to obtain further employment and discomfort with volatility, have chosen low volatility, low return portfolios comprised largely of cash and government bonds. If their portfolios, combined with other sources of income such as Canada Pension Plan (“CPP”) and Old Age Security (“OAS”) payments, do not provide them with a desired level of income, then expenses will have to be reduced beyond prior expectations or the gap filled by support from family members. This has given rise to the term “sandwich generation”, describing those who support both their own children as well as their aging parents.

Fortunately, for other people and especially for young adults, there is a solution to the problem. Since the risk of *money-weighted* returns being much lower than *time-weighted* returns arises

because many people have much more invested in their later investing years than they do in their early investing years, the solution is to invest more in one's earlier years. How does one do that, considering that typically many younger people have minimal net worth and are just making ends meet? *The answer is to use leverage.* In other words, borrow money in the early years so as to increase one's earlier investment portfolios, thus spreading the size of one's lifetime investment portfolio more evenly over the years so that the cumulative, money-weighted result is less exposed to sequence risk. Spreading out one's investment portfolio more evenly over the years is called *temporal diversification*, also known as *time diversification*.

The controversial but logical advice to use leverage to spread investment portfolios more evenly over time is expounded by two professors at Yale University, Ian Ayres and Barry Nalebuff, in their book, *Lifecycle Investing*.<sup>9</sup> I wholeheartedly endorse their concept of using leverage, prudently, so as to spread investments more evenly over time. As I've written before, the popular prejudice against using leverage for investing is both hypocritical (for those who use, or endorse the use of, mortgages, which are another form of leverage) and is not justified by the facts.<sup>10</sup> Furthermore, the professors urge the use of leverage in order to increase one's exposure to equities. That is partly because equities are expected to remain the best-performing asset class over the long term. It is also because, from a recipient's point of view, government-sponsored support payments such as CPP and OAS have the characteristics of fixed income investments.<sup>11</sup> They are like fixed annuities, payable in one's retirement years, whose value is not dependent upon equity markets. As a result, in order to achieve an appropriate asset mix, the leveraged portfolios that we directly control ourselves should be invested in equities.

As is noted by the professors, although prudent use of leverage may be wise in theory, it is difficult to implement in practice. For example, as shown in the table below, the average margin interest rates charged by the self-directed brokerage divisions of Canada's three largest banks (based on market capitalization) for borrowings in Canadian dollars (C\$) and US\$ are currently 4.10% and 4.75%, respectively.<sup>12</sup>

Margin loan rates of three largest

banks,

regular accounts, all balances:

	C\$	US\$
RBC Direct Investing	4.10%	4.75%
Scotia iTrade	3.95%	4.75%
TD Direct Investing	4.25%	4.75%
Average margin loan rates	4.10%	4.75%

I find the above rates to be extremely high given current low levels of inflation and bank funding costs. Given recent (and, in my opinion, prospective) low asset class returns, the use of leverage at the interest rates above would not, in my opinion, provide sufficient additional investment return to compensate for the additional risk. There is one independent firm, Interactive Brokers Canada Inc. ("IB"), which offers much lower interest rates. IB's target clients, however, are financial professionals so the firm may not be suitable for most Canadians. Furthermore, IB is able to offer lower inter-

est rates (at least in part) because its systems are highly automated including real-time, intra-day calculation of margin and automatic selling of securities (perhaps without notice) in order to restore adequate margin. In my opinion, that exposes clients using margin to material, permanent losses of capital in the event of intra-day “flash crashes” such as happened on May 6, 2010.<sup>13</sup> In fact, a miniature flash crash happened as recently as August 24, 2015, when the S&P 500 Index (and other markets) fell as much as (5%) in the opening minutes of trading before staging a recovery.<sup>14</sup>

Professors Ayres and Nalebuff also advise against traditional margin loans because of the possibility of a margin call and because many brokers charge high interest rates.<sup>15</sup> Their advice is for investors to leverage using deep in-the-money Long-term Equity Anticipation Securities, known by their acronym LEAPS.<sup>16</sup> These are long-dated call options giving the holders the right to buy a certain amount of securities, such as an amount of the S&P 500 Index, at a specified price for a specified period of time. In my view, however, the use of LEAPS to leverage would have its own drawbacks, such as: high trading costs; incurring the cost of the options’ time value (which is implied interest); and adverse tax consequences (in Canada, option transactions are generally on income account and do not receive the favourable tax treatment accorded dividends and capital gains). Also, in my opinion, using LEAPS would demand a level of financial and mathematical sophistication which is beyond the scope of many lay people (and perhaps even many financial professionals).

So if using leverage is the key to achieving temporal diversification (i.e., spreading one’s investments more evenly over a lifetime so as to minimize sequence risk), but margin accounts at the big banks and the use of LEAPS are both undesirable or impractical, what’s the solution? At the risk of sounding self-serving, I believe that the solution is...the Fund! The Fund offers the use of leverage to investors on attractive terms, including:

- **Low interest rates.** Currently, the Fund’s average cost of C\$ and US\$ borrowing is 1.47% which is almost three percentage points lower than the average rate of 4.43% (shown in the table above) offered to retail clients by the major banks. For example, if the Fund borrows on average \$0.50 for every dollar of net assets, and does so at interest rates 3.0% lower than individual investors could achieve themselves, then the interest savings of 1.5% per year alone would be enough to offset the Fund’s series F management fee of 1.0% and operating expenses of 0.5%.
- **No margin call to investors.** Leverage is at the Fund level, not the investor level, so investors are not exposed to a margin call. The Fund has that risk but we at PIC deal with it through continuous monitoring, and active management, of the Fund’s leverage. Also, in the event of temporary market dislocations, management of the Fund is aided by our long-standing relationship with the Fund’s custodian.
- **Professional management of leverage.** As the saying goes, leverage works both ways: it both enhances positive returns and accentuates negative returns. Using leverage is not for the faint of heart or inexperienced. I believe that for most people, use of leverage in their

investments would result in more harm than good. By investing through the Fund, however, clients can obtain the benefits of enhanced long-term return and temporal diversification enabled through the use of leverage, while leaving the decisions about when to use it, and how much, to a trained and experienced professional.

### **Mr. Market Remains Manic-Depressive**

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Benjamin Graham, in his classic book *The Intelligent Investor*, introduced the now-famous parable of Mr. Market.<sup>17</sup> Graham suggested that being a stock market investor is akin to being in private business with a partner who is sometimes rational; at other times fearful or enthusiastic. Every day, Mr. Market states a price at which he will either buy your interest in the business or sell you his. Depending upon Mr. Market's mood, these prices may seem about right, absurdly low or unduly high. You are free to act on the quoted prices, or not, at your choice and only when you believe it is to your advantage. As Graham implied, the market is there to serve you, not to guide you.

When I first began sketching an outline of this letter, in mid-2015, I titled this section "Mr. Market Is Increasingly Optimistic". In fact, we can now say, with hindsight, that the S&P 500 Index reached its all-time high in May 2015. In the second half of 2015, however, the stock market's former confidence waned and there were even two brief periods when the S&P 500 Index entered into territory commonly defined as a "correction" (i.e., a decline of 10% or more from a recent peak). The S&P/TSX Index, meanwhile, attained its 2015 high in April and then began a steady slide, ending the year firmly in correction territory. As a result, I've renamed this section of the letter to reference both sides of Mr. Market's manic-depressive nature. The next four sections of this letter, the first two of which were drafted during the stock market's happier time, further expand upon Mr. Market's volatile personality and serve as cautionary tales.

### **An Undertaking Of Great Advantage, But Nobody To Know What It Is**

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In May of 2015, when I read the use of proceeds of a \$2.2 billion equity issue, I laughed out loud.

The term sheet announcing the equity issue stated that the use of proceeds was "future acquisitions." As a student of stock market history, I couldn't help but be reminded of a memorable tale related by author Charles Mackay in his book, *Extraordinary Popular Delusions and the Madness of Crowds*.<sup>18</sup> Mackay describes perhaps the world's first stock market mania, the South Sea Bubble of the early 1700s. The British public became infatuated with the excitement and riches of the New World that would be exploited by the South Sea Company. The company purchased the rights to all British trade in the newly-discovered regions from the Crown and purported to pay for those rights, and the cost of its voyages, by issuing shares which were listed on the nascent British stock exchange. The price of the shares soared higher than a topsail (before later sinking into the depths) and more and more companies issued shares to cash in on the public's buying frenzy. One such enterprise, started by a previously unknown adventurer, was titled "A company for carrying on an undertaking of great advantage, but nobody to know what it is." As the story goes, once the promoter received the initial subscriptions in the princely sum of £2,000, he disappeared to the Continent and was never heard from again.

I don't mean to pass any comment on the merits of the equity issue referred to above or that company's management. In fact, it is but one example among many. Recent years have witnessed the creation of a large number of "capital pool" companies. These were formerly known as "blind pools" before their promoters hit upon a moniker which is more marketable, if no more insightful. One recent article stated that as of the fall of 2015 there were 130 companies listed on the TSX Venture Exchange Capital Pool Company List.<sup>19</sup> What, you may ask, is the point of this story? It is simply to say that when large sums can be raised by unproven companies without specified uses, it suggests that equity markets are frothy and wariness is in order. A similar sign of the times is described immediately below.

### **Price Is What You Pay; Value is What You Get**

There is a well-known expression of legendary investor Warren Buffett: "price is what you pay; value is what you get."<sup>20</sup> By this, Buffett means that with regard to common shares, there is no necessary connection between price and value. Given the earlier-noted manic-depressive tendencies exhibited by the stock market, when considering shares of a business, price (what you pay) could be materially higher or lower than the company's intrinsic value (what you get). It is the objective of the investor to buy high-quality businesses at significant discounts to their intrinsic values.

To illustrate how wide the disparity between price and value can be, let's now consider a tale of two companies. While these are actual businesses listed on the Toronto Stock Exchange, for now we'll call them Company A and Company B. A brief statistical comparison of the two companies is provided in the table below.<sup>21</sup>

<u>Selected data items (C\$ millions):</u>	<u>Company A</u>	<u>Company B</u>
Market capitalization (July 31, 2015)	\$110,051	\$107,439
Common shareholders' equity	\$51,779	\$8,027
Tangible common shareholders' equity	\$40,110	(\$42,344)
Average annual net income (loss), 2010-2014	\$6,704	(\$31)
Dividend (July 31, 2015 indicated annual rate)	\$4,441	\$0
Corporate credit rating	AA-	BB-

The data items listed in the table are as follows:

- **Market capitalization** is the product of the number of shares outstanding multiplied by the market price per share. At the date of the comparison (July 31, 2015), both companies had a market capitalization (i.e., "price") of about \$110 billion. By contrast, indicators of the disparity in "value" are listed in the remainder of the table.
- **Common shareholders' equity** is the amount of the company's assets (at their accounting or carrying value) minus all of the company's liabilities. Using the most recent quarterly information publicly available prior to the date of the comparison, Company A had com-

mon equity of about \$52 billion, compared to Company B's common equity of \$8 billion.

- **Tangible common shareholders' equity** is the amount of common equity (as per above) minus the carrying value of goodwill and intangible assets. Company A had tangible common equity of \$40 billion. Company B had negative tangible common equity of (\$42) billion.
- **Average annual net income (loss)** shows the average net income recorded for the five most recently completed years (i.e., 2010 to 2014, inclusive) prior to the date of the comparison. Company A had average net income of \$6.7 billion. Company B had an average net loss of (\$31) million.
- **Dividend** is the indicated rate of the company's annual amount of common share dividends as of the date of the comparison. Company A was paying annual dividends of \$4.4 billion. Company B did not pay a dividend.
- **Corporate credit rating** shows that Company A's credit rating from Standard & Poor's ("S&P") was (and is) AA-. Of that rating category, S&P states that the issuer's capacity to meet its financial commitments is "very strong."<sup>22</sup> Conversely, Company B's credit rating was BB-. An issuer in that category, according to S&P, "faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment[s]."<sup>23</sup>

Let's assume, for a moment, that you have just won a monstrously large lottery in the amount of \$110 billion (or maybe you just happen to have that much money lying around). The condition of the prize, however, is that you must invest the entire amount into 100% ownership of Company A or Company B. Furthermore, the only information provided to you about the two companies is the data in the table above. Would it take you more than a few seconds to select Company A? I think not.

Company A is Royal Bank of Canada ("RBC"), which is owned in the Fund. Company B is Valeant Pharmaceuticals International Inc. ("Valeant"), which is not owned in the Fund. Price is what you pay. Value is what you get.

In late July 2015, Valeant briefly surpassed RBC to become Canada's largest company in terms of market capitalization. The unfortunate history of the limited number of companies which have attained that height is detailed in the next section of this letter.

### The RBC Curse

In overtaking RBC's market capitalization, Valeant joined a short list (pun intended) of other companies which have accomplished that feat since the turn of the century. In every case, subsequent performance was disastrous. To paraphrase Groucho Marx, this is a club to which you do not want to belong. In chronological order, its other members are:<sup>24</sup>

- **Nortel Networks Corporation.** After passing RBC in market capitalization at the height of

the technology and telecommunications bubble (which peaked in the year 2000), Nortel flamed out in epic fashion, ending in bankruptcy.

- **Manulife Financial Corporation.** Following its acquisition of John Hancock for US\$10.3 billion in stock, Manulife passed RBC, for a brief moment in March 2005, to become Canada's largest company by market capitalization. Profits boomed while Manulife issued insurance policies to protect clients against stock market declines without, ironically, insuring itself. One global financial crisis, two equity issues and a (50%) dividend cut later, Manulife limped into the end of 2015 with a market capitalization slightly more than one-third that of RBC's.
- **Encana Corporation.** After surpassing RBC in both 2005 and 2008 (at peaks of enthusiasm for energy companies generally), the former EnCana subsequently split into two companies: the gas-focused Encana Corporation; and the oil-focused Cenovus Energy Inc. Cyclical commodity prices then took their toll. At the end of 2015, the two companies had a combined market capitalization of less than one-fifth that of RBC's.
- **Research in Motion Limited.** Riding the wave of global enthusiasm for its mobile devices and their innovative email functionality, RIM reached its zenith as Canada's most valuable company in the fall of 2007. Rapid technological change and widespread competition, most notably from Apple Inc., then took a horrible toll. By the end of 2015, the market capitalization of BlackBerry Ltd., as the company is now known, was one-nineteenth that of RBC's.
- **Potash Corporation of Saskatchewan.** The company's reign as Canada's most valuable company, a level reached in mid-2008, didn't last long. Potash Corp.'s stock price plunged in the fall of 2008 during the global financial crisis. It, and the price of potash itself, have never recovered to the heights reached in 2008. At the end of 2015, Potash Corp.'s market capitalization was less than one-fifth that of RBC's.
- **Barrick Gold Corporation.** From its depths in October 2008 (at the height of the global financial crisis) to January 2009, Barrick's stock price doubled as gold benefitted from its "safe haven" reputation during the crisis and the US\$ rose sharply in relation to the C\$. For one brief, shining moment, Barrick surpassed RBC in market capitalization. As life gradually settled into what has become the new normal, gold has since lost its lustre. That, compounded by the company's self-inflicted mistakes, has contributed to the company's undoing. By the end of 2015, Barrick's market capitalization was one-ninth that of RBC's.

And what has become of Valeant since its peak in July? Space doesn't permit a full re-telling of its subsequent series of unfortunate events. Suffice it to say that they include alleged improprieties, closure of an affiliated business, sharply lower financial guidance and a congressional investigation.

By the end of 2015, Valeant's market capitalization was considerably less than half that of RBC's.

At least three things can be learned from the woeful tales listed above. If any Canadian company ever surpasses RBC in market capitalization, then: i) that company should be considered as a short sale candidate; ii) investors should be wary of overall stock market conditions (since many of the instances cited above occurred not long before significant stock market declines); and iii) RBC is a very profitable, cash-generating franchise which should not be underestimated.

### **Where She Stops, Nobody Knows**

For the last several years, stock markets have been pulled in a tug-of-war-like fashion by opposing forces. On one side, the tugs down have been caused by disappointment with the historically weak economic recovery and with often-legitimate concerns such as sharply rising government debt and deteriorating finances of some businesses (e.g., commodity producers). The tugs up have come primarily from ultra-low (in some countries, negative) interest rates. These low rates have made equities look attractive compared to the very low interest rates obtainable on cash and government bonds. Accordingly, some have summarized the case for investing in equities by stating There Is No Alternative, a condition that has come to be known by its acronym, TINA. On balance, this tug of war has resulted in steadily higher equity valuations, as shown in the following table:

<u>S&amp;P 500 Index</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Average index value	1,268	1,379	1,643	1,932	2,061
Closing index value	1,258	1,426	1,848	2,059	2,044
Operating earnings	96.44	96.82	107.30	113.01	100.44
Average price-earnings ratio	13.1x	14.2x	15.3x	17.1x	20.5x
Closing price-earnings ratio	13.0x	14.7x	17.2x	18.2x	20.3x

In the last four years, the S&P 500 Index rose significantly, increasing from 1,258 at the end of 2011 to 2,044 at the end of 2015; a gain of 62%. In the same period, earnings growth was sluggish; earnings actually declined in 2015 because of the poor results of energy and materials companies and the strong US\$ which reduced the international earnings of many American businesses when expressed in US\$. In total, the S&P 500 Index's operating earnings increased from 96.44 in 2011 to an estimated 100.44 in 2015 (with 98% of companies having reported), a gain of only 4%.<sup>25</sup> The combination (over the four year period) of stock price gains of 62% with earnings growth of only 4% resulted in the S&P 500 Index's steadily higher trailing price-earnings ("P/E") ratio, which rose from 13.0x at the end of 2011 to 20.3x at the end of 2015.

Nobody knows how high the P/E ratio of the S&P 500 Index will go before it stops rising. Low interest rates, which have underpinned equity markets for the last seven years, continue to prevail. At the same time, history strongly suggests that paying too-high prices for common stocks will result in, at some point, a period of poor or negative returns. In the Fund, I have tried to buy only excellent businesses at sensible valuations and have tread carefully in the use of leverage. That caution has contributed to the Fund's strong performance to date. There are certain to be periods of weak stock prices in the years ahead. When that happens, there will likely be many opportunities to acquire excellent long-term investments at bargain prices. Those investments will enhance future returns. Accordingly, as I stated in the 2013 Letter, long-term investors should embrace lower stock prices

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Fund’s portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Fund LP Offering Memorandum, March 1, 2016, p. 2. The OM is available at <http://www.portlandic.com/focusedplusfundLP.html>
3. For a discussion, see 2013 Letter, p. 3.
4. OM, p. 14.
5. OM, pp. 6-7 and pp. 13-14.
6. See [http://wiki.fool.com/How\\_to\\_Calculate\\_IRR\\_With\\_Unequal\\_Timing\\_of\\_Cash\\_Flows](http://wiki.fool.com/How_to_Calculate_IRR_With_Unequal_Timing_of_Cash_Flows)
7. 2014 Letter, p. 33.
8. Chiappinelli, Peter and Thirukkonda, Ram. “Who Ate Joe’s Retirement Money? Sequence Risk and its Insidious Drag on Retirement Wealth,” GMO LLC, August 2015.
9. Ayres, Ian and Nalebuff, Barry. *Lifecycle Investing: A New, Safe and Audacious Way to Improve the Performance of Your Retirement Portfolio* (Basic Books, 2010).
10. 2013 Letter, pp. 5-7.
11. Ayres and Nalebuff, op. cit., pp. 33-35.
12. Margin loan rates are as of February 22, 2016. See <https://www.rbcdirectinvesting.com/pricing/cash-margin-rates.html#margin-balances-debit>, <http://www.scotiabank.com/itrade/en/0,,3693,00.html> and <https://www.td.com/ca/products-services/investing/td-direct-investing/accounts/rates.jsp>.
13. See <http://www.investopedia.com/terms/f/flash-crash.asp>
14. Bloomberg L.P.
15. Ayres and Nalebuff, op. cit., pp. 16-17.
16. Ibid., pp. 11-26.
17. Graham, Benjamin. *The Intelligent Investor* (Harper & Row, Fourth Revised Edition, 1973), pp. 108-109.
18. Mackay, Charles. *Extraordinary Popular Delusions and the Madness of Crowds* (Harmony Books, 1980; originally published in 1841), pp. 55-56.
19. Zaramian, Reuben. “The capital pool company: an alternative way to go public,” Deal Law Wire, October 28, 2015, available at [https://www.google.ca/?gws\\_rd=ssl#q=capital+pool+companies+deal+law+wire](https://www.google.ca/?gws_rd=ssl#q=capital+pool+companies+deal+law+wire)
20. See, e.g., Bloch, Robert L. *My Warren Buffett Bible* (Skyhorse Publishing, 2015), p. 22.
21. In the table, market capitalizations are from TD Securities Inc.; corporation data items are from company reports; and credit ratings are from Standard & Poor’s. Company B reports in US\$; its balance sheet items were converted to C\$ at the rate of exchange on June 30, 2015 while its average annual net loss (as originally reported) was converted to C\$ at the rate of exchange on July 31, 2015.
22. See [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352)
23. Ibid.
24. Sources for the companies that have surpassed RBC in market capitalization include TD Securities Inc. and several media articles. See, e.g., Berman, David. “Usurping RBC: The curse continues.” The Globe and Mail, October 23, 2015, p. B12 and Pelletier, Martin. “Steer clear of market rabbits.” National Post, October 27, 2015.
25. The source for S&P 500 Index earnings is Standard & Poor’s itself at <https://my.spindices.com/indices/equity/sp-500>
26. 2013 Letter, pp. 12-13.

The PORTLAND FOCUSED PLUS FUND LP (the "Fund") is not publicly offered. It is only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Fund is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Fund is made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Fund's performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Commissions, trailing commissions, management fees and expenses all may be associated with investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or optional charges or income taxes payable by any unitholder in respect of a fund that would have reduced returns. Funds are not guaranteed, their values change frequently and past performance may not be repeated.

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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel: 1-888-710-4242 • Fax: 1-866-722-4242 • www.portlandic.com • info@portlandic.com

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**Portland Focused Plus Fund LP**  
**Portland Focused Plus Fund**  
ANNUAL LETTER TO INVESTORS  
FOR THE YEAR ENDED DECEMBER 31, 2016

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund LP				S&P/TSX Composite Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.5%
2013	33.0%	34.1%	37.7%	34.4%	13.0%	32.4%
2014	15.6%	16.8%	18.8%	17.5%	10.6%	13.7%
2015	6.5%	7.5%	8.3%	8.5%	-8.3%	1.4%
2016	39.0%	40.4%	45.5%	41.6%	21.1%	12.0%

Since Inception (Oct. 31, 2012)

Compound annual	22.3%	23.5%	26.1%	24.3%	8.3%	14.1%
Cumulative return	131.5%	140.9%	162.9%	147.4%	39.5%	73.4%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund				S&P/TSX Composite Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	15.8%	10.5%

Notes:

Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (collectively, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the LP for 2013 ("2013 Letter"), 2014 ("2014 Letter") and 2015 ("2015 Letter") are available on the web site of Portland Investment Counsel Inc. ("Portland") at <http://www.portlandic.com/focusedplusfundLP.html>. Important subject areas regarding investing and portfolio management are discussed in detail in those letters. When those letters were written, the remarks therein were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters (which are incorporated herein by reference).

**Investment Objective**

As stated in the Funds' Offering Memorandum dated March 1, 2016 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance Of The LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The LP's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end including annualized returns over various time periods, may be found at [www.portlandic.com/focusedplusfundLP.html](http://www.portlandic.com/focusedplusfundLP.html).

In 2016, the LP's series F units (the highest fee series without embedded advisor compensation) achieved a return of 40.4% (net of fees and expenses). That compares to a return of 21.1% for the S&P/TSX Index and to a return of 12.0% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of 16.5%. For the entire period since inception of the LP on October 31, 2012 to December 31, 2016, the LP's series F units achieved a cumulative return of 140.9%. That compares to a cumulative total return of 39.5% for the S&P/TSX Index and 73.4% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 56.5%. Accordingly, in both 2016 and for the cumulative period since the LP's inception, the LP has met its investment objective of preservation of capital and a satisfactory return.

A comparison of the LP's performance to other funds in its category is also revealing. ***I'm pleased to report that for the three years ended December 31, 2016, the performance of the LP's series M units of 23.2% per annum ranked it as the top-performing series among all alter-***

*native strategies funds in Canada as ranked by Global Investor - Funds.*<sup>4</sup> That performance far exceeded the average return for funds in the category of 3.8% per annum. Further, the LP's strong performance to date bodes well for its five-year performance and ranking which will first be available in November 2017.

### **Launch, Management And Performance Of The Trust**

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The LP was launched on October 31, 2012. It was (and is) intended for investment by non-registered plans for which the most tax-efficient legal form is, in my opinion, a limited partnership. Unfortunately, limited partnerships such as the LP are not eligible for investment by registered plans (such as registered retirement savings plans ("RRSPs"), tax-free savings accounts ("TFSA's") and registered education savings plans ("RESPs"). Registered plans represent a large proportion of the investment portfolios of many Canadians. Given the strong performance of the LP since its inception, there has been investor demand for a fund like the LP but in the form of a mutual fund trust which would be eligible for investment by registered plans. In response to this demand, PIC launched the Trust on March 31, 2016. The Trust's investments are managed in a virtually identical manner to those of the LP. The two Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end, the Funds make such portfolio transactions as are necessary to harmonize their two portfolios. As a result, investors should expect that the management and long-term performance of the two funds will be very similar. That is why Portland has decided to distribute this 2016 Letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at [www.portlandic.com/focusedplusfundtrust.html](http://www.portlandic.com/focusedplusfundtrust.html).

In the nine month period from the Trust's inception on March 31, 2016 to December 31, 2016, the Trust's series F units (the highest fee series without embedded advisor compensation) achieved a return of 29.3% (net of fees and expenses). That compares to a return in the same period of 15.8% for the S&P/TSX Index and of 10.5% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of 13.1%. Nine months is much too short a period to assess whether the Trust has met its investment objective of preservation of capital and a satisfactory return. Its strong initial performance is very encouraging, however, and investors should derive further confidence from the excellent performance record of the LP upon which the Trust is modelled.

### **Operating Expenses**

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The Funds incur operating expenses for such items as fund administration, audit and legal fees.<sup>5</sup> From the inception of the Funds to December 31, 2016, the Funds' operating expenses have each been 0.50% per annum plus applicable taxes. While there can be no assurance that the Funds' operating expenses will remain at 0.50% per annum, PIC remains committed to tight management of fees and expenses so as to maximize the Funds' returns.

## Series Of Fund Units

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The Funds have four series of units outstanding. The features of each are outlined below:<sup>6</sup>

- **Series A units** have: a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit (“High Water Mark”) of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have: a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have: a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee; and
- **Series P units** have: a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee.

As can be seen in the tables on the inside front cover of this letter, for the period from October 31, 2012 to December 31, 2016, the LP’s series F units had a cumulative return of 140.9% while the LP’s series M units and series P units had higher cumulative returns of 162.9% and 147.4%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2016, the Trust’s series F units had a cumulative return of 29.3% whereas the Trust’s series M units and series P units had higher cumulative returns of 33.6% and 30.6%, respectively.

Going forward, for each of the LP and the Trust, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long term performance.

### LP For Non-registered Accounts, Trust For Registered Accounts

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In my opinion, with the limited exceptions noted at the end of this section, non-registered investment accounts should invest in the LP whereas registered accounts should invest in the Trust.

A full explanation of the differences between limited partnerships (such as the LP) and mutual fund trusts (such as the Trust) is beyond the scope of this letter. The following, however, summarizes some of the major differences between the two legal forms:

- In a limited partnership, all income and expense items retain their tax character and are flowed directly out to investors. For example, the LP has earned considerable income from eligible Canadian

dividends and capital gains. These forms of income are taxed preferentially (i.e., at lower rates than regular income) as a result of the dividend tax credit and the fact that only half of capital gains are included in taxable income. However, all of the LP's expenses (i.e., management fees, performance fees, operating expenses and interest expense on margin loans) are fully deductible against income. The result is that, as was described in detail in the 2014 Letter, the net effective tax rate applicable to the LP's reported income is much lower than the tax rate normally applicable to ordinary income.<sup>7</sup> Conversely, in a mutual fund trust, expenses are netted against income which may result in a higher effective tax rate than if the same income and expense items arose in a limited partnership;

- Limited partnerships are able to allocate net capital losses to investors whereas mutual fund trusts are not permitted to do so. In the event that the Funds should realize net capital losses in a calendar year (which has not occurred in the history of the Funds through the end of 2016), the LP would be able to allocate such losses to its investors for utilization by them whereas the Trust would only be able to carry forward net capital losses for application against future realized capital gains;
- In a limited partnership, the partnership agreement may permit the allocation of income and expenses for tax purposes to limited partners based on their average ownership percentage of the partnership during a calendar year (a practice which is, in fact, followed by the LP). Mutual fund trusts, however, must distribute all of their income (net of expenses) in each taxation year. Any net income and capital gains not already distributed are paid to investors of record as of a specific date, typically late in every calendar year. For example, since the Trust does not pay distributions throughout the year, its net income and capital gains are distributed to investors as of December 31 (prior to giving effect to subscriptions and redemptions as of that date). The result is that an investor who subscribes for Trust units partway through a calendar year may receive a higher taxable distribution of net income and capital gains (some of which may have arisen before the investor became a unitholder) than if the investor had subscribed for units of the LP; and
- The management fees, performance fees and operating expenses of limited partnerships are subject to sales tax based on the partnership's province of residence, whereas the same items in a mutual fund trust are subject to sales tax based on the weighted average rate applicable in the provinces where the trust's investors reside. Since the LP is based in Alberta (where I live), its fees and expenses are subject only to Goods and Services Tax (GST) at a rate of 5%. By contrast, in December 2016, for example, the Trust's series F fees and expenses were subject to Harmonized Sales Tax (HST) at a weighted average tax rate of 12% (which is the weighted average rate of sales tax applicable in the provinces in which the Trust's investors reside). If, for example, the Funds' fees and expenses in a given year were 2.0% of their net asset values, and the sales tax rates for the LP and Trust were 5% and 12%, respectively, then the sales taxes (GST or HST, as applicable) for the LP and Trust would amount to (0.10%) and (0.24%) of their net asset values, respectively. While this difference of (0.14%) may seem small, compounded over a long period of time it could make a meaningful difference to cumulative returns.

For all of the reasons stated above, generally, non-registered investment accounts should invest in the LP whereas registered accounts (which are all tax-deferred or tax-free, so that all but the last of the tax considerations stated above are irrelevant) should invest in the Trust. There are, however, three special cases described below which I believe are exceptions to this rule:

1. Investors with a target non-registered investment amount of at least \$500,000 but less than \$1,000,000 might choose to invest in the Trust so as to access the lower fees applicable to the

series M and series P units (for such series, the Trust has a minimum purchase amount of \$500,000 whereas the LP has a minimum purchase amount of \$1,000,000);

2. Quebec-based investors (both registered and non-registered) may only invest in the Trust. That is because, as a result of a complex and expensive administrative burden applicable to limited partnerships sold in that province, the LP is currently not distributed in Quebec; and
3. Non-Canadian investors may not subscribe for units of the LP but are permitted to subscribe for units of the Trust.

### **Unrealized Capital Gains (Losses)**

In 2015, significant increases in income tax rates were announced at both the provincial and federal levels. For example, in Alberta (which is the home province of the holders of a large percentage of the LP's units), the highest provincial income tax rate was increased from 10% to 15%. This increase in the income tax rate of five percentage points was one-quarter effective (i.e., 1.25%) for 2015 and was fully effective (i.e., 5.0%) for 2016 and subsequent years. Federally, the Government of Canada increased its highest income tax rate by four percentage points (from 29% to 33%) effective January 1, 2016.

I strive to manage the LP in a tax-efficient manner. That is why substantial capital gains were realized in the LP in 2015 before most of the recent income tax rate increases were effective. As a result, and combined with the fact that some of the LP's equity investments declined in market value late in 2015, the LP realized for tax purposes a larger amount of capital gains in 2015 than it earned in that year. At December 31, 2015 the LP had net unrealized capital losses of about (\$747,000) or (4%) of its net asset value as of that date.<sup>8</sup>

This situation was reversed in 2016 during which the LP earned much more in capital gains than it realized for tax purposes. At December 31, 2016, therefore, the LP had net unrealized capital gains of about \$3,219,000 or 14% of its net asset value as of that date. Similarly, at the end of 2016, the Trust had net unrealized capital gains of about \$1,012,000 or 13% of its net asset value.

Unrealized capital gains are a double-edged sword. On the one hand, they are tax-efficient as they represent capital gains which have been earned and on which tax has yet to be paid. On the other hand, since the Funds are open-ended (i.e., subscriptions and redemptions may be made at any month-end), unrealized capital gains expose new investors to potentially paying taxes on gains as they are realized, even though such investors may not have enjoyed the returns in the Funds when the capital gains were achieved. In order to balance these two competing interests (deferring the capital gains tax without punishing new investors), the Funds are generally managed so as to try to keep unrealized capital gains as of any December 31 in the range of 10% to 25% of each Fund's net asset value. That way, investors who subscribe for units of the Funds at any time and hold such units for the long term (at least five years) should be allocated amounts for tax purposes during their holding period which are broadly in line with their actual investment experience.

Another consideration of which investors should be aware is that there has been recent media speculation that the federal government may increase the capital gains inclusion rate. Currently, one-half (i.e., 50%) of capital gains are included in taxable income. If the capital gains inclusion rate were increased (say, to 75% or 100%), and the increase was effective on the day the federal budget was announced (as is typically the case in such situations), then the LP's investors would face higher taxes in the future on unrealized capital gains than if such capital gains had been realized before budget day. This possibility also argues for realizing some capital gains as time goes by and not allowing unrealized capital gains to reach an excessive level relative to the Funds' net asset values.

Having said all of the above, the Funds will not let the tax tail wag the investment dog. In particular, the Funds will not refrain from selling securities simply to defer capital gains taxes. The best way to maximize after-tax returns is to maximize pretax returns. Tax consequences are an important, but secondary, consideration (and will vary with each investor in any event).

### **Change Of Prime Broker**

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During 2016, the LP changed the location of its prime brokerage account. It is now held at RBC Dominion Securities Inc. ("RBCDS"). Since the Trust's inception, its prime brokerage account has also been held at RBCDS. Some advantages of this change to RBCDS as compared to the LP's former custodian include:

- Lower interest rates on margin borrowings;
- A more robust institutional trading platform; and
- The ability to engage in short selling.

Lower interest rates and a better trading platform are unequivocally positive. With reference to short selling, however, the 2013 Letter described some of its potential perils and stated that "short selling in the Fund is likely to be limited in both amount and duration."<sup>9</sup> It remains true that, to date, the Funds have not engaged in short sales. Investors should be aware, nonetheless, that given the relentless rise in stock market valuations as discussed later in this letter in the section titled "TINA Is Still Rocking", and the fact that the Funds are now able to sell short using the facilities of their prime broker, short selling is a strategy which is being considered for use in the Funds.

### **Banks Reduced**

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One of the reasons for the Funds' strong performances in 2016 was their large shareholdings of leading North American banks. For example, at the end of 2015, the LP had investments in the common shares of four leading Canadian banks representing a total of 106% of the LP's net asset value at that time (enabled by the use of margin borrowings). After the Trust was created on March 31, 2016, it also bought large percentage weights in Canadian banks. Furthermore, over the course of 2016 each of the Funds bought positions in three leading U.S.-based banks: JPMorgan Chase & Co., Citigroup Inc. and Wells Fargo & Company. In all cases, the Funds bought their bank investments when valuations and media reports both suggested that the banks

were deeply out of favour. Such disfavour was engendered by a combination of: industry-wide concerns (such as energy-related loan losses for the Canadian banks); political events (such as the “Brexit” vote in June 2016, in which voters in the United Kingdom decided in favour of the U.K.’s withdrawal from the European Union); and company-specific events (such as the Wells Fargo scandal regarding sales practices). In all cases, I believed that such concerns were either overblown or unfounded and that they created buying opportunities in these excellent businesses.

Confidence in the banks was quickly vindicated by their strong performance as the aforementioned concerns abated. Indeed, bank share prices rose to levels from which the risk / reward combinations were not nearly as compelling as they had been and did not justify the continued holding of such very large positions. Accordingly, the Funds substantially reduced their bank holdings, particularly in late 2016. At the end of 2016, both the LP and the Trust had shareholdings in banks totalling 30% (in the case of the LP, down from 106% at the end of 2015) of their net asset values.

Selected banks remain outstanding businesses and excellent candidates for investment. I hope that someday they again fall out of favour and that large percentage weights in leading banks are re-established in the Funds. If that should occur (as I believe is highly likely, given normal volatility of investor sentiment), then the title of a section of a future letter heralding that news may be “Banks Redux”. For now, it’s “Banks Reduced”.

### **It’s Electric!**

At the risk of dating myself again (the 2014 Letter concluded with a reference to the Beatles), I’m old enough to remember when Marcia Griffiths released the song Electric Boogie (which gained fame as the soundtrack for the dance known as the Electric Slide). With electricity, as in the song’s refrain, “You can’t see it. It’s electric! You gotta feel it. It’s electric!”

The LP (the Fund, not the song) has previously had investments in electric utility companies. The 2014 Letter, for example, included a detailed analysis of the LP’s investment in the Newfoundland-based utility company, Fortis Inc.<sup>10</sup> That investment was the LP’s biggest winner in the history of the LP to the end of 2014. During 2016, two events, each of which precipitated a drop in the share prices of electric utility companies, were used as opportunities to buy large positions in two of such businesses on what I believe were favourable terms.

The first event was in February, when Fortis announced its planned acquisition of ITC Holdings Corp., the largest independent electric transmission company in the United States, for US\$11.3 billion (the acquisition was completed in October).<sup>11</sup> Arbitrage activity related to the proposed acquisition caused the share price of Fortis to drop sharply, for a few days. In February, the LP established a new position in Fortis and the company was also purchased in the Trust following its launch.

The second event occurred in November, when the surprising result of the U.S. presidential election triggered a sharp increase in interest rates, and declines in the share prices of utility compa-

nies (which are widely perceived as interest-sensitive and whose share prices often decline when interest rates rise). The Funds used this period of weakness to add to their holdings in Fortis and initiate new positions in Nova Scotia-based utility Emera Inc. (which on July 1, 2016 had completed its own large U.S. acquisition, that of TECO Energy, Inc., for US\$6.5 billion).<sup>12</sup> At the end of 2016, the shareholdings in Fortis and Emera represented combined weights in both the LP and Trust of 88%.

With the Funds' large investments in electric utilities, are we going (as Marcia would say) on a party ride? I certainly believe that these two investments will deliver satisfactory long-term returns with limited risk. If for any reason the Funds' investments in electric utility companies don't work out, I already have a title selected for the section of a future annual letter that will describe the result: "The Big Short".

### TINA Is Still Rocking

As described in the 2015 Letter, persistently low interest rates have buttressed the demand for equities since they look attractive compared to the very low interest rates obtainable on cash and government bonds. This phenomenon has been widely described as There Is No Alternative, a condition that is better known by its acronym, TINA.<sup>13</sup>

How has TINA been doing in the last year? Very well, thank you. The year 2016 is added to the table below, which was included in the 2015 Letter.

<u>S&amp;P 500 Index</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Average index value	1,268	1,379	1,643	1,932	2,061	2,094
Closing index value	1,258	1,426	1,848	2,059	2,044	2,239
Operating earnings	96.44	96.82	107.30	113.01	100.45	106.60
Average price-earnings ratio	13.1	14.2	15.3	17.1	20.5	19.6
Closing price-earnings ratio	13.0	14.7	17.2	18.2	20.3	21.0

In 2016, S&P 500 Index earnings rose to \$106.60 (with 96% of companies having reported at time of writing), an increase in the year of about 6%.<sup>14</sup> That increase was bolstered by 2015 having been a low base year as it was adversely affected by very poor earnings of the producers of energy and other raw materials. The average S&P 500 Index level rose from 2,061 in 2015 to 2,094 in 2016, a gain of less than 2%. As a result, the average price-earnings ("P/E") level declined from 20.5 times in 2015 to 19.6 times in 2016. The average, however, tells only part of the story. The S&P 500 Index experienced very strong gains following the November U.S. presidential election. As a result, at the close of 2016, the P/E of the S&P 500 Index based on its operating earnings for that year rose to 21.0x. ***That is the S&P 500 Index's highest closing P/E in a non-recession year since the year 2000.***

As stated in the 2015 Letter, nobody knows how high the P/E ratio of the S&P 500 Index will go before it stops rising (or declines). Indeed, some of the recent increase may prove to be justified based upon proposed economic measures which might be enacted in 2017. With the

Republicans in control of all three of the presidency, Senate and House of Representatives, they have no excuse for not enacting some of the measures which they have long espoused. Chief among these, from an investor's perspective, may be corporate tax reform. It is certainly possible that during 2017, the U.S. federal corporate tax rate might be lowered from 35% to about 20% together with a temporary tax rate of about 10% applicable to the repatriation of accumulated foreign earnings. These measures would, all other things being equal (as economists like to say), result in a significant increase in corporate profitability and financial strength. The expectation of these measures being implemented resulted in a significant increase in U.S. stock prices late in 2016 (which has continued in early 2017).

While some of the recent stock market gains may thus be justified based on fundamental factors, I'm wary about counting too many chickens before they're hatched. As stated in the 2015 Letter (as adjusted to pluralize "Funds" following the launch of the Trust), history "strongly suggests that paying too-high prices for common stocks will result in, at some point, a period of poor or negative returns. In the Funds, I have tried to buy only excellent businesses at sensible valuations and have tread carefully in the use of leverage. That caution has contributed to the Funds' strong performances to date. There are certain to be periods of weak stock prices in the years ahead. When that happens, there will likely be many opportunities to acquire excellent long-term investments at bargain prices. Those investments will enhance future returns."<sup>15</sup>

As a final thought on stock market valuations, those despairing that TINA may cause stock prices to stay permanently high (thereby preventing attractive buying opportunities) may wish to consider the following words which I recently read in a book written by a corporate shareholder about his investment:

A high price of shares causes concern to many who are not accustomed to it. But reasonable men [and women] need not be disturbed about the matter, since every day the position of the Company becomes more splendid, the state wealthier, and the revenue from investments at fixed interest becomes less, inasmuch as it is difficult to find ways of investing money. The rate of interest on ordinary loans amounts to only 3 per cent a year, and, if the creditor receives security, to only 2½ per cent. Therefore, even the wealthiest men are forced to buy stocks, and there are people who do not sell them when the prices have fallen, in order to avoid a loss. But they do not sell at rising prices, either, because they do not know a more secure investment for their capital.<sup>16</sup>

The foregoing passage was written (probably with a quill pen) by author Joseph de la Vega in the year 1688. The company referred to in the text is the Dutch East India Company, one of the world's earliest corporations.

I cite the passage above to make the point that the world has experienced the phenomenon of low interest rates before, at least as far back as 1688. Yet for more than three centuries since

then, investment opportunities have continued to abound. All that is necessary to succeed is for investors to supply two of the most difficult of virtues: patience and fortitude. The next section of this letter discusses that investment opportunities did, in fact, arise in 2016. What was critical was the patience to wait for such opportunities and the fortitude to seize them when they arose. The strong performance of the Funds is a testament to the rewards that await those who exhibit those traits.

### The Immaculate Correction

Given the recent ebullience in global stock markets, it's worth remembering that it wasn't that long ago that investors were much more pessimistic. The table below shows, for selected major stock market indices, the percentage decline (excluding dividends) from their highest levels in 2015 to their lowest levels in 2016. The table also shows the subsequent percentage increases in the indices from their 2016 lows to their highest levels to date in 2017 (through February 24, 2017).

Selected Stock Market Indices		% decline from 2015 high to 2016 low	% gain from 2016 low to 2017 YTD high
Index	Country / Region		
S&P 500	U.S. large capitalization	-15.2%	30.8%
ASX All Ordinaries	Australia	-20.1%	23.5%
FTSE 100	U.K.	-22.8%	33.7%
MSCI EAFE	Europe, Australia & Far East	-24.8%	20.0%
S&P/TSX Composite	Canada	-25.7%	38.3%
Russell 2000	U.S. small capitalization	-27.2%	49.5%
Nikkei 225	Japan	-29.1%	32.0%
Euro Stoxx 50	Europe	-30.3%	25.5%
Hang Seng	Hong Kong	-36.1%	32.5%
Shanghai SE Composite	China	-49.0%	23.7%

In stock market parlance, the widely-accepted definition of a “correction” is a price decline from a recent high of at least 10% but less than 20%. A “bear market” is a decline of 20% or more. By that definition, all of the major stock market indices listed above, except one, experienced a bear market that ended in 2016. The sole exception was the biggest stock market index listed, the S&P 500 Index. Its percentage decline from its 2015 peak to its 2016 trough was only (15.2%), which was even less of a decline if its dividends were included. Not only did the percentage decline stay muted, but also the volatility in that period was generally subdued. That, and the fact that the decline seemed to lack traditional fundamental causes, is why one commentator dubbed the decline that ended in 2016 as the “immaculate correction”.<sup>17</sup>

Many people have long lamented persistently high stock prices, thinking that they would invest more capital if only stock prices would decline. Yet when share prices dropped sharply by early

2016, did those people load up on the more attractively priced equities? Some did. Most famously, it was widely publicized on February 11, 2016 that the chief executive officer of JPMorgan Chase, Jamie Dimon, had just bought with his own money 500,000 shares of the company (which closed that day at \$53.07 per share and ended 2016 at \$86.29 per share, for a gain versus its February 11 closing price of 63%).<sup>18</sup> That day proved to be the lowest level of the S&P 500 Index in 2016, from which it has since soared. In fact, Dimon's action was strongly reminiscent of the actions of financier J.P. Morgan himself, who is widely credited with ending the Panic of 1907 by making large deposits into leading U.S. banks.<sup>19</sup>

Jamie Dimon's (very profitable) heroics aside, did investors en masse take advantage of the lower stock prices in early 2016? Alas, there is no evidence to suggest that. In fact, historical evidence suggests the opposite: that the owners of equity mutual funds tend to invest more after periods of strong market performance and redeem investments after periods of weak market performance.<sup>20</sup> The fact that, despite their stated intentions, many (perhaps most) investors do not buy equities when the news is negative and stock prices are low reminds me of the words of world champion boxer Mike Tyson: "everyone has a plan until they get punched in the mouth."<sup>21</sup>

### **Coin Flipping And Its Lessons For Investors**

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A recent newspaper article discussed a computer-simulated coin flipping experiment in which participants are informed at the start of play that there is a 60% chance that the coin will come up heads (and therefore only a 40% chance that the coin will come up tails).<sup>22</sup> Participants start the game with \$25, the game's time limit is 30 minutes and flippers may bet as often as they like within that time frame. Before each coin flip, participants decide whether to bet on heads or tails and how much of their virtual pot to bet. The article was based on an experiment conducted by Victor Haghani and Richard Dewey which was described by them in an academic paper published in 2016.<sup>23</sup> Before reading on, please take just a few minutes to visit <http://coinflipbet.herokuapp.com/> and try it yourself.

The actual experiment was played by 61 subjects. They were primarily university students studying economics and finance and young professionals at finance firms. The sample consisted of 49 males and 12 females. The experiment involved real money (subject to a cap on any flipper's pot of \$250 which they would be informed of if they got close).

One might think that with a known probability of winning each bet of 60%, and with well-educated and motivated coin flippers involved, the flippers would do very well. That was not the case. As Haghani and Dewey noted, "while we expected to observe some suboptimal play, we were surprised by the pervasiveness of it. Suboptimal betting came in all shapes and sizes: over-betting, under-betting, erratic betting and betting on tails were just some of the ways a majority of players squandered their chance to take home \$250 for 30 minutes of play...[t]he straightforward notion of taking a constant and moderate amount of risk and letting the odds work in one's favor just doesn't seem obvious to most people."<sup>24</sup> In brief, 28% of players went bust (i.e., ended with less than \$2); 5% ended with between \$2 and the initial \$25; 31% ended with between \$25 and \$100; 15% ended with between \$100 and \$200; and only 21% maxed out by attaining over \$200. For the record, having previously read a great deal in the field of behavioural finance,

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Fund LP and Portland Focused Plus Fund Offering Memorandum, March 1, 2016, p. 2. The OM is available at [www.portlandic.com/focusedplusfundLP.html](http://www.portlandic.com/focusedplusfundLP.html) and [www.portlandic.com/focusedplusfundtrust.html](http://www.portlandic.com/focusedplusfundtrust.html).
3. For a discussion, see 2013 Letter, p. 3.
4. As ranked by The Globe and Mail in the Alternative Strategies asset class in the 3 year category out of 480 funds. In the 1 year category the LP’s ranking is 19th. Ranking is subject to change every month. See [http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund\\_filter?pi\\_type=B](http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund_filter?pi_type=B).
5. OM, p. 14.
6. OM, pp. 6-7 and pp. 13-14.
7. 2014 Letter, pp. 10-13.
8. The amount of unrealized capital gains (losses) at any year-end has been calculated as the fair value of total investments minus the cost of total investments, both as shown in the Schedule of Investment Portfolio in the financial statements of the LP and Trust which are mailed together with this letter and which may be found at <http://www.portlandic.com/focused-plusfundLP.html> and <http://www.portlandic.com/focusedplusfundtrust.html>, respectively.
9. 2013 Letter, pp. 10-11.
10. 2014 Letter, pp. 8-10.
11. See press releases dated February 9, 2016 and October 14, 2016 available at <https://www.fortisinc.com/news-and-media/news-releases>.
12. See <http://investors.emera.com/file.aspx?IID=4072693&FID=34951054>.
13. 2015 Letter, pp. 14-15.
14. Data is as of February 28, 2017. The source for S&P 500 Index earnings is Standard & Poor’s itself at <https://my.spindices.com/indices/equity/sp-500>.
15. 2015 Letter, p. 15.
16. de la Vega, Joseph. *Confusion de Confusiones* (Martino Publishing, 2013), p. 13. The book was originally published in Spanish in 1688. German and Dutch translations were completed in 1919 and 1939, respectively. An English translation was published by Harvard University Press in 1957.
17. David Kelly, chief global strategist at J.P. Morgan Asset Management; see the video at <http://video.cnbc.com/gallery/?video=3000493655>.
18. <http://www.cnbc.com/2016/02/11/jamie-dimon-buys-more-than-25m-in-jpmorgan-stock-source.html>.
19. [https://en.wikipedia.org/wiki/Panic\\_of\\_1907](https://en.wikipedia.org/wiki/Panic_of_1907).
20. <https://www.bloomberg.com/view/articles/2014-07-09/how-not-to-beat-the-market-ritholtz-chart>.
21. This quotation has been popularized by replacing “mouth” with “face”, which I believe results in a catchier phrase, but it’s not what Tyson actually said. See [http://articles.sun-sentinel.com/2012-11-09/sports/sfl-mike-tyson-explains-one-of-his-most-famous-quotes-20121109\\_1\\_mike-tyson-undisputed-truth-famous-quotes](http://articles.sun-sentinel.com/2012-11-09/sports/sfl-mike-tyson-explains-one-of-his-most-famous-quotes-20121109_1_mike-tyson-undisputed-truth-famous-quotes).
22. McGugan, Ian. “How a simple coin-toss game can make you a better investor.” The Globe and Mail, December 3, 2016 p. B14.
23. Haghani, Victor and Dewey, Richard. “Rational Decision-Making under

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The PORTLAND FOCUSED PLUS FUND LP (the "LP") and PORTLAND FOCUSED PLUS FUND (the "Trust") (collectively, the "Funds") are not publicly offered. They are only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Funds is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Funds made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Commissions, trailing commissions, management fees and expenses all may be associated with investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or optional charges or income taxes payable by any unitholder in respect of a fund that would have reduced returns. Funds are not guaranteed, their values change frequently and past performance may not be repeated.

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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel: 1-888-710-4242 • Fax: 1-866-722-4242 • [www.portlandic.com](http://www.portlandic.com) • [info@portlandic.com](mailto:info@portlandic.com)



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**Portland Focused Plus Fund LP**  
**Portland Focused Plus Fund**  
ANNUAL LETTER TO INVESTORS  
FOR THE YEAR ENDED DECEMBER 31, 2017

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund LP				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.5%
2013	33.0%	34.1%	37.7%	34.4%	13.0%	32.4%
2014	15.6%	16.8%	18.8%	17.5%	10.6%	13.7%
2015	6.5%	7.5%	8.3%	8.5%	-8.3%	1.4%
2016	39.0%	40.4%	45.5%	41.6%	21.1%	12.0%
2017	16.4%	17.5%	19.9%	18.6%	9.1%	21.8%

Since Inception (Oct. 31, 2012)

Compound annual	21.2%	22.3%	24.9%	23.2%	8.5%	15.6%
Cumulative return	169.4%	183.1%	215.3%	193.4%	52.3%	111.3%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	15.8%	10.5%
2017	15.5%	16.7%	19.4%	18.1%	9.1%	21.8%

Since Inception (Oct. 31, 2012)

Compound annual	25.5%	26.6%	30.6%	28.1%	14.3%	18.5%
Cumulative return	48.7%	51.0%	59.5%	54.3%	26.4%	34.6%

Notes:

Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (individually, the "Fund" and jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

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Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at <http://www.portlandic.com/focusedplusfundLP.html> for the LP and at <http://www.portlandic.com/focusedplusfundtrust.html> for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks therein were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

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As stated in the Funds' Offering Memorandum dated March 1, 2016 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance Of The LP**

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The performance of the LP and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The LP's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end including annualized returns over various time periods, may be found at the LP's web page referenced above.

In 2017, the LP's series F units (the highest fee series without embedded advisor compensation) achieved a return of 17.5% (net of fees and expenses). That compares to a return of 9.1% for the S&P/TSX Index and to a return of 21.8% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of 15.5%. For the entire period since inception of the LP on October 31, 2012 to December 31, 2017, the LP's series F units achieved a cumulative return of 183.1%. That compares to a cumulative total return of 52.3% for the S&P/TSX Index and 111.3% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 81.8%. Accordingly, in both 2017 and for the cumulative period since the LP's inception, the LP has met its investment objective of preservation of capital and a satisfactory return. It's worth noting that the LP also offers two series of units with lower fees for larger investors; both of these series have even higher returns than the series F units. The different series are discussed further below and their performance is shown on the inside front cover of this letter.

A comparison of the LP's performance to other funds in its category is also revealing. **I'm pleased to report that for the five years ended December 31, 2017, the performance of the LP's series**

**M units of 25.3% per annum ranked it as the second-best performing series among all alternative strategies funds in Canada.**<sup>4</sup> That performance far outstripped the average return for funds in the category of 5.3% per annum.

### **Private Capital Markets Association Of Canada Investment Fund Award**

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The strong performance of the LP has not gone unnoticed. I'm also pleased to report that the LP was the winner of the 2017 Investment Fund Award conferred by the Private Capital Markets Association of Canada. Portland and I are proud that the LP received this award as it underscores not only the strong long-term performance of the LP but also the LP's innovative product design and Portland's commitment to the best long-term interests of the LP's investors.

### **Performance Of The Trust**

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As discussed in detail in the 2016 Letter, the LP is intended, with very limited exceptions, for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. The Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, and as discussed more fully later in this letter, investors should expect that the management and long-term performance of the two Funds will be similar. That is why Portland has decided to distribute the same annual letters to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2017, the Trust's series F units (the highest fee series without embedded advisor compensation) achieved a return of 16.7% (net of fees and expenses). That compares to a return of 9.1% for the S&P/TSX Index and to a return of 21.8% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of 15.5%. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2017, the Trust's series F units achieved a cumulative return of 51.0%. That compares to a cumulative total return of 26.4% for the S&P/TSX Index and 34.6% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 30.5%. Accordingly, in both 2017 and for the cumulative period since the Trust's inception, the Trust met its investment objective of preservation of capital and a satisfactory return. As was noted with reference to the LP, the Trust also offers two series of units with lower fees for larger investors; both of these series have even higher returns than the series F units. The different series are discussed further below and their performance is shown on the inside front cover of this letter. The Trust's strong performance since its inception 21 months ago is very encouraging. Investors should derive further confidence from the excellent performance of the LP upon which the Trust is modelled.

## Series Of Fund Units

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The Funds have four series of units. The features of each are outlined below:<sup>6</sup>

- **Series A units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit (“High Water Mark”) of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee; and
- **Series P units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee.

As can be seen in the tables on the inside front cover of this letter, for the period from October 31, 2012 to December 31, 2017, the LP’s series F units had a cumulative return of 183.1% while the LP’s series M units and series P units had higher cumulative returns of 215.3% and 193.4%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2017, the Trust’s series F units had a cumulative return of 51.0% whereas the Trust’s series M units and series P units had higher cumulative returns of 59.5% and 54.3%, respectively.

Going forward, with respect to each of the Funds, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long term performance.

### Performance Difference Between The LP And The Trust

Since 2017 was the first year in which both the LP and the Trust operated for a full calendar year, and since I have noted that the two Funds are managed in a highly similar manner, it's worthwhile to compare the returns of the two Funds in 2017. This is done in the table below.

#### Performance

Year ended Dec. 31, 2017

	Series A	Series F	Series M	Series P
LP	16.4%	17.5%	19.9%	18.6%
Trust	15.5%	16.7%	19.4%	18.1%
LP vs. Trust	0.8%	0.8%	0.5%	0.5%

As can be seen from the table, the LP's performance was higher than that of the Trust by about 0.8% for the series A and series F units (note that the series A column does not add due to rounding) and by about 0.5% for the series M and series P units. In my opinion, the performance differential between the two Funds is primarily a result of the following two factors:

- The Trust experienced higher net sales relative to its asset base than did the LP and these cash flows entered the Trust during a period of steadily higher equity prices, resulting in a slight lag in its performance compared to that of the LP. During 2017, the net assets of the LP and the Trust increased by 74% and 139%, respectively. On balance, therefore, the Trust experienced a higher percentage increase in its net assets from new subscriptions than did the LP (although both grew significantly). There is a lag of about two business days between the date that new subscriptions are recorded (on the last business day of every month) and when the cash is actually transferred into the brokerage accounts of the Funds for their use. In 2017, during which equity prices (particularly in the United States) marched steadily higher, this slight delay in receipt and investment of cash contributed to a slight lag in the performance of the Trust compared to that of the LP. This difference could have gone either way, depending upon how equity markets performed in the first couple of business days in every month. Since equity market returns were generally positive, there was a small impact on the performance of the Trust.
- As noted in the 2016 Letter, since the LP is based in Alberta, its management fees, performance fees and operating expenses are subject only to Goods and Services Tax (GST) at a rate of 5%.<sup>7</sup> The Trust's fees and expenses, however, are subject to sales tax for each series based on the weighted average rate applicable in the provinces where the series investors reside. In December 2017, for example, the Trust's series F fees and expenses were subject to Harmonized Sales Tax (HST) at a weighted average rate of 12.1%. If in a year the Trust's series F units incurred management fees, performance fees and operating expenses equal to an aggregate of 2.5% of the series net assets, and the series tax rate were 12.0%, then the tax applicable to the fees and expenses would be 0.30% of net assets (i.e., 2.5% x 12.0% = 0.30%). Conversely, for the same fees and expenses in the LP, which is taxed at only 5.0%, the tax applicable to the fees and expenses would be 0.13% of net assets (i.e., 2.5% x 5.0% = 0.13%). Thus, in this scenario, for identical pretax returns, the reported after-tax return of the LP would be higher than the after-tax return of the Trust by 0.17% (i.e., 0.30% - 0.13% = 0.17%). Provided that there are no changes to Canadian tax laws which affect the taxation of limited partnerships and mutual fund trusts, and no introduction of a provincial

sales tax in Alberta, this disparity in taxation will confer a permanent performance advantage on the LP. In other words, for this reason alone, the annual performance of the LP's series A and series F units can be expected to be slightly higher than that of the series A and series F units of the Trust (because both of these Trust series have many investors who reside in higher tax rate provinces such as Ontario).

Please note that an item which did not contribute to the performance differential between the LP and the Trust was operating expenses. That is because to date, in both the LP and the Trust, operating expenses have been 0.5% per annum.

### **Operating Expenses**

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The Funds incur operating expenses for such items as fund administration, audit fees, legal fees, and preparation of income tax returns and tax slips.<sup>8</sup> From the inception of the Funds to December 31, 2017, operating expenses for each of the LP and the Trust have been 0.50% per annum plus applicable taxes. While there can be no assurance that the Funds' operating expenses will remain at or below this level, Portland remains committed to tight management of fees and expenses so as to maximize the Funds' returns.

As noted earlier in this letter, the net assets of the LP and Trust increased in 2017 by 74% and 139%, respectively. The net assets of the LP and the Trust as of December 31, 2017 (prior to giving effect to subscriptions and redemptions effective as of that date) were \$38.2 and \$17.0 million, respectively. If the Funds maintain their level of net assets as of December 31, 2017 (or better yet, increase them), then it is possible that through economies of scale their operating expense rates may be lower in the future than the levels of 0.50% per annum that have prevailed to date.

### **LP Metrics**

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In 2017, the LP celebrated its five-year anniversary. The LP has now been in existence for long enough that it's worthwhile to examine some statistical measures of the LP's operations and performance. Some measures (in all cases to December 31, 2017) that are particularly important are described below.

- Equities as a percentage of the LP's net asset value (since February 28, 2013, after creation of the LP's initial portfolio) have averaged 149%, in a range of 84% to 219%. In other words, on average, the LP has borrowed (through its margin facility) \$0.49 for every \$1.00 of net assets. This supports the view that the LP's use of leverage has been prudent: enough to enhance returns given the low cost of borrowing (which at December 31, 2017 was only 2.2%), but not so high so as to have jeopardized the LP in the event of a sudden, severe equity market decline.
- Foreign equities (almost entirely U.S.) have averaged 40% of total equities. This coincides with the LP's published strategy that it would invest in both Canadian and non-Canadian equities. This also supports the suggestion (noted at the start of this letter) that a reasonable performance benchmark against which to assess the LP's performance is a simple average of the returns of the S&P/TSX Composite Index and the S&P 500 Index (in US\$).
- The LP's worst 12-month return for its series F units was only slightly negative, at -3.1%. That was for

the 12 months ended February 29, 2016. Significantly, of the LP's 51 overlapping 12-month periods, that was the only period for which 12-month performance was negative.

- The LP's largest drawdown, meaning its largest decline in net asset value per unit (series F) from a peak to a subsequent trough, was -16.5%. That was for the period from October 31, 2014 to January 31, 2015. During that period, oil prices collapsed, as did the share prices of energy companies (some of which were owned in the LP at the start of that period) and Canadian banks. In the latter case, the declines were caused by what proved to be ill-founded concerns about the impact of possible energy-related loan losses on bank profitability and capital ratios.
- The LP's longest period between record highs in net asset value per unit (series F) was only six months. That was from October 31, 2014 to April 30, 2015. In other words, only three months after the decline noted immediately above, the LP had completely recovered its former decline and attained a new record high in net asset value per unit. That sharp rebound arose because not only did the LP maintain its non-energy holdings during that period, but also it used its margin facility to add to holdings at the low equity prices that prevailed in early 2016. When stock prices rebounded, as they quickly did, the LP's net asset value per unit jumped to a new high.

I would caution that the period since the LP's inception has been one of, on balance, steadily rising stock prices (particularly in the U.S.) and steadily declining volatility. There are certain to be periods in the future when these conditions reverse (i.e., when stock prices decline and volatility rises, such as has been the case in early 2018). Once the LP has passed through such a period, investors will be able to draw more meaningful conclusions about the LP's long-term performance.

### **Canadian Banks Put It Up to 11**

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Previous annual letters have favourably discussed the investment merits of the leading Canadian banks.<sup>9</sup> I remain very positively inclined toward these outstanding businesses with their variation in portfolio weight being dependent primarily upon valuation. For example, at the end of 2017, the percentage of the LP's net assets (prior to subscription and redemptions effective as of that date) invested in the common shares of three of the five largest Canadian banks was a combined amount of 56%. Excluding distributions paid in the Trust at year-end (most of which were reinvested), the percentage of the Trust's and LP's net assets held in Canadian banks was virtually identical.

Since the global financial crisis, the unimaginative but effective response of banking regulators has been to require ever-higher capital ratios as protection from future adverse events for both individual banks and more importantly the financial system. To measure capital levels, the single most important measure is what is known as the common equity tier 1 ("CET1") ratio. The calculation of this ratio is made accorded to rules issued under the Basel III international regulatory environment for banks. The table below shows the CET1 ratios of the five largest Canadian banks at two points in time: at January 31, 2013 (when the banks first published their Basel III CET1 ratios) and at October 31, 2017 (the end of the banks' 2017 fiscal years).

Canadian bank CET1 ratios	31-Jan-13	31-Oct-17
Bank of Montreal	9.4%	11.4%
Bank of Nova Scotia	8.2%	11.5%
Canadian Imperial Bank of Commerce	9.6%	10.6%
Royal Bank of Canada	9.3%	10.9%
Toronto-Dominion Bank	8.8%	10.7%
Weighted average of big five banks	9.0%	11.0%

The CET1 ratio is calculated by dividing capital by risk-weighted assets. A higher number is safer, therefore, as it shows that more capital is invested in a bank per dollar of that bank's risk-weighted assets. As the table shows, the weighted average CET1 ratio of the big five Canadian banks increased from 9.0% at January 31, 2013 to 11.0% at October 31, 2017. The latter date represents the first fiscal year-end for which the banks reported an average CET1 ratio at or above 11%. There are clear signs that global banking regulators are easing off on their pressure for ever-higher capital ratios (which come at the cost, for example, of lower bank returns on equity and a reluctance to lend). As evidence of this seeming capital plateau, the average of the big five CET1 ratios was in a tight range of 11.0% to 11.1% at the end of each of the four quarters of fiscal 2017.

What does it mean now that banks have reached a Basel III CET1 ratio of 11% if no further capital ratio increases are required? It means that bank profits, instead of being forced to be significantly devoted to increasing bank capital ratios as has been the case for the last five years, will now be much more available for shareholder-friendly measures such as internal growth, dividends and share repurchases. To paraphrase a recent brokerage research report, "it's all about that Basel – no trouble".

### **Tax Cuts and Jobs Act**

In late 2017, a landmark event occurred when the U.S. passed into law the Tax Cuts and Jobs Act ("Act"). The Act makes sweeping changes to both corporate and individual taxation and marked the first major U.S. tax reform since 1986. The tax rate changes in the Act became effective on January 1, 2018. A full analysis of the Act is beyond the scope of this letter. Some of its major changes to corporate taxation are as follows.

- The U.S. federal tax was decreased from 35% to 21%, a decline of 14 percentage points; and
- A new provision states that currently deferred foreign profits are deemed to have been repatriated and are subject to tax at a rate of 15.5% for cash and cash-equivalent profits and 8% for reinvested foreign earnings.<sup>10</sup>

The Act has already had profound impacts on American businesses. Several large companies

have celebrated by raising employee wages and paying special bonuses. Others have announced plans to repatriate foreign-held cash, pay taxes to the U.S. treasury and make new domestic investments. Estimated earnings for the S&P 500 Index have risen sharply. And, of course, the U.S. equity market has rejoiced, posting strong returns in 2017 with further gains in 2018 to date.

The U.S. equities held in the Funds have benefitted from passage of the Act. At the end of 2017, U.S. equities represented 29% of the LP's equity investments (equivalent to about 54% of the LP's net assets at December 31, 2017, prior to subscriptions and redemptions effective as of that date). Excluding distributions paid in the Trust at year-end (most of which were reinvested), the percentage of the Trust's and LP's net assets held in U.S. equities was virtually identical.

The impact of the Act on Canada is not so positive. In recent years, Canadian governments at the federal and provincial level have generally been raising income tax rates and imposing new carbon taxes. In addition, municipalities have been raising property taxes. All three levels of government have also tended to increase regulatory burden. In the last year, however, the United States, which is both Canada's largest customer and its largest competitor, has been moving in the opposite direction. This divergence has eroded Canada's competitiveness. For example, U.S. state corporate income tax rates range from 0% to 12% with an average of about 6%.<sup>11</sup> When combined with the new federal corporate tax rate of 21%, the total U.S. corporate tax rate is in a range of 21% to 33% with an average of about 27%. In Canada, the federal corporate income tax rate is 15% and most provincial corporate income tax rates are in a tight range of 11.5% to 12%.<sup>12</sup> The combined federal/provincial corporate tax rate is thus 26.5% to 27%, essentially the same as in the U.S. This means that the significant corporate tax rate advantage that Canada has enjoyed for more than a decade is gone. In addition, prospective investors in Canada must weigh the potential threat to Canada's access to U.S. markets that might arise from the current talks (or their failure) to revise the North American Free Trade Agreement. Finally, insufficient pipeline capacity to transport Canada's oil and gas production to market is costing the country many billions of dollars per year in foregone product sales and tax revenues.

Canadian governments at all levels ignore the large and important U.S. tax changes in the Act at our peril. Canadian governments simply must do a better job than they have done in recent years to improve, rather than worsen, Canada's competitiveness with respect to taxation, regulation and market access.

### **Editing**

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Little-known to readers of these letters is that my wife, Jamie Mason, is both a lawyer and serves as my volunteer editor (and I hereby thank her profusely for her services). Last year, perhaps in an effort to reduce her work load, she bought me a book on writing intelligible prose.<sup>13</sup> The book describes various websites that are available to test a written work's readability.<sup>14</sup> Apparently, one of the first books on the subject was *The Art of Readable Writing* by Rudolf Flesch, who inspired Dr. Seuss to write *The Cat in the Hat*. Rudolf's work also inspired the creation of the Flesch Reading Ease index. It (and other formulas) is available at [www.readabilityformulas.com](http://www.readabilityformulas.com). The

**Notes**

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Fund’s portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, March 1, 2016, p. 2. The OM is available at [www.portlandic.com/focusedplusfundLP.html](http://www.portlandic.com/focusedplusfundLP.html) and [www.portlandic.com/focusedplus-fundtrust.html](http://www.portlandic.com/focusedplus-fundtrust.html).
3. For a discussion, see 2013 Letter, p. 3.
4. Source: Globefund at [http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund\\_filter?pi\\_type=B](http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund_filter?pi_type=B).
5. 2016 Letter, pp. 5-6.
6. OM, pp. 6-7 and pp. 13-14.
7. 2016 Letter, p. 6.
8. OM, p. 14.
9. 2014 Letter pp. 20-25, 2015 Letter pp. 12-14 and 2016 Letter p. 8.
10. <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>.
11. [https://en.wikipedia.org/wiki/Corporate\\_tax\\_in\\_the\\_United\\_States](https://en.wikipedia.org/wiki/Corporate_tax_in_the_United_States).
12. <https://www.taxtips.ca/smallbusiness/corporatetax/corporate-tax-rates-2018.htm>.
13. Evans, Harold. *Do I Make Myself Clear?* (Little, Brown & Company, 2017).
14. *Ibid.*, pp. 40-43.

The PORTLAND FOCUSED PLUS FUND LP (the "LP") and PORTLAND FOCUSED PLUS FUND (the "Trust") (collectively, the "Funds") are not publicly offered. They are only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Funds is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Funds made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Commissions, trailing commissions, management fees and expenses all may be associated with investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or optional charges or income taxes payable by any unitholder in respect of a fund that would have reduced returns. Funds are not guaranteed, their values change frequently and past performance may not be repeated.

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**Portland Focused Plus Fund LP**  
**Portland Focused Plus Fund**  
ANNUAL LETTER TO INVESTORS  
FOR THE YEAR ENDED DECEMBER 31, 2018

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund LP				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.5%
2013	33.0%	34.1%	37.7%	34.4%	13.0%	32.4%
2014	15.6%	16.8%	18.8%	17.5%	10.6%	13.7%
2015	6.5%	7.5%	8.3%	8.5%	-8.3%	1.4%
2016	39.0%	40.4%	45.5%	41.6%	21.1%	12.0%
2017	16.4%	17.5%	19.9%	18.6%	9.1%	21.8%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-8.9%	-4.4%

Since Inception (Oct. 31, 2012)

Compound annual	14.4%	15.5%	17.7%	16.4%	5.4%	12.1%
Cumulative return	129.4%	143.3%	172.6%	154.6%	38.7%	102.0%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	15.8%	10.5%
2017	15.5%	16.7%	19.4%	18.1%	9.1%	21.8%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-8.9%	-4.4%

Since Inception (Mar. 31, 2016)

Compound annual	8.6%	9.6%	12.1%	10.9%	5.3%	9.6%
Cumulative return	25.5%	28.8%	36.9%	33.0%	15.1%	28.7%

Notes:

Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund (jointly, the “Funds”) are net returns after all fees and expenses (and taxes thereon) have been deducted. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportion, the performance of the Funds may not

be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

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Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at <http://www.portlandic.com/focusedplusfundLP.html> for the LP and at <http://www.portlandic.com/focusedplusfundtrust.html> for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

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As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

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The performance of the LP and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The LP's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end including annualized returns over various time periods, may be found at the LP's web page referenced above.

In 2018, the LP's series F units (the highest fee series without embedded advisor compensation) had a negative return of -14.0% (net of fees and expenses). That compares to a return of -8.9% for the S&P/TSX Index and to a return of -4.4% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of -6.7%. Accordingly, in the one-year period of 2018, the LP did not meet its investment objective of preservation of capital and a satisfactory return. Much more importantly, however, over the cumulative period since the LP's inception, it has met its investment objective. For the entire period since inception of the LP on October 31, 2012 to December 31, 2018, the LP's series F units achieved a cumulative return of 143.3%. That compares to a cumulative total return of 38.7% for the S&P/TSX Index and 102.0% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 70.3%. It's worth noting that the LP also offers four series of units with lower fees for larger investors, two of which series have units outstanding (series M and series P). Due to their

lower fees, both of these latter series have even higher returns than the series F units. The different series are discussed further below and their performance is shown on the inside front cover of this letter, where applicable. Additional comments on performance of both equity markets and the Funds in 2018 and January 2019 are contained below in the section titled “How The Grinch Stole Christmas.”

### **Canadian Hedge Fund Award**

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I’m pleased to report that the LP was a winner of a 2018 Canadian Hedge Fund Award for achieving 3<sup>rd</sup> place in the category of Equity Focused funds, Best 5-Year Return.<sup>4</sup> This was the LP’s second national award, following its receipt of the 2017 Investment Fund Award conferred by the Private Capital Markets Association of Canada.<sup>5</sup> These awards recognize the LP’s superior long-term performance. Since the LP may be affected by short-term vagaries in equity markets, which may be accentuated by the LP’s use of leverage, it has always been suggested that investors assess performance over periods of not less than five years.<sup>6</sup> It seems particularly appropriate to restate this advice given the LP’s 2018 performance which was not representative of its long-term average.

### **Performance of the Trust**

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>7</sup> The Trust’s investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the management and long-term performance of the two Funds will be similar. That is why Portland has decided to distribute the same annual letters to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Trust’s Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust’s web page referenced at the start of this letter.

In 2018, the Trust’s series F units (the highest fee series without embedded advisor compensation) had a negative return of -14.7% (net of fees and expenses). That compares to a return of -8.9% for the S&P/TSX Index and to a return of -4.4% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have experienced a return of -6.7%. Accordingly, in the one-year period of 2018, the Trust did not meet its investment objective of preservation of capital and a satisfactory return. Much more importantly, however, over the cumulative period since the Trust’s inception, it has met its investment objective. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2018, the Trust’s series F units achieved a cumulative return of 28.8%. That compares to a cumulative total return of 15.1% for the S&P/TSX Index and 28.7% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices would have returned 21.9%. As was noted with reference to the LP, the Trust also offers four series of units with lower

fees for larger investors, two of which series have units outstanding (series M and series P). Due to their lower fees, both of these latter series have even higher returns than the series F units. The different series are discussed further below and their performance is shown on the inside front cover of this letter, where applicable.

### **How the Grinch Stole Christmas**

Equity market conditions in 2018, and the Funds' performance, merit some further comment. On September 21, 2018, the S&P 500 Index reached its all-time intraday high of 2940.9.<sup>8</sup> The S&P 500 Index then headed south, reaching its lowest closing level for the year on Christmas Eve. After taking a day off for the holiday, the S&P 500 Index headed lower still, reaching its lowest intraday level for the year of 2346.6 on the morning of Boxing Day (which is not a holiday in the U.S.). From peak to trough on an intraday basis, the S&P 500 Index fell by (20.2%), meeting the widely-accepted definition of a bear market.<sup>9</sup> The S&P 500 Index then turned sharply higher for the balance of 2018, a rally which has continued in early 2019. Nonetheless, in 2018 the S&P 500 Index posted its worst December performance since 1931, resulting in its worst annual performance since 2008.<sup>10</sup>

The performance of the Funds was influenced by these equity market conditions. However, with very focused portfolios that do not adhere to index sector weightings, and given their use of leverage, the Funds may experience performance that is significantly different than their two benchmark indices, even over short-term periods. The performance of the Funds was negative overall for the first five months of 2018 as three of their then-largest holdings, electric utilities Fortis Inc. ("Fortis") and Emera Inc. ("Emera") and drugstore retailer Walgreens Boots Alliance Inc. ("Walgreens"), were deeply out of investor favour. Over the subsequent six months, these three companies came back into investor favour, helping propel the Funds to new record highs at November 30, 2018. Then along came the Grinch. The December declines in the S&P/TSX Index and the S&P 500 Index were accentuated in the Funds by their use of leverage and by declines in the prices of shares purchased in December, so that in that month each of the Funds declined by (19.7%), by far their worst-ever monthly performance.

I am pleased to report that in early 2019, these negative conditions largely reversed themselves. For the month ended January 31, 2019, the series F units of the LP and the Trust had by far their highest-ever monthly total returns of 36.0% and 36.6%, respectively, with both of the Funds reaching new all-time highs (adjusted for distributions). By contrast, in January, the S&P/TSX Index and the S&P 500 Index had returns of only 8.7% and 8.0%, respectively. This recent period is an excellent demonstration of the truth of the "Mr. Market" allegory described by "the father of value investing", Benjamin Graham.<sup>11</sup> He explained that owning publicly-traded securities is like being in partnership with a manic-depressive whose quoted price for the business may vary wildly based on his mood swings, unrelated to changes in the intrinsic value of the business.<sup>12</sup> The referenced period also underscores the wisdom of the adage not to get too excited about short-term results (whether negative or positive), but instead to focus on long-term averages. The long-term average results of the Funds are very good.

### **Monthly Fund Updates**

Shortly after every month-end, I send out fund updates by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, net asset value per unit (“NAVPU”) and net assets. When circumstances merit, these updates may also include comments on important events impacting the LP and the Trust and the investment outlook. Canada’s Anti-Spam Legislation restricts Portland’s ability to add anyone’s email address to the list to receive these updates without that person’s written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an “unsubscribe” button that you may click on to be removed from that list.

### Offering Memorandum

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On October 25, 2018, Portland renewed the Funds’ OM. This is the second complete refresh of the Funds’ offering memorandum since the inception of the LP. The first refresh was effective on March 1, 2016; its primary purpose was to incorporate the launch of the Trust. The primary purpose of the most recent update of the OM was to permit the issuance of series Q units, described more fully below.

### Series of Fund Units

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The Funds have designated six series of units, four of which have units outstanding. The features of each of the series are outlined below:<sup>13</sup>

- **Series A units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever NAVPU (“High Water Mark”) of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee;
- **Series P units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee;
- **Series O units** are charged a negotiated management fee and/or performance fee directly to Portland. Series O units will only be issued to certain institutional or other investors. No series O units have yet been issued; and

- **Series Q units** have a minimum initial subscription amount of \$10,000,000; and a management fee of 0.75% per annum. Series Q units do not have a performance fee. No series Q units have yet been issued.

As can be seen in the tables on the inside front cover of this letter, for the period from October 31, 2012 to December 31, 2018, the LP's series F units had a cumulative return of 143.3% while the LP's series M units and series P units had higher cumulative returns of 172.6% and 154.6%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2018, the Trust's series F units had a cumulative return of 28.8% whereas the Trust's series M units and series P units had higher cumulative returns of 36.9% and 33.0%, respectively.

Going forward, with respect to each of the Funds, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long-term performance.

#### **Performance Difference Between the LP and the Trust**

The performance of the LP and the Trust in 2018 is shown in the table below:

Performance Year ended Dec. 31, 2018	Series A	Series F	Series M	Series P
LP	-14.8%	-14.0%	-13.5%	-13.2%
Trust	-15.6%	-14.7%	-14.2%	-13.8%
LP vs. Trust	0.8%	0.7%	0.7%	0.5%

As can be seen from the table, the LP's performance was higher than that of the Trust by 0.8% for the series A units, 0.7% for the series F and series M units and 0.5% for the series P units (its column does not add due to rounding). In my opinion, the performance differential between the two Funds in 2018 was primarily a result of the following two factors:

- As was noted in the 2016 Letter, since the LP is based in Alberta, its management fees, performance fees and operating expenses were (until December 31, 2018) subject only to Goods and Services Tax (GST) at a rate of 5%.<sup>14</sup> The Trust's fees and expenses, however, were (and are) subject to sales tax for each series based on the weighted average rate applicable in the provinces where the series' investors reside. In December 2018, for example, the Trust's series F fees and expenses were subject to Harmonized Sales Tax (HST) at a weighted average rate of 12.3%. There has been a change to Canadian tax law which stipulates that effective January 1, 2019 the fees and expenses of limited partnerships will be taxed in a manner similar to those of mutual fund trusts (like the Trust). As a result, the performance difference between the LP and the Trust with respect to the tax rates

levied on their fees and expenses should be materially lower in 2019 and in future years; and

- The LP had a lower operating expense ratio than the Trust. This is discussed in the next section.

## **Operating Expenses**

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The Funds incur operating expenses for such items as fund administration, audit fees, legal fees, and preparation of income tax returns and tax slips.<sup>15</sup> From the inception of the Funds to December 31, 2017, the Funds' operating expenses were both 0.50% of net assets per annum plus applicable taxes. I'm pleased to report that in 2018, however, the LP's operating expense ratio fell to 0.37% plus tax. That is because the LP's assets rose to the point that its operating expenses, which are relatively fixed and are insensitive to asset size, fell as a percentage of the LP's net assets so that the operating expenses were below the former operating expense recovery ratio of 0.50%. All other things being equal (as economists like to say), a lower operating expense ratio results in higher reported investment performance. Thus, the economies of scale of the larger LP have redounded to the benefit of investors in the LP. Conversely, the Trust has yet to achieve the same economies of scale, so its operating expense ratio in 2018 remained at 0.50% of net assets plus tax. At December 31, 2018, the net asset values of the LP and Trust (before subscriptions and redemptions effective on that date) were \$33.6 million and \$15.3 million, respectively (in the latter case, after the deduction of year-end distributions of \$2.3 million, almost all of which were reinvested).

While there can be no assurance that the operating expense ratios of the LP and Trust will remain at or below their 2018 levels of 0.37% and 0.50%, respectively (in both cases, plus tax), Portland remains committed to tight management of fees and expenses so as to maximize the Funds' returns.

## **Allocations, Distributions and Returns**

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The Funds earn investment income and incur expenses. Based upon communications that I have received, it is clear that there is some confusion among investors (and even financial advisors) as to how the two Funds attribute their income and expenses to their investors, and the implications for calculating returns. Since the LP and the Trust have different legal forms, the way in which they attribute income and expenses to their investors is also different, as is the method for calculating each Fund's rate of return. This is explained in the rest of this section. Please note that the discussion below is not intended to constitute tax advice; if in doubt, investors should consult their own tax professionals.

The LP does not pay distributions. Instead, the LP allocates its income and expenses to its investors on a pro rata basis. These allocations are recorded for tax purposes on T5013 slips which are issued to investors annually in March in respect of the preceding calendar year. One of the attractive features of limited partnerships is that income earned and expenses incurred by them retain their tax character when they are attributed to investors. For example, most of the LP's income is tax-advantaged as it is in the form of capital gains and eligible Canadian dividends (only half of capital gains are included in taxable income and eligible Canadian dividends earn significant tax credits). At the same time, the LP's expenses (i.e., management fees, perfor-

mance fees, operating expenses and interest expense on margin loans) are all fully deductible in the computation of taxable income (with the exception of foreign dividend withholding taxes, which also earn a tax credit). For tax purposes, these expense items (other than foreign withholding taxes) are all aggregated into one number (reported on the T5013 slips) called “carrying charges”. Note that since the LP does not actually pay distributions, investors must have some other means to pay any taxes owing by them on their allocation of the LP’s income and expenses. In my experience, investors generally fund their LP-related tax obligations using other resources held by them or by redeeming some of their units of the LP. Upon receiving each T5013 slip, investors should adjust the adjusted cost base (“ACB”) of the LP’s units that they own by increasing the ACB by the amount of income items allocated, and decreasing the ACB by the amount of expense items allocated. In this way, investors in the LP avoid double taxation (which would otherwise arise if investors paid taxes on income allocated to them but not actually received by them, and then, when they eventually redeem their units, had not adjusted their ACB for the cumulative amounts of income and expenses allocated to them).

An important feature of the fact that the LP does not pay distributions is that it is extremely easy to calculate the LP’s cumulative return over any period. All that is needed is the ending and beginning NAVPU. For example, as noted earlier, the cumulative performance of the LP’s series F units from inception on October 31, 2012 to December 31, 2018 was 143.3%. That can be readily calculated by dividing its NAVPU at December 31, 2018 of \$121.66 by its NAVPU at inception of \$50.00 and subtracting one:  $\$121.66/\$50.00 - 1 = 143.3\%$ .

A closely-related feature of the fact that the LP does not pay distributions is that for investors in the LP, “book value” equals cost. Book value is a figure that is widely reported in statements issued by brokerage firms and investment managers (including Portland). Book value is generally the sum of cost (i.e., the amount actually paid by investors for units) and reinvested distributions. Since the LP does not pay distributions, for its investors, book value equals cost. For investors in the LP, their personal, cumulative return is computed by dividing market value by cost. Since book value equals cost, investors in the LP can compute their cumulative return by simply dividing market value by book value (as both are reported on their statements). That is not the case for investors in the Trust, however, as we shall soon see.

In contrast to the LP, the Trust does pay distributions (as it is required to do so for tax purposes). Moreover, unlike the LP, mutual fund trusts, such as the Trust, are not permitted to directly allocate their expenses to their investors. Instead, the Trust’s expenses are netted against its income (such as dividend income) and the net amount of income is distributed to investors, together with a distribution of capital gains. These distributions occur annually on December 31 and are recorded on T3 slips issued to investors in March in respect of the preceding calendar year. For example, on December 31, 2018, the Trust paid a distribution of \$7.40 per series F unit. For investors in registered plans who reinvested their distributions, the distribution had no financial consequence as they simply ended up with more units at a lower NAVPU with no change in their total net asset value in dollars. For non-registered investors, the distribution was tax-efficient as 94% of it was in the form of capital gains that are only taxed at half of the rates applicable to

regular income.

An important consequence of the fact that the Trust pays distributions is that it is impossible to calculate the Trust's performance over any period that includes one or more December 31s without adjusting for distributions. For such periods, to determine performance, one can't simply divide the ending NAVPU by the beginning NAVPU (as one can always do with the LP). For example, the Trust's NAVPU of its series F units at November 30, 2018 was \$72.28 and their NAVPU on December 31, 2018 was \$50.66, a seeming decline of -29.9%. The Trust's NAVPU on December 31, 2018, however, was after the payment on that date of the above-noted distribution of \$7.40 per unit. Adjusting for this, the Trust's series F NAVPU on December 31, 2018 prior to distributions was \$58.06 per unit:  $\$50.66 + \$7.40 = \$58.06$ . When compared to its NAVPU on November 30, 2018, the resulting performance was the as-reported figure of -19.7%:  $\$58.06/\$72.28 - 1 = -19.7\%$ . Also noteworthy is the fact that, as discussed in the 2016 Letter, the Funds are generally managed so as to try to keep unrealized gains as of any December 31 in the range of 10% to 25% of each Fund's net asset value.<sup>16</sup> As 2018 amply demonstrated, however, volatility in equity markets, particularly toward year-end, may result in actual unrealized capital gains (or losses) being outside of the range of 10% to 25% of net assets (either higher or lower), but that is the aspiration. If that target (i.e., to keep unrealized capital gains at December 31 of any year in the range of 10% to 25% of net assets) were achieved, then the Trust's NAVPU at December 31 year-ends would generally remain in the range of \$55.00 to \$62.50, regardless of how strong performance might have been, or for how many years. That is because the Trust's NAVPU at inception for all series was \$50.00. Adding in the goal for unrealized gains at year-ends of 10% to 25% of net assets results in target NAVPUs for the Trust of \$55.00 to \$62.50. This analysis underscores that to measure the Trust's performance over any period that includes one or more year-ends, one must consult performance tables (such as the one on the inside front cover of this letter), not simply look at NAVPUs. As noted earlier, performance over various periods is included in the Fund's monthly fund briefs. These are generally posted to Portland's web site within a few business days after every month-end. Further, links to the fund briefs are included in the Funds' monthly fund updates.

The fact that the Trust pays distributions means that each investor's book value of units held will tend to rise over time, even if she makes no further subscriptions after her initial investment. A numerical example will help to illustrate this point. Let's assume that on December 31, an investor subscribes for \$1,000 of Trust units. With the Trust's NAVPU at an assumed level of \$50.00 (as it was at inception), the investor would receive 20 units:  $\$1,000 / \$50.00 = 20$ . Further assume that in the subsequent year, the Trust has a net return of 15%, all of which is realized (i.e., there is no change in the Trust's unrealized capital gains in the year). That means that at the next year-end, prior to paying distributions, the Trust's NAVPU would be \$57.50:  $\$50.00 \times 1.15 = \$57.50$ . Since we assumed that all of the 15% return was realized, the Trust must pay out the return of \$7.50 per unit as a distribution. After giving effect to the distribution, the Trust's reported NAVPU on this latter December 31 would be \$50.00, the same as it was at the prior year-end, despite the 15% return in the year. On this latter date, the investor would receive a distribution of \$7.50 per unit for each of her 20 units, for a total of \$150. If she chose to have her distributions

reinvested into additional units, as the vast majority of investors do, she would receive three additional units:  $\$150 / \$50 = 3$ . She now owns a total of 23 units which, at the NAVPU of \$50.00, have a market value of \$1,150:  $23 \times \$50 = \$1,150$ . From an accounting standpoint, the value of her \$150 distribution is added to her original cost of \$1,000 so that on the latter December 31, the book value of her units is reported at \$1,150, which in this example would be the same as the market value. If this result were repeated year after year, both the investor's market value and book value would grow steadily, and they would always be the same as each other. An investor could be forgiven for looking at her statements and thinking, "Geez! I've owned this fund for years and I've never made any money. Every year, market value is the same as book value!" Meanwhile, in reality, the fund has been compounding at an annual rate of 15%! The misunderstanding arises because of the confusion of book value with cost. In the above example, the investor's cost was \$1,000 and that never changed. This is the denominator that should be used by investors to compute their returns. In brief, investors in the Trust who hold units through at least one December 31 *cannot compute their cumulative return by comparing their market value to their book value*. To derive their return, they must compare market value with their original cost, or use the performance tables in the inside front cover of this letter, in the monthly fund briefs or on Portland's web site, or consult the personal rates of return that brokerage firms and investment managers are now required to provide to their clients annually.<sup>17</sup>

Phew! Here endeth the lesson on allocations, distributions and returns. I'm reminded of a statement that I use in some presentations and was inspired by Tim Cestnick, a former colleague who is one of Canada's foremost tax professionals: "if you took all the people in the world who'd ever fallen asleep at an accounting seminar, and laid them end-to-end...they'd be a lot more comfortable."

### **Electric Utilities: Lights Out**

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It's now worthwhile reviewing some of the Funds' former major holdings that were mentioned in previous letters or shown in the Funds' previous financial statements.

As described in the 2016 Letter, during 2016 the Funds bought large positions in two electric utility companies, Fortis and Emera.<sup>18</sup> Those two companies represented 88% and 60% of the LP's net assets at the end of 2016 and 2017, respectively (and a similar percentage of the Trust's net assets on those dates, before giving effect to subscriptions, redemptions and distributions). Their decline in percentage weight in 2017 did not arise from share sales; in fact, by utilizing both companies' dividend reinvestment plans, the Funds owned more shares of both companies at the end of 2017 than they had at the end of 2016. The decline in the portfolio weight in utilities in 2017 arose because the growth in the net assets of the Funds in that year exceeded the share price appreciation of both Fortis and Emera.

For most of 2018, the total returns of the utilities were fairly poor, both on an absolute basis and relative to equity markets such as the S&P 500 Index (which peaked on September 21). For the utility shares, this period could be characterized as a brownout. Then, a remarkable thing happened. On October 3, 2018, Jerome "Jay" Powell, the chair of the U.S. Federal Reserve ("Fed")

(which determines short-term interest rates), gave an interview in which he stated that “interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral... We may go past neutral, but we’re a long way from neutral at this point, probably.”<sup>19</sup> That was certainly the most hawkish statement by a Fed chair that I have heard since Paul Volcker (who served as Fed chair from 1979 to 1987).<sup>20</sup> The world took notice. If you want to know why equity markets tanked in the fourth quarter of 2018, you can trace a direct line from that interview. In the two days that followed Powell’s statement, market interest rates ticked up. For example, on October 5, 2018, the 10-year U.S. Treasury yield reached 3.23%, almost its highest level for all of 2018.<sup>21</sup> Then, perhaps counter-intuitively, market interest rates began to decline sharply. By the end of 2018, the 10-year U.S. Treasury yield had fallen to 2.69% while equity markets had also fallen sharply. In my opinion, these market movements occurred because investors feared that the Fed would raise short-term interest rates so aggressively that it would tip the economy into recession.

The decline in long-term interest rates starting in early October caused utility share prices to shoot the lights out. From that time on, they soared in price while equity markets, in general, fell. As a result, both the absolute and relative return prospects of the utilities gradually grew dimmer. In response to this market divergence, all of the shares of Fortis and Emera that had been held in the Funds at the time of Powell’s October 3 interview were sold (in November and December) at substantially higher prices. The proceeds were reallocated to what I felt were better opportunities that offered superior combinations of expected returns and downside risk.

On balance, I consider that the returns in the two utilities over the Funds’ two-year holding period of them met the expectations stated in the 2016 Letter: that they would “deliver satisfactory long-term returns with limited risk.”<sup>22</sup> The Funds’ recent experience with the two utilities also demonstrates the importance of two portfolio management tenets employed in the management of the Funds: i) buy high-quality, large companies when they’re out of favour (as the utilities were in late 2016); and ii) have some diversification (by sector and geography) so that, ideally, not all stocks held in the Funds will move in the same direction at the same time. Some diversification (without taking it to excessive levels) may afford profitable opportunities to reallocate capital, as was the case in late 2018.

### **Reports of Retailing’s Death Have Been Greatly Exaggerated**

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Another large, high quality company that was bought in the Funds when it was out of favour was Walgreens. At December 31, 2017, the position in Walgreens was equal to 26% of the LP’s net assets (and a similar percentage of the Trust’s net assets).

Walgreens is the second-largest pharmacy store chain in the U.S. and one of the largest in the world. The Funds invested in Walgreens in October 2017, when bricks and mortar retailers fell far out of favour because of concern about increasing competition from Amazon.com, Inc. (“Amazon”). The Funds were quickly rewarded with substantial appreciation of Walgreens’ stock price until late January 2018. Over the next five months, however, in tandem with weak equity markets and the announcement of Amazon’s purchase of online pharmacy PillPack, Walgreens’

stock price fell even lower than it had been at the time of the Funds' purchase. By late June, Walgreens had fallen to what would prove to be its 2018 lowest stock price of just over US\$59 per share. One of the things that consoled me at that time (other than the fact that Walgreens' stock was cheap) was that its financial position was strong and that it would use that strength to repurchase a significant amount of its shares at such low prices that it would enhance the company's per-share intrinsic value to the benefit of the remaining shareholders. Indeed, during its fiscal year ended August 31, 2018, Walgreens reduced its basic shares outstanding by (7%).<sup>23</sup> As it happened, Walgreens began to climb back into investor favour. After the Powell interview referred to above, not only did the share prices of utilities rise strongly, but also so did the shares of consumer staples companies, such as Walgreens. I then felt, as with the utilities referenced above, that it was desirable to reallocate the capital invested in Walgreens to better-priced opportunities. All Walgreens shares that had been held in the Funds were sold in October and November 2018 for an average of over US\$80 per share. For the holding period of about one year, the Walgreens investment netted the Funds a tidy total return (in U.S. dollars) of over 20%.

The stock market was not wrong in its apparent belief that bricks and mortar retailers are losing market share to online retailing. The market simply, as it is wont to do, exaggerated the impact of a negative event or trend, resulting in the stock prices of the affected businesses (in this case, traditional pharmacy retailers) trading at far below their intrinsic values. The Funds' positive experience with Walgreens was another example of the benefits of buying high quality businesses when they're on sale (i.e., out of investor favour). It also underscores the importance of share repurchases, discussed more fully below.

### **Optionality and Share Repurchases**

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As noted previously in these letters, the Funds seek to invest in companies that are in strong financial positions.<sup>24</sup> In part, that is because the Funds already use leverage as one of their core strategies; the Funds don't need or want that leverage to be compounded by high and uncertain leverage in the Funds' investee companies. Also, if the companies in which the Funds invest are in strong financial positions, the businesses have optionality. That simply means that they have the financial means to pursue a range of alternatives for increasing shareholder value, including internal growth, acquisitions and share repurchases. When doing fundamental research on public companies, there is no one measure which captures financial strength. I consider a range of measures, including: income statement measures, such as interest coverage; balance sheet measures, such as debt-to-equity; cash flow measures, such as the amount of free cash flow that the business generates; liquidity; credit ratings; schedules of debt maturities; and industry-specific financial metrics.

The 2013 Letter included some comments on share repurchases.<sup>25</sup> Given what seem to be common, persistent misunderstandings regarding share repurchases, it's worth revisiting this topic. Despite what one may read, share repurchases are neither inherently good nor bad. Every share repurchase must be considered in light of the circumstances prevailing at the time of the repurchase. As famed investor (and our role model) Warren Buffett has noted, there are two conditions that must both be satisfied for share repurchases to be advisable: "[f]irst, the company has avail-

able funds – cash plus sensible borrowing capacity – beyond the near-term needs of the business and, second, finds its stock selling below its intrinsic value, conservatively-calculated.”<sup>26</sup> It is amazing (and somewhat disheartening) to observe how many share repurchases fail either one or both of these two simple tests. By repurchasing shares when they do not have adequate financial strength to do so, companies place their entire business in peril. Moreover, by repurchasing shares when their stock market prices are above their intrinsic value, companies reduce the per-share intrinsic value of the remaining shares, thus they punish their remaining shareholders. The fact that some companies choose to implement share repurchases that fail one or both of these tests while the company’s senior executives simultaneously exercise stock options and sell into the strength created by the share repurchase, just makes this practice even more unseemly.

Conversely, share purchases that meet both of the tests described above are unequivocally positive. Such repurchases are an intelligent and responsible use of the company’s financial strength and serve to increase the per-share intrinsic value of the continuing shareholders. It is explicitly part of the Funds’ investment methodology to invest in businesses that have both the ability and the willingness to repurchase shares if circumstances warrant (and only if they warrant). It is thus not a coincidence that several of the Funds’ investee companies have completed what I believe are among the largest share repurchases (as a percentage of outstanding shares) among all Canadian and U.S. businesses. That includes Walgreens; two other examples are given below.

### **Banks Redux**

Previous annual letters have included many positive comments about banks.<sup>27</sup> In the 2016 Letter, which noted that the Funds had greatly reduced their former bank investments for valuation reasons, I stated that “[s]elected banks remain outstanding businesses and excellent candidates for investment. I hope that someday they again fall out of favour and that large percentage weights in leading banks are re-established in the Funds.”<sup>28</sup> I’m pleased to report that, as was sung in the old advertising jingle, “the future is now.”<sup>29</sup>

During 2018, especially late in the year, bank stocks fell very far out of investor favour. The Funds used that weakness as an opportunity to add to existing bank positions and to buy new ones. The LP’s bank holdings are summarized in the table below. The first numerical column shows each holding’s percentage weight of the LP’s net assets at December 31, 2018 (before subscriptions and redemptions effective on that date). The Trust’s weights in the banks named in the table, excluding the Trust’s year-end distributions (almost all of which were reinvested), were virtually identical to those of the LP.

<u>Banks held in the LP at Dec. 31,</u>					
<u>Company</u>	<u>% of LP's net</u>	<u>Dividend Yield</u>	<u>P/E ratio</u>	<u>P/B ratio</u>	<u>P/TB ratio</u>
Bank of Nova Scotia, The	43.6%	5.0%	9.6	1.4	1.9
Canadian Imperial Bank of Commerce	21.6%	5.4%	8.3	1.4	1.8
Citigroup Inc.	43.2%	3.5%	7.8	0.7	0.8

Goldman Sachs Group, Inc., The	35.0%	1.9%	7.0	0.8	0.8
Toronto-Dominion Bank, The	44.6%	3.9%	10.5	1.7	2.3
Total / weighted average	188.0%	3.9%	8.8	1.2	1.5

Further comments on the table are listed below:

- At December 31, 2018 the LP had 188% of its net assets invested in banks (enabled by the use of margin borrowings). By comparison, at December 31, 2017, the LP's percentage of its net assets invested in banks was 56%. During 2018, the LP increased its weight in banks by 132 percentage points. Almost all of that increase arose during the fourth quarter of 2018. One of the investee companies was Citigroup Inc., which in 2018 reduced its basic shares outstanding by (8%);<sup>30</sup>
- The weighted average dividend yield of the LP's bank holdings was 3.9%. The dividend yield for each bank was its indicated annual dividend rate divided by its share price at December 31, 2018. It's worth noting that the average dividend yield alone exceeded the LP's cost of borrowing (i.e., its margin interest rates). Thus, the bank holdings provided positive cash flow to the LP even before consideration of the use of their retained earnings to increase their shareholder value over time;
- The weighted average price/earnings ("P/E") ratio of the banks was only 8.8 times. For each bank, that ratio was calculated by dividing its share price at December 31, 2018 by its earnings per share excluding specified items for 2018. For the Canadian banks, the figures used were their earnings for their fiscal years ended October 31, 2018 (which were reported shortly before the end of calendar 2018); for the U.S. banks, the figures were their earnings for calendar 2018 (which were reported shortly after year-end). I believed that the average trailing P/E ratio of only 8.8 times was very attractive, especially in the context of current low interest rates;
- The weighted average price/book ("P/B") ratio of the banks was only 1.2 times. For each bank, that ratio was calculated by dividing its share price at December 31, 2018 by its book value per share (for the Canadian banks, as of October 31, 2018; for the U.S. banks, as of December 31, 2018). In my opinion, the average trailing P/B ratio of only 1.2 times was also very attractive; and
- The weighted average price/tangible book ("P/TB") ratio of the banks was only 1.5 times. Tangible book value is calculated by deducting from common equity intangible assets such as goodwill and identified intangible assets that have arisen on acquisitions. For each bank, the P/TB ratio was calculated by dividing its share price at December 31, 2018 by its tangible book value per share (for the Canadian banks, as of October 31, 2018; for the U.S. banks, as of December 31, 2018). The average trailing P/TB ratio of only 1.5 times represented compelling value. In fact, at year-end the two U.S. banks traded at *discounts* to their tangible book values of about (20%). That is an uncommon condition which usually presages strong share price performance thereafter.

Given the low bank valuations that prevailed at December 31, 2018, it is not surprising that a partial recovery of bank share prices helped drive the Funds' exceptionally strong performance in January 2019. I remain very positively inclined toward the investment merits of leading banks. They have strong financial positions, excellent management teams, are diversified by both revenue and geography, have large barriers to entry and generate significant free cash flows. This view is held in common with Warren Buffett's Berkshire Hathaway Inc. ("Berkshire Hathaway"). At the end of 2018, Berkshire Hathaway counted among its largest shareholdings the following banks: Bank of America Corporation; The Bank of New York Mellon Corporation; The Goldman

Sachs Group, Inc.; JPMorgan Chase & Co.; U.S. Bancorp; and Wells Fargo & Company.<sup>31</sup> As Buffett once wryly observed when he was asked about the investment merits of ranching, “I know people that have done reasonably well in cattle but they’ve usually owned banks on the side.”<sup>32</sup>

### Other Investments

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Normally, these letters don’t dwell on the Funds’ individual investments and the presentations that I give on the Funds almost never have slides on individual holdings. The primary reason for that is that I have found that the more one discusses individual holdings, the more one is likely to keep them in the Funds, even if changing valuations or other circumstances suggest one should do otherwise. The Funds’ investment objective has never changed nor have the strategies used to pursue their investment objective. Those may be sacrosanct, but individual holdings are not. Holdings are always subject to change if it is deemed to be in the best interests of the Funds. Nevertheless, given the sharp equity market declines in December 2018, I thought investors might appreciate a review that underscores the high quality of the Funds’ investee companies. The Funds’ five bank holdings are summarized above; their three non-bank holdings are discussed briefly below (in order of percentage weight in the LP, highest to lowest; the weights of these businesses in the Trust were similar).

- **Magna International Inc.** (“Magna”; 46.3% of the LP’s net assets at December 31, 2018). Magna is one of the world’s largest automotive parts manufacturers. Its 2018 sales were US\$40.8 billion. The company is highly diversified by customer, product and geography. It is in a strong financial position and generates considerable free cash flow. In 2018, Magna reduced its common shares outstanding by (9%);<sup>33</sup>
- **McKesson Corporation** (“McKesson”; 34.2% of the LP’s net assets). McKesson is one of largest drug distributors in the United States (and also owns Canada’s Rexall and Rexall Pharma Plus pharmacy chains).<sup>34</sup> In McKesson’s latest fiscal year ended March 31, 2018, its sales were US\$208 billion. While drug distributors have been out of favour for some of the same reasons as Walgreens, they are not as exposed to traditional retailing; and
- **Berkshire Hathaway** (1.3% of the LP’s net assets). It is not the Funds’ normal practice to hold small positions. The LP bought shares in Berkshire Hathaway in early 2016 (before the launch of the Trust), near the stock market low at that time and at a very favourable price. As Berkshire Hathaway’s stock price soared very soon thereafter, I acted quickly to reduce the holding for valuation reasons that proved to be far too conservative. The residual position remains in the Funds as a two-fold reminder: first, to follow the company’s practice of investing in large, high quality businesses; and second, if I ever again get the opportunity to buy Berkshire Hathaway shares on anything like the terms that prevailed in early 2016, back up the truck and don’t let them go.

### In Memoriam: John C. Bogle

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In January 2019, the world marked the passing of investment giant John C. “Jack” Bogle at the age of 89.<sup>35</sup>

Beginning with his Princeton University thesis in 1951, Bogle posited two ideas which were then revolutionary: i) most active portfolio managers will underperform their benchmark because of the impact of fees, operating expenses and trading costs; and ii) therefore, investors should invest so as to replicate the underlying benchmark as closely as possible, while keeping fees, operating

expenses and trading costs to the bare minimum.<sup>36</sup> By doing so, investors can get closer to their benchmark's return and outperform most active managers. Bogle preached these simple, logical, powerful ideas for the rest of his life, to the massive and incalculable benefit of investors around the world.

In 1975, Bogle put these then-radical ideas into action by founding what has become The Vanguard Group, Inc. ("Vanguard") and launching the first index fund (what is now known as the Vanguard 500 Index Fund).<sup>37</sup> While it took many years for index funds to catch on, by the 1990s they had demonstrated the success of their model. Index funds do, however, have one major drawback: investors do not know the exact price that they will pay to buy (or receive to sell) when they submit an order because orders must be submitted before the index fund is priced, which is usually at the close of every trading day (after all orders have been received). Eventually, the quest to address this drawback led to the creation of exchange-traded funds (ETFs). These married the index fund model with pricing certainty (since one can submit limit orders during the trading day and know exactly what one will pay or receive for an ETF). The rest is history. Over the last 20 years, ETFs have taken the world by storm. Today, Vanguard manages over \$5.1 trillion. It is the world's largest provider of mutual funds and the second-largest provider of ETFs (after only ETF juggernaut BlackRock, Inc.).<sup>38</sup> Bogle's personal benefit from this phenomenal success was relatively modest. That is because he deliberately structured Vanguard as a mutual company, meaning that Vanguard is owned by the funds managed by the company. Thus, as Vanguard grew, its economies of scale resulted in lower management fees and operating expense ratios to the benefit of the investors in its funds.

It may seem incongruous for an active manager like me to celebrate Bogle's life and influence. On the contrary, however, I have read several of Bogle's books and have benefited greatly by them. Further, I agree with Bogle's irrefutable logic that a large majority of active managers will underperform their relevant benchmark. That is why I believe that appropriate investments resemble a barbell. At one end, for those who desire the simplicity and predictability of achieving index-like returns, are index funds and ETFs. At the other end are investments like the Funds which are highly differentiated, highly focused and un-index like. What investors should avoid is the "mushy middle": closet index funds that charge high fees and expenses for providing active management and advice while providing little, if any, of either.

Given Bogle's sound arguments, I believe that the burden of proof lies with active managers to explain how they propose to outperform. Investors may then judge whether the articulated strategy is sensible and measure each active fund's long-term performance to determine whether it has been successful. I had Bogle's teachings in mind when the first of the Funds, the LP, was designed and launched in 2012. Its key tenets, which have been employed in the Funds ever since, are as follows:

- **Use of leverage.** Borrowing costs for the last decade have been (and remain today) far below the long-term historic and expected rate of return on equities. I posited that careful use of a discretionary, variable amount of leverage would provide extra returns to the Funds sufficient to exceed the fees,

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [www.portlandic.com/focusedplusfundLP.html](http://www.portlandic.com/focusedplusfundLP.html) and [www.portlandic.com/focused-plusfundtrust.html](http://www.portlandic.com/focused-plusfundtrust.html).
3. For a discussion, see 2013 Letter, p. 3.
4. <http://alternativeiq.com/canadian-hedge-fund-awards/about/>. The awards are based solely on quantitative performance data of 207 Canadian hedge funds to June 30th, 2018 with Fundata Canada managing the collection and tabulation of the data to determine the winners. There is no nomination process or subjective assessment in identifying the winning hedge funds.
5. 2017 Letter, p. 4.
6. 2013 Letter, p. 3.
7. 2016 Letter, pp. 5-6.
8. All S&P 500 Index data in this section is from Bloomberg LP.
9. Some market participants assess whether the bear market threshold of a decline of at least (20%) has been attained based on closing low compared to closing high, while others assess it based on intraday low compared to intraday high. I am in the latter group as is the business news network, CNBC. See <https://www.cnbc.com/2018/12/24/whats-a-bear-market-and-how-long-do-they-usually-last-.html>.
10. <https://www.foxbusiness.com/markets/dow-sp-500-having-worst-month-since-1931-as-grinch-hits-wall-st>.
11. [https://en.wikipedia.org/wiki/Benjamin\\_Graham](https://en.wikipedia.org/wiki/Benjamin_Graham).
12. Graham, Benjamin. *The Intelligent Investor* (Harper & Row, Fourth Revised edition, 1973), pp. 108-109.
13. OM, pp. 6-7 and pp.13-14.
14. 2016 Letter, p. 6.
15. OM, pp. 14-15.
16. 2016 Letter, pp. 6-7.
17. The personal rate of return provided to investors by brokers and investment managers is calculated on a money-weighted basis whereas standard investment returns (such as are stated in this letter and in Portland’s monthly fund briefs) are calculated on a time-weighted basis. For the difference between these two methods, please see the 2015 Letter, pp. 5-8.
18. 2016 Letter, pp. 8-9.
19. <https://www.youtube.com/watch?v=IEPcPIYTMYO> and <https://www.cnbc.com/2018/10/03/powell-says-were-a-long-way-from-neutral-on-interest-rates.html>.

20. Volcker famously raised short-term interest rates to 20% in order to curb high inflation and inflation expectations. See [https://en.wikipedia.org/wiki/Paul\\_Volcker](https://en.wikipedia.org/wiki/Paul_Volcker).
21. [https://ycharts.com/indicators/10\\_year\\_treasury\\_rate](https://ycharts.com/indicators/10_year_treasury_rate).
22. 2016 Letter, p. 9.
23. Walgreens' annual report on form 10-K for the fiscal year ended August 31, 2018, p. 58.
24. See, e.g., 2013 Letter, p. 9.
25. 2013 Letter, p. 10.
26. Berkshire Hathaway Inc. 1999 annual report, p. 16.
27. 2014 Letter, p. 15 and pp. 20-25; 2015 Letter, pp. 12-14; 2016 Letter, p. 8; and 2017 Letter, p. 8.
28. 2016 Letter, p. 8.
29. <https://www.youtube.com/watch?v=Xg32JxTC5jc>.
30. Citigroup Inc. Q4'18 Quarterly Financial Data Supplement, p. 1.
31. Berkshire Hathaway Inc. 2018 annual report, p. 12.
32. Berkshire Hathaway Inc. annual general meeting held on April 30, 2016, as transcribed by the author.
33. Magna's press release for the fourth quarter of 2018, p. 10.
34. <https://www.rexall.ca/company>.
35. For a biographical sketch of John Bogle as well as a 16-minute undated interview with him that appears to be from late 2017, see [https://www.cnn.com/2019/01/16/investing/john-bogle-  
obituary/index.html](https://www.cnn.com/2019/01/16/investing/john-bogle-obituary/index.html).
36. This brief summary of John Bogle's life and career is based on general knowledge gleaned from Bogle's books and extensive interviews. See also his Wikipedia entry at [https://  
en.wikipedia.org/wiki/John\\_C.\\_Bogle](https://en.wikipedia.org/wiki/John_C._Bogle).
37. [https://en.wikipedia.org/wiki/The\\_Vanguard\\_Group](https://en.wikipedia.org/wiki/The_Vanguard_Group).
38. Ibid.
39. 2013 Letter, p. 17.
40. The Funds' Annual Financial Report for the year ended December 31, 2018, note 1, p. 22.
41. OM, p. 7.
42. 2013 Letter, pp. 13-14.
43. The Funds' Annual Financial Report for the year ended December 31, 2018, p. 10.

The PORTLAND FOCUSED PLUS FUND LP (the "LP") and PORTLAND FOCUSED PLUS FUND (the "Trust") (collectively, the "Funds") are not publicly offered. They are only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Funds is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Funds made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Commissions, trailing commissions, management fees and expenses all may be associated with investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or optional charges or income taxes payable by any unitholder in respect of a fund that would have reduced returns. Funds are not guaranteed, their values change frequently and past performance may not be repeated.

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**Portland Focused Plus Fund LP**  
**Portland Focused Plus Fund**  
ANNUAL LETTER TO INVESTORS  
FOR THE YEAR ENDED DECEMBER 31, 2019

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund LP				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.5%
2013	33.0%	34.1%	37.7%	34.4%	13.0%	32.4%
2014	15.6%	16.8%	18.8%	17.5%	10.6%	13.7%
2015	6.5%	7.5%	8.3%	8.5%	-8.3%	1.4%
2016	39.0%	40.4%	45.5%	41.6%	21.1%	12.0%
2017	16.4%	17.5%	19.9%	18.6%	9.1%	21.8%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-8.9%	-4.4%
2019	49.3%	50.8%	54.7%	52.4%	22.9%	31.5%

Since Inception (Oct. 31, 2012)

Compound annual	18.7%	19.9%	22.2%	20.8%	7.7%	14.6%
Cumulative return	242.5%	267.0%	321.7%	288.0%	70.5%	165.6%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Annual Total Return					
	Portland Focused Plus Fund				S&P/TSX Index	S&P 500 Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	15.8%	10.5%
2017	15.5%	16.7%	19.4%	18.1%	9.1%	21.8%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-8.9%	-4.4%
2019	48.5%	50.1%	53.2%	51.8%	22.9%	31.5%

Since Inception (Mar. 31, 2016)

Compound annual	18.1%	19.2%	21.8%	20.6%	9.7%	15.0%
Cumulative return	86.4%	93.3%	109.7%	101.9%	41.5%	69.2%

Notes:

Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. Performance for both indices is per TD Securities Inc. The S&P 500 Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the

Funds' returns reflect the use of leverage. The use of a benchmark is for illustrative purposes only, and is not an indication of performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

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Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at <http://www.portlandic.com/focusedplusfundLP.html> for the LP and at <http://www.portlandic.com/focusedplusfundtrust.html> for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

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As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

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The performance of the LP and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The LP's factsheet ("Fund Brief"), which shows performance updated to the latest available month-end including annualized returns over various time periods, may be found at the LP's web page referenced above.

For 2019, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 50.8% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 22.9% for the S&P/TSX Index and to a return of 31.5% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices had a return of 27.2%. For the entire period since inception of the LP on October 31, 2012 to December 31, 2019, the LP's series F units achieved a cumulative return of 267.0%. That compares to a cumulative total return of 70.5% for the S&P/TSX Index and 165.6% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices had a cumulative return of 118.0%. Accordingly, in both the one-year period of 2019 and the cumulative period since the LP's inception, the LP has met its investment objective of preservation of capital and a satisfactory return. It's worth noting that the LP also offers four series of units with lower fees for larger investors, three of which series have units outstanding (Series M, Series P and Series Q). Due to their lower fees, these latter three series have even higher returns than the series F. The different series are discussed further below.

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## Awards

I'm pleased to report that the LP was a winner of three 2019 Canadian Hedge Fund Awards in the category of Equity Focused funds for achieving 3<sup>rd</sup> place, Best 3-Year Return; 2<sup>nd</sup> place, Best 1-Year Return; and, most importantly from my perspective (because it's the longest time period), 1<sup>st</sup> place, Best 5-Year Return.<sup>4</sup> This follows receipt by the LP of a 2018 Canadian Hedge Fund Award for achieving 3<sup>rd</sup> place in the category of Equity Focused funds, Best 5-Year Return and the LP's receipt of the 2017 Investment Fund Award conferred by the Private Capital Markets Association of Canada.<sup>5</sup> These awards recognize the LP's long-term performance. Since the LP may be affected by short-term vagaries in equity markets, which may be accentuated by the LP's use of leverage, it has always been suggested that investors assess performance over periods of not less than five years.<sup>6</sup>

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## Performance of the Trust

As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts while the Trust is intended for registered investment accounts and for non-Canadians.<sup>7</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the management and long-term performance of the two Funds will be similar. That is why Portland has decided to distribute the same annual letters to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the table on the inside front cover of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

For 2019, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 50.1% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 22.9% for the S&P/TSX Index and to a return of 31.5% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices had a return of 27.2%. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2019, the Trust's series F units achieved a cumulative return of 93.3%. That compares to a cumulative total return of 41.5% for the S&P/TSX Index and 69.2% for the S&P 500 Index in US\$. A 50%/50% blend of the two indices had a cumulative return of 55.3%. Accordingly, in both the one-year period of 2019 and the cumulative period since the Trust's inception, the Trust has met its investment objective of preservation of capital and a satisfactory return. As was noted with reference to the LP, the Trust also offers four series of units with lower fees for larger investors, two of which series have units outstanding (Series M and Series P). Due to their lower fees, both of these latter series have even higher returns than the series F units. The different series are discussed further below.

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## Monthly Fund Updates

Shortly after every month-end, I send out fund updates by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, net asset value per unit and

net assets. When circumstances merit, these updates may also include comments on important events impacting the LP and the Trust and the investment outlook. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from that list.

### Series of Fund Units

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The Funds have designated six series of units, five of which have units outstanding. The features of each of the series are outlined below:<sup>8</sup>

- **Series A units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit ("High Water Mark") of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee;
- **Series P units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee;
- **Series O units** are charged a negotiated management fee and/or performance fee directly to Portland. Series O units will only be issued to certain institutional or other investors. No series O units have yet been issued; and
- **Series Q units** have a minimum initial subscription amount of \$10,000,000; and a management fee of 0.75% per annum. Series Q units do not have a performance fee. The LP has issued series Q units while the Trust has not.

As can be seen in the tables on the inside front cover of this letter, for the period from October 31, 2012 to December 31, 2019, the LP's series F units had a cumulative return of 267.0% while the LP's series M units and series P units had higher cumulative returns of 321.7% and 288.0%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2019, the Trust's series F units had a cumulative return of 93.3% whereas the Trust's series M units and series P units had higher cumulative returns of 109.7% and 101.9%, respectively.

Going forward, with respect to each of the Funds, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent

that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long-term performance.

### **Operating Expenses**

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The Funds incur operating expenses for such items as fund administration, audit fees, legal fees, and preparation of income tax returns and tax slips.<sup>9</sup> These expenses are relatively fixed (i.e., they are insensitive to a fund's asset size). That means that as a fund grows, and its operating expenses are spread over a larger asset base, the fund's operating expense ratio (i.e., the ratio of its operating expenses to its net assets) tends to decline which helps drive better fund performance.

I'm pleased to report that the LP's operating expense ratio fell from 0.37% plus applicable tax in 2018 to 0.24% plus applicable tax in 2019. That is because the LP's average net assets rose from \$36.7 million in 2018 to \$48.1 million in 2019. Conversely, the Trust, which was launched 3½ years after the LP, has yet to achieve the same economies of scale. The Trust's operating expense ratio in both 2018 and 2019 remained at 0.50% of net assets plus tax. At December 31, 2019, net assets of the LP and Trust (before subscriptions and redemptions effective on that date) were \$52.8 million and \$30.4 million, respectively (in the latter case, excluding distributions payable, almost all of which were reinvested).

While there can be no assurance that the operating expense ratios of the LP and Trust will remain at or below their 2019 levels of 0.24% and 0.50%, respectively (in both cases, plus applicable tax), Portland remains committed to tight management of fees and expenses so as to maximize the Funds' returns. Indeed, if the Trust maintains its current level of net assets, its operating expense ratio may decline in 2020.

### **Leverage Management**

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As I wrote this section I was reminded of the Academy Award-nominated song that has been performed by Bing Crosby, Paul McCartney and many others: "Ac-Cent-Tchu-Ate the Positive."<sup>10</sup> As suggested by that title, in this section we discuss how the Funds seek to vary their asset mix to enhance their returns.

The 2013 letter discussed at length the LP's use of leverage.<sup>11</sup> Leverage refers to buying stocks on margin (i.e., using borrowed money) to increase the Funds' assets and potentially their rates of return. In simple (pretax) terms, if stocks bought with borrowed money achieve rates of return (dividends plus capital gains) higher than the rate of interest on the borrowed funds, then the use of leverage would enhance the Funds' performance. Certainly, the careful use of a variable amount of leverage has been an important factor in achieving the Funds' strong performance outlined earlier in this letter.

As good as the Funds' performance has been, however, there is no room for complacency. As with other endeavours, examining history is an excellent means of learning from the past and

seeking to do better in the future. In my opinion, an examination of the Funds' history reveals that performance would have been even better had I more actively managed the Funds' leverage. By that I do not mean *increasing* the amount of leverage. The Funds already have a proven history of increasing leverage when favourable opportunities have arisen (while always leaving room for a possible further equity market decline so as to avoid a margin call, which neither Fund has ever experienced). Instead, if more significant changes in leverage seem appropriate, and it can't (for prudence reasons) be done at the high end of leverage, then it must be done at the low end, i.e., by selling stocks and reducing the Funds' equity weights more aggressively when conditions are favourable. That is exactly what the Funds did in 2019, particularly in the second half of the year. At December 31, 2018, the LP's common stock investments comprised 270% of its net assets (facilitated by the use of margin borrowings). At December 31, 2019, however, the LP's weight in common stocks had fallen dramatically to 57% of the LP's net assets while the remaining 43% was held in cash and other assets (the Trust's asset mix at both year-ends was similar, before giving effect to subscriptions, redemptions and distributions). This recent high cash weighting, which is unprecedented in the life of either the LP or Trust, is a response to stock markets which hit record levels in late 2019 (and which set even higher records in early 2020) and that carried stocks into territory that I believe is relatively expensive. The high cash weights may cause the Funds to lag if stock markets go ever higher. If, however, as history suggests, there will always be occasional periods in which equity markets decline, the high cash positions will limit the Funds' downsides in such periods and provide excellent opportunities to deploy capital when stocks are more favourably priced. In brief, the purpose of the Funds' leverage management strategy is to, as Bing Crosby sang, "spread joy up to the maximum, bring gloom down to the minimum."

### **Tax Management**

The 2016 Letter stated that the Funds are generally managed so as to try to keep unrealized capital gains as of any December 31 in the range of 10% to 25% of each Fund's net asset value.<sup>12</sup> The Funds' more active leverage management discussed above, however, has implications for unrealized gains. In brief, more active leverage management, such as selling down holdings that have appreciated in order to reduce margin debt, suggests that unrealized capital gains may not be as high a percentage of net assets as they have sometimes been in the past. Therefore, the updated target is to try to keep unrealized capital gains as of any December 31 in the range of -10% to +10% of each Fund's net asset value. At December 31, 2019, unrealized gains were within this range as they were approximately 6% of the LP's net assets (and a similar percentage of the Trust's net assets, excluding the impact of distributions payable at year-end). As 2018 amply demonstrated, volatility in equity markets, particularly toward year-end, may result in actual unrealized capital gains (or losses) being outside of the range of -10% to +10% of net assets (either higher or lower), but that is the aspiration. Further, striving to keep unrealized capital gains in the range of -10% to +10% of net assets helps to minimize the likelihood of an investor subscribing for units when the Funds have substantial unrealized capital gains in which the investor did not participate. As stated in the 2016 Letter, "the Funds will not let the tax tail wag the investment dog...Tax consequences are an important, but secondary, consideration (and will vary with each investor in any event)."

### TINA meets FOMO (or Party Like It's 1999)

As described in the 2015 and 2016 Letters, persistently low interest rates have buttressed the demand for equities since they look attractive compared to the very low interest rates obtainable on cash and government bonds.<sup>13</sup> This phenomenon has been widely described as ‘there is no alternative’, a condition that is better known by its acronym, TINA. In my opinion, the unrelenting melt-up in equity prices since December 2018 has now morphed into something even stronger. This is what younger people, consumed by envy regarding the great lives that their peers are seemingly enjoying as suggested by their posts on social media, refer to as ‘fear of missing out’, or FOMO. Similarly, those investors holding low or negative yielding cash and bonds, watching as investors in equities have been enjoying steady gains, are capitulating so that they, too, can join the party. What happens when TINA meets FOMO? The table below updates one that was included in the 2015 and 2016 Letters.<sup>14</sup>

S&P 500 Index	2012	2013	2014	2015	2016	2017	2018	2019
Average index value	1,379	1,643	1,932	2,061	2,094	2,448	2,744	2,912
Closing index value	1,426	1,848	2,059	2,044	2,239	2,674	2,507	3,231
Operating earnings	96.82							
Average price-earnings	14.2	15.3	17.1	20.5	19.7	19.7	18.1	18.7
Closing price-earnings	14.7	17.2	18.2	20.3	21.1	21.5	16.5	20.7

In brief, while the S&P 500 Index's average price/earnings (P/E) ratio on 2019 operating earnings (i.e., excluding specified items) in 2019 was a robust but not excessive 18.7 times, by the end of 2019 it had shot up to a closing P/E ratio of 20.7 times (with, at time of writing, 88% of S&P 500 companies having reported their 2019 results). That level is certainly on the high side compared to its historical levels, although it is by no means unprecedented.

Some people would assert that because of today's low interest rates, stocks should trade at much higher P/E ratios than they have historically. In other words, some would assert that “this time it's different”. I consider those to be the four most dangerous words in investing. If they are used to justify recent equity valuations, the implicit premise is that interest rates will stay low forever. That may not be the case. In any event, even if it were, it would not prevent occasional material declines in equity prices. Indeed, even though interest rates have stayed historically very low since stocks bottomed in March 2009 (during the global financial crisis), there have been what I consider to be three bear markets in equities (i.e., declines of at least 20%) since that time, as follows:

- From the high of the S&P 500 Index on May 2, 2011, to its low on October 4, 2011, the index declined by 21.6%.<sup>15</sup> During this time, Standard & Poor's downgraded the credit rating of the U.S. government,<sup>16</sup> and there were also market concerns about slowing economic growth in China and falling commodity prices;
- From the S&P 500 Index's 2015 high to its low on February 11, 2016, the index declined by 15.2%.

As was described in the 2016 letter, however, during that period many of the world's equity markets experienced drops of more than 20%, with Canada's S&P/TSX Index declining by 25.7%.<sup>17</sup> During this period, market concerns included the collapse in world oil prices and whether banks would have significant energy-related loan losses (which, as subsequent performance showed, they didn't); and

- From the S&P 500 Index's then record high on September 21, 2018 to its low on December 26, 2018 (Boxing Day Sale!), the index declined by 20.2%. The greatest market concern in that period appeared to be a hawkish statement from Jerome ("Jay") Powell, the chair of the Federal Reserve, which suggested that interest rates might rise significantly.<sup>18</sup>

The last of these periods, in particular, should serve as a cautionary tale for investors. If interest rates rise when they are expected to stay flat, or even if interest rates stay flat when they are expected to decline, equity prices could decline.

Mark Twain is alleged to have said that "history doesn't repeat, but it rhymes."<sup>19</sup> To me, while recent market conditions have been nowhere near as extreme as the technology bubble of 1999, there is some resemblance. Then, numerous companies sported market capitalizations so high that they cast, to put it mildly, reasonable doubt on the long-term rates of return that investors would earn if they bought companies at such high valuations. That is to say nothing of the many companies who commanded large market capitalizations that had never been profitable. Today, several (generally technology-related) companies now command market capitalizations of over \$1 trillion.<sup>20</sup> For investors to earn an 8% return on investing in such businesses, their market capitalizations would have to increase by \$80 billion per year (before accounting for dividends or the impact of possible share repurchases). That is a tall order for any business, no matter how profitable. Speaking of profits, at least one company that has never had a profitable year now commands a market capitalization of well over \$100 billion.<sup>21</sup>

What is an investor to do in the current circumstances? Should we throw caution to the wind and, as music icon Prince suggested, "Party Like It's 1999"?<sup>22</sup> Or should we, as anecdotally it seems that far too many investors have done in the last decade, go entirely to cash and wait for another apocalyptic meltdown? I prefer the middle path, which is to continually recall that it is not a stock market, it's a market of stocks. If one is investing in a stock market index, then index valuations are of great importance. For the Funds, however, in my estimation all that they need is a handful of undervalued, high quality, large capitalization companies in order to be invested so as to fulfill their investment objectives of, over the long term, preservation of capital and satisfactory returns. Current bullish equity market conditions make that job harder, but not impossible. As for the future, someday equities will be the artist formerly known as a bull market. When that day arrives, I hope, through the prudent leverage management described earlier in this letter, to be able to increase the Fund's equity weights significantly.

### **Five Years Down, 45 More Years to Go**

In the 2014 Letter, I had the audacity (foolhardiness?) to provide 50-year return forecasts for selected major asset classes (hey, I'm unlikely be alive in 2064 to have to defend the forecasts!).<sup>23</sup> How time flies! Already, five years have passed. This is an appropriate time to check in

with those forecasts to see how the various items have actually been doing. As a reminder from the 2014 Letter, actual results will differ from these forecasts and the differences could be material. The predictions do not account for major, low probability, outlier events which have come to be known as “black swans”. These could include, for example, a nuclear terrorist attack on the U.S. or a global pandemic which could dramatically affect investment returns. I’ve assumed, instead, that the world will muddle through as that is the high-probability scenario for which one should plan (while remaining mindful of downside risk in extreme scenarios).

The following table summarizes the 50-year return forecasts made in the 2014 Letter, with a starting point of December 31, 2014, and the actual returns for the five years ended December 31, 2019:<sup>24</sup>

Asset class total returns  
Forecast vs. actual returns  
Five years ended 2019

	50-year fore- cast	Actual, 5 years ended 2019
S&P/TSX Canadian banks index	8.50%	8.51%
S&P 500 Index, US\$	6.00%	11.68%
S&P 500 Index ETF, C\$	5.59%	13.78%
Canadian bond index ETF	2.67%	2.97%
Cash	2.50%	1.00%
Inflation	2.00%	1.84%

What I consider were the three most important projections (all with a 50-year horizon from the end of 2014 to the end of 2064) that the 2014 Letter tried to convey were as follows:

- Among the three major asset classes, stocks would outperform bonds which would outperform cash;
- Canadian bank stocks would provide total returns of 8.5% per annum; and
- Canadian bank stocks would outperform the S&P 500 Index.

How have things been working out so far? Well, in the words of Meat Loaf, “two out of three ain’t bad”.<sup>25</sup> First, the rank ordering of returns of the three major asset classes has been as predicted (i.e., stocks have outperformed bonds which have outperformed cash). Second, in a feat of either great foresight or extraordinary luck (can we tell them apart?), the Canadian banks have had annualized total returns as predicted (i.e., 8.5% per annum). Third, contrary to the forecast in the 2014 Letter, the S&P 500 Index in US\$ has enjoyed even stronger returns than have the Canadian banks, and its returns in Canadian dollars (C\$) have been stronger still. What have been the reasons for these various returns, and what implications do they have for the future? At the outset, I should state that I stand by the asset class return forecasts I made in the 2014 Letter. I don’t intend to update them as they were purposefully planned to be very long-term. The following three paragraphs address in general terms each of the above three major projections.

First, regarding the rank ordering of asset class returns, the yields offered on bonds and cash at the end of 2014 were so paltry that it was plain that under any reasonably likely scenario for equities, they would outperform bonds and cash. That remains the case today. That is why the Funds continue to seek out equity investments which, if they exceed 100% of the Funds' net assets, are financed with margin borrowings at very low interest rates.

Second, the returns from investing in Canadian banks were predicted to be comprised of an initial dividend yield of 4.0%, real growth of dividend of 2.5%, inflation of 2.0%, and no change in valuation (P/E ratio or price to dividends), for expected total returns of 8.5% per annum.<sup>26</sup> That is broadly speaking how it has played out so far, although the growth rates of earnings and dividends have been higher than forecast, offset by some contraction in valuation. Going forward, I continue to believe that high quality banks bought at sensible valuations will provide satisfactory total returns. That is why banks remain an important component of the Funds' portfolios. At December 31, 2019, before giving effect to subscriptions and redemptions as of that date, North American banks represented 46.6% of the LP's net assets (and a similar percentage of the Trust's net assets, also before giving effect to its year-end distributions).

Third, I would attribute the outperformance of the S&P 500 Index in the last five years primarily to U.S. public policy changes which have been generally favourable for equities. In particular, the reduction in the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018 resulted in a substantial increase in corporate earnings and a commensurate increase in stock prices. This, combined with deregulation and generally pro-business public policy, has unleashed what John Maynard Keynes referred to as "animal spirits",<sup>27</sup> so that not only have earnings increased, but also so has the P/E ratio. This combination multiplied together has resulted in the substantial outperformance of U.S. equities. Finally, in the 2014 Letter I expected the long-term value of the Canadian dollar to remain at its level then of C\$1.00 = US\$0.86.<sup>28</sup> Instead, sustained low world oil prices, combined with what I believe has been bad public policy in Canada by the federal government (such as higher income tax rates, cancellation of certain major infrastructure projects and increased regulatory burden and uncertainty), has decreased Canada's attractiveness as a place in which to invest and likely contributed to the decline of the C\$. For the five years from the end of 2014 to the end of 2019, the C\$ fell from US\$0.86 to US\$0.77 (i.e., the US\$ appreciated from C\$1.16 to C\$1.30), further boosting U.S. equity returns when expressed in C\$.

### **Who Wants to Be a Millionaire?**

The primary purpose of doing the 50-year asset class return forecasts included in the 2014 Letter was to provide guidance to a hypothetical young adult, who was assumed to have turned 18 in 2014, as to how to invest his or her tax-free savings account (TFSA). This was described in the final section of the 2014 Letter titled "Using Tax-Free Savings Accounts for Long-Term Wealth Creation".<sup>29</sup> That section described how a person just turned 18 (the minimum age for having a TFSA), who contributed the maximum amount to her TFSA at the beginning of every year, and who earned a compound annual rate of return of 8.5% (which was the long-term rate of return then estimated for Canadian bank stocks), would by the end of 2064 build a TFSA with a value

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [www.portlandic.com/focusedplusfundLP.html](http://www.portlandic.com/focusedplusfundLP.html) and [www.portlandic.com/focused-plusfundtrust.html](http://www.portlandic.com/focused-plusfundtrust.html).
3. For a discussion, see 2013 Letter, p. 3.
4. <http://alternativeiq.com/canadian-hedge-fund-awards/about/>. The awards are based solely on quantitative performance data of 197 Canadian hedge funds to June 30th, 2019 with Fundata Canada managing the collection and tabulation of the data to determine the winners. There is no nomination process or subjective assessment in identifying the winning hedge funds.
5. 2017 Letter, p. 4. The Canadian Hedge Fund Awards are based solely on quantitative performance data of 207 Canadian hedge funds to June 30th, 2018 with Fundata Canada managing the collection and tabulation of the data to determine the winners. There is no nomination process or subjective assessment in identifying the winning hedge funds. Private Capital Markets Award nominees are evaluated based on their leadership in the industry, their contribution to the deal, innovative market, product or investment opportunities created, the benefits of the deal for the issuer and for investors, and the overall impact of the deal on the quality and integrity of the private capital markets.
6. 2013 Letter, p. 3 and especially p. 8.
7. 2016 Letter, pp. 5-6.
8. OM, pp. 6-7 and pp.13-14.
9. Ibid., pp. 14-15.
10. [https://en.wikipedia.org/wiki/Ac-Cent-Tchu-Ate\\_the\\_Positive](https://en.wikipedia.org/wiki/Ac-Cent-Tchu-Ate_the_Positive)
11. 2013 Letter, pp. 5-8.
12. 2016 Letter, pp. 6-7.
13. 2015 Letter, pp. 14-15; and 2016 Letter, pp. 9-10.
14. 2015 Letter, p. 14; 2016 Letter, p. 9.
15. Unless otherwise noted, all data in this section is from Refinitiv (formerly Thomson Reuters). Also, index levels are intraday highs and lows (not daily close highs and lows).
16. [https://money.cnn.com/2011/08/05/news/economy/downgrade\\_rumors/index.htm](https://money.cnn.com/2011/08/05/news/economy/downgrade_rumors/index.htm)
17. 2016 Letter, pp. 11-12.
18. 2018 Letter, pp. 10-11.
19. <https://quoteinvestigator.com/2014/01/12/history-rhymes/>
20. <https://www.cnbc.com/2020/01/31/amazon-amzn-reaches-1-trillion-market-cap.html>

21. <https://markets.businessinsider.com/news/stocks/tesla-stock-price-gain-brings-market-value-100-billion-first-2020-1-1028835953>
22. <https://www.youtube.com/watch?v=rblt2EtFfC4>
23. 2014 Letter, pp. 16-27 (especially the table on pp. 25-26).
24. Actual returns have been sourced as follows. The returns of the S&P/TSX Canadian banks index and the S&P 500 Index in US\$ are from Bloomberg. The returns of the S&P 500 Index exchange-traded fund (ETF) in Canadian dollars (C\$) are those of the iShares Core S&P 500 Index ETF (symbol XUS). The returns of the Canadian bond index ETF are those of the iShares Core Canadian Universe Bond Index ETF (symbol XBB). The returns for cash are those of 91-day Canadian treasury bills according to Bloomberg. The annual inflation rate is according to the Bank of Canada's inflation calculator.
25. [https://en.wikipedia.org/wiki/Two\\_Out\\_of\\_Three\\_Ain%27t\\_Bad](https://en.wikipedia.org/wiki/Two_Out_of_Three_Ain%27t_Bad)
26. 2014 Letter, pp. 23-25 (especially the table on p. 25).
27. Keynes, John Maynard. *The General Theory of Employment, Interest, and Money* (first Harcourt, Inc., edition, 1964, originally published in 1936), p. 161.
28. 2014 Letter, pp. 19-20.
29. *Ibid.*, pp. 32-34.
30. *Ibid.*, p. 33.
31. <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/tax-free-savings-account/contributions.html>
32. [https://en.wikipedia.org/wiki/Who\\_Wants\\_to\\_Be\\_a\\_Millionaire\\_\(American\\_game\\_show\)](https://en.wikipedia.org/wiki/Who_Wants_to_Be_a_Millionaire_(American_game_show))
33. 2014 Letter, p. 34.

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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2020

**Portland Focused Plus Fund LP  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.8%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.9%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.7%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	21.2%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.1%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-10.0%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.5%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%

Year	Annualized Total Returns as of December 31, 2020					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
3 years	16.9%	18.1%	20.4%	19.3%	4.2%	14.5%
5 years	20.9%	22.1%	25.0%	23.3%	8.1%	15.1%
Since inception	19.6%	20.7%	23.2%	21.7%	6.6%	14.7%

Year	Cumulative Total Returns as of December 31, 2020					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
3 years	59.9%	64.7%	74.7%	69.7%	13.0%	50.0%
5 years	158.6%	171.7%	204.8%	185.0%	47.4%	101.6%
Since inception	330.8%	366.3%	450.7%	397.9%	68.3%	205.8%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.0%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.1%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-10.0%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.5%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%

Year	Annualized Total Returns as of December 31, 2020					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
3 years	16.8%	18.1%	20.2%	19.4%	4.2%	14.5%
Since inception	19.9%	21.1%	23.9%	22.5%	7.7%	15.7%

Year	Cumulative Total Returns as of December 31, 2020					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
3 years	59.4%	64.7%	73.8%	70.2%	13.0%	50.0%
Since inception	137.1%	148.6%	177.1%	162.6%	42.3%	100.1%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012 and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportions, the performance of the Funds may not be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup> Note that prior to 2020, Portland had used as benchmarks the S&P/TSX Composite Index ("S&P/TSX Index") and the Standard & Poor's 500 Index ("S&P 500 Index") in US\$. The change was made for reasons of cost effectiveness; the long-term performance of MSCI Canada is similar to that of the S&P/TSX Index, and likewise the long-term performance of MSCI USA is similar to that of the S&P 500 Index.

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables have been expanded in this year's letter to include annualized and cumulative returns over various time periods, as are shown in the LP's monthly factsheet ("Fund Brief"). The latter may be found at the LP's web page referenced above. To accommodate the extra information, the performance tables are now spread out over two pages of this letter, one page each for the LP and the Trust.

For 2020, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 27.1% (all performance figures for the Funds are net of fees, expenses and taxes thereon). That compares to a return of 3.5% for MSCI Canada and to a return of 20.7% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 12.1%. For the entire period since inception of the LP on October 31, 2012 to December 31, 2020, the LP's series F units achieved a cumulative return of 366.3%. That compares to a cumulative total return of 68.3% for MSCI Canada and 205.8% for MSCI USA in US\$. A 50%/50% blend of the two indices had a cumulative return of 137.1%. Accordingly, in both the one-year period of 2020 and the cumulative period since the LP's inception, the LP has met its investment objective of preserva-

tion of capital and a satisfactory return. It's worth noting that the LP also offers four series of units with lower fees for larger investors, three of which series have units outstanding (series M, series P and series Q). Due to their lower fees, these latter three series have even higher returns than the series F. The different series are discussed further below. Also, in December 2020, Portland began distributing the LP in Quebec. This award-winning fund is now available across Canada.

### **Canadian Hedge Fund Award**

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I'm pleased to report that the LP was a winner of a 2020 Canadian Hedge Fund Award for achieving 3rd place in the category of Equity Focused funds, Best 5-Year Return.<sup>4</sup> This marked the third consecutive year in which the LP has won at least one Canadian Hedge Fund Award. These awards followed the LP's receipt of the 2017 Investment Fund Award conferred by the Private Capital Markets Association of Canada.<sup>5</sup> These awards recognize the LP's long-term performance. Since the LP may be affected by short-term vagaries in equity markets, which may be accentuated by the LP's use of leverage, it has always been suggested that investors assess performance over periods of not less than five years.<sup>6</sup>

### **Performance of the Trust**

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>7</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the management and long-term performance of the two Funds will be similar. That is why Portland has decided to distribute the same annual letters to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2020, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 28.6% (all performance figures for the Funds are net of fees, expenses and taxes thereon). That compares to a return of 3.5% for MSCI Canada and to a return of 20.7% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 12.1%. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2020, the Trust's series F units achieved a cumulative return of 148.6%. That compares to a cumulative total return of 42.3% for MSCI Canada and 100.1% for MSCI USA in US\$. A 50%/50% blend of the two indices had a cumulative return of 71.2%. Accordingly, in both the one-year period of 2020 and the cumulative period since the Trust's inception, the Trust has met its investment objective of preservation of capital and a satisfactory return. As was noted with reference to the LP, the Trust also offers four series of units with lower fees for larger investors, two of which series have units outstanding (series M and series P). Due to their lower fees, both of these latter series have even higher returns than the series F units. The different series are discussed further below.

## Monthly Fund Updates

Shortly after every month-end, I send out fund updates by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, net asset value per unit and net assets. When circumstances merit, as was the case during 2020, these updates may also include comments on important events impacting the LP and the Trust and the investment outlook. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from that list.

## Series of Fund Units

The Funds have designated six series of units, five of which have units outstanding. The features of each of the series are outlined below:<sup>8</sup>

- **Series A units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit ("High Water Mark") of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee;
- **Series P units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount above the High Water Mark of the series. Series P units do not have a management fee;
- **Series O units** are charged a negotiated management fee and/or performance fee directly to Portland. Series O units will only be issued to certain institutional or other investors. No series O units have yet been issued; and
- **Series Q units** have a minimum initial subscription amount of \$10,000,000; and a management fee of 0.75% per annum. Series Q units do not have a performance fee. The LP has issued series Q units while the Trust has not.

As can be seen in the tables on pages two and three of this letter, for the period from October 31, 2012 to December 31, 2020, the LP's series F units had a cumulative return of 366.3% while the LP's series M units and series P units had higher cumulative returns of 450.7% and 397.9%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2020, the Trust's series F units had a cumulative return of 148.6% whereas the Trust's series M units and series P units had higher cumulative returns of 177.1% and 162.6%, respectively.

Going forward, with respect to each of the Funds, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long-term performance.

### **Operating Expenses**

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The Funds incur operating expenses for such items as fund administration, audit fees, legal fees, and preparation of income tax returns and tax slips.<sup>9</sup> These expenses are relatively fixed (i.e., they are insensitive to a fund's asset size). That means that as a fund grows, and its operating expenses are spread over a larger asset base, the fund's operating expense ratio (i.e., the ratio of its operating expenses to its net assets) tends to decline which helps drive better fund performance.

I'm pleased to report that the LP's operating expense ratio fell from 0.24% plus applicable tax in 2019 to 0.18% plus applicable tax in 2020. That is partly because the LP's average net assets rose from \$48.1 million in 2019 to \$48.2 million in 2020. Similarly, the Trust's operating expense ratio fell from 0.50% plus applicable tax in 2019 to 0.30% plus applicable tax in 2020. That was largely because the Trust's average net assets rose from \$26.6 million in 2019 to \$32.4 million in 2020. At December 31, 2020, net assets of the LP and Trust (before subscriptions and redemptions effective on that date) were \$67.2 million and \$45.5 million, respectively (in the latter case, excluding distributions payable, almost all of which were reinvested).

While there can be no assurance that the operating expense ratios of the LP and Trust will remain at or below their 2020 levels of 0.18% and 0.30%, respectively (in both cases, plus applicable tax), Portland remains committed to tight management of fees and expenses so as to maximize the Funds' returns.

### **COVID-19**

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No 2020 investment letter would be complete without a section on the coronavirus disease 2019 ("COVID-19") pandemic.<sup>10</sup> The first case was identified in Wuhan, China in December 2019. By early March 2020, COVID-19 had been reported in a number of countries around the world. On March 11, 2020, the World Health Organization declared that COVID-19 could be characterized as a pandemic.<sup>11</sup>

Just as the spread of the virus was swift, so, too, was the reaction in financial markets. The following is just a sampling of the tumultuous events that characterized the first few months of 2020:

- The S&P 500 Index (cited here because of its wide use) experienced its fastest-ever declines

of (10%)<sup>12</sup>, (20%)<sup>13</sup> and (30%)<sup>14</sup>. For example, from its peak on February 19, 2020, it took just 22 trading days to fall by (30%).<sup>15</sup> From its peak on February 19, 2020 until its ultimate bear market low on March 23, 2020, just over a month later, the S&P 500 Index declined (on an intraday basis) by a total of (35.4%).<sup>16</sup>

- On March 16, 2020, the VIX Index (which is the popular name for the Chicago Board Options Exchange's CBOE Volatility Index, and that is often referred to as a fear gauge) closed at 82.7, its highest level ever (yes, even higher than during the global financial crisis).<sup>17</sup>
- On March 25, 2020, one-month and three-month U.S. Treasury yields turned negative for only the second time ever.<sup>18</sup> And,
- On April 20, 2020, West Texas Intermediate ("WTI") crude oil futures prices briefly fell into negative territory for the first time ever. Market participants who owned the expiring futures contracts had to pay buyers over US\$37 per barrel to take the commodity off their hands.<sup>19</sup>

Yet despite the carnage of the virus in human terms (that continues to this day), its carnage in financial markets proved to be short-lived. On August 18, 2020, just five months after its bear market low and only six months since its February 19, 2020 record high, the S&P 500 Index reached a new record high, marking its fastest-ever recovery from a bear market.<sup>20</sup> U.S. equities continued to advance and, as noted earlier in this letter, the MSCI USA Index (in US\$) ultimately posted a return for 2020 of 20.7% (while the MSCI Canada Index lagged far behind with a 2020 return that, while positive, was only 3.5%).

What accounted for this remarkable stock market advance in the face of great economic adversity? To me, the primary factor, which has been written about in previous annual letters, is that There Is No Alternative, a phenomenon better known by its acronym, TINA.<sup>21</sup> Historically, the three main asset classes have been considered to be equities (stocks), fixed income (bonds) and cash and cash equivalents.<sup>22</sup> Apart from equities, the other two major asset classes (i.e., cash and fixed income) currently have yields at or very near zero. Adjusted for inflation, such yields are often negative in real terms. For those seeking positive real returns, that leaves equities as the only traditional asset class (together with some other non-traditional asset classes, discussed in the next section). The TINA factor accounts for stock market indices hitting record highs notwithstanding COVID-19's heavy human and economic toll. Further, the virus seems likely to be with us indefinitely (despite vaccinations which should greatly reduce, but not eliminate, its impact by the end of 2021). The stock market ebullience in the face of the COVID-19 pandemic reminds me of those stock market pundits, rock group R.E.M., who sang "It's the End of the World as We Know It (and I Feel Fine)".<sup>23</sup>

### **If I Had A Trillion Dollars**

Many years ago, U.S. Senator Everett McKinley Dirksen, referring to out of control federal government spending, wryly observed that "a billion here, a billion there, and pretty soon you're talking real money."<sup>24</sup> More recently, Canadian rock band Barenaked Ladies sang "if I had a million dol-

lars, I'd be rich."<sup>25</sup>

How quaint those notions seem now. Today, a million dollars is certainly not rich; in fact, it may not be enough to fund long and uncertain retirement expenses (let alone buy anyone's love). As for governments, a billion dollars is now chump change. Government spending, deficits and debt are now measured in trillions. For example, on March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief and Economic Security Act, also known as the CARES Act.<sup>26</sup> It created government spending of US\$2.2 trillion. Following another relief bill passed in December 2020 with a price tag of US\$0.9 trillion, in January 2021 newly-inaugurated President Biden proposed yet another relief plan with a cost of US\$1.9 trillion.<sup>27</sup> The total assets of the U.S. central bank (i.e., the Federal Reserve) increased from US\$0.9 trillion at the end of 2007 (just before the global financial crisis), to US\$4.2 trillion at the end of 2019 (just before the pandemic), to US\$7.4 trillion at the end of 2020.<sup>28</sup> In 2020, a broad measure of U.S. money supply known as M2 (that includes cash, chequing deposits, savings deposits and money market securities)<sup>29</sup> increased by over 24%.<sup>30</sup>

In my opinion, the unprecedented spending and money creation that have occurred since the start of the pandemic will inevitably result in higher inflation. By definition, inflation is a general increase in prices and fall in the purchasing power of money.<sup>31</sup> As discussed in the 2013 Letter, over the long term inflation inflicts a terrible toll on investors.<sup>32</sup> Yet according to the U.S. Labor Department, U.S. inflation in 2020 was only 1.4%.<sup>33</sup> While inflation as measured in the ivory towers of government agencies remains subdued, out in the real world, inflation is already running rampant. For example, the table on the next page shows the price changes of selected items during 2020.<sup>34</sup>

#### SELECTED ASSETS PRICE CHANGE IN 2020

Asset	Price 31-Dec-19	Price 31-Dec-20	% change
Gold, US\$/oz.	\$1,517.27	\$1,898.36	25%
Natural gas, US\$/mcf	\$2.19	\$2.54	16%
Copper, US\$/lb.	\$2.80	\$3.52	26%
Corn, US\$/bushel	\$4.11	\$4.84	18%
MSCI USA Index			19%
House price index, Canada			9%

To summarize the above table, in 2020, the price of gold, considered for centuries to be an inflation hedge, rose in price (in US\$) by 25% (while the price of bitcoin, promoted by some who foresee the declines of fiat currencies, rose 305%. That is not shown in the table since bitcoin is relatively new, small and speculative). Natural gas, a fuel in widespread use for electricity generation and home heating, rose 16%. Copper, an essential commodity used in wiring, construction and industrial machinery, rose 26%. Corn, the most valuable crop in America,<sup>35</sup> rose 18%. The MSCI USA Index, which may be thought

of as the price to buy a thin sliver of U.S. public companies, rose 19%. And for all you home-gamers (as CNBC's Jim Cramer would say), the Canadian house price index rose by 9%. To paraphrase Senator Dirksen: homes, stocks, gold, copper, gas, corn; pretty soon you're talking about a general increase in prices. In my opinion, investors must assume that inflation will continue and they should give serious thought to how their investments may perform if inflation should accelerate.

### **Turning Japanese (and British and French)**

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As I reflect on 2020, I'm reminded of the hit song by English new wave group The Vapors, "Turning Japanese".

The financial statements of the Funds are posted at their web pages (the LP's web page is [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) while the Trust's is [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust)). Those who have reviewed these financial statements over the years (OK, has anyone done that besides me?) couldn't help but notice a material change in 2020. Whereas in prior years the equities held in the Funds were almost entirely domiciled in Canada and the U.S., in 2020 that changed. At the end of 2020, as a percentage of the LP's net assets (prior to subscriptions and redemptions), equities held were domiciled in the U.S., 55.6%; Japan, 39.1%; the U.K., 18.1%; France, 7.5%; and Canada, 6.9%. These percentages sum to greater than 100% because of the LP's use of margin borrowings. Also, the Trust's percentage weights were similar to those of the LP, exclusive of year-end distributions paid by the Trust, most of which were reinvested.

What changed in 2020 was the addition of Dragos Stefanescu to Portland's investment team. Dragos is a CFA charterholder with considerable investment management experience. Prior to joining Portland, Dragos was an investment professional at Ontario Teachers' Pension Plan for 16 years culminating in his role as Director, Global Equities. One of the roles that Dragos has at Portland is to work with me in the management of the Funds and to generate investment ideas for possible inclusion in the Funds. The global experience that Dragos brings to this role has been reflected in the portfolios of the Funds. Their portfolios are now more diversified by sector and geography than was previously the case. That is helpful because considering a wider range of investment opportunities is, in my opinion, likely to enhance the long-term returns of the Funds. Just as importantly, this greater investment diversity can serve to mitigate risk. For example, with the addition of Dragos to Portland's investment team, I am now prepared to hold as many as 15 companies in the Funds as compared to my former self-imposed limit of 10 (which happened to be the number held at December 31, 2020). Per capita (i.e., per investment professional researching the Funds' investments), this is still tightly focused, as the Funds have been since their inceptions and will remain.

As always, I am fully responsible for the investment decisions and resulting performance of the Funds. If the Funds continue to succeed, please spread the praise, while if there is ever a short-fall, blame me (not Dragos). I am genuinely excited about the potential return-enhancing, risk-reducing benefits to the Funds from their greater international diversification. So yes, at least for now, the Funds are turning Japanese, I really think so.

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. <http://alternativeiq.com/canadian-hedge-fund-awards/about/>. The Canadian Hedge Fund Awards are based solely on quantitative performance data of 214 Canadian hedge funds to June 30th, 2020 with Fundata Canada managing the collection and tabulation of the data to determine the winners. There is no nomination process or subjective assessment in identifying the winning hedge funds.
5. 2017 Letter, p. 4. Private Capital Markets Award nominees are evaluated based on their leadership in the industry, their contribution to the deal, innovative market, product or investment opportunities created, the benefits of the deal for the issuer and for investors, and the overall impact of the deal on the quality and integrity of the private capital markets.
6. 2013 Letter, p. 3.
7. 2016 Letter, pp. 5-6.
8. OM, pp. 6-7 and pp.13-14.
9. OM, pp. 14-15.
10. [https://en.wikipedia.org/wiki/Coronavirus\\_disease\\_2019](https://en.wikipedia.org/wiki/Coronavirus_disease_2019)
11. <https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020>
12. <https://www.cnbc.com/2020/02/27/this-is-the-fastest-stock-market-correction-in-history.html>
13. <https://www.ft.com/content/d895a54c-64a4-11ea-a6cd-df28cc3c6a68>
14. <https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html>
15. Ibid.
16. Source: Bloomberg LP.
17. <https://en.wikipedia.org/wiki/VIX>
18. <https://www.cnbc.com/2020/03/25/negative-rates-come-to-the-us-1-month-and-3-month-treasury-bill-yields-are-now-negative.html>
19. <https://www.bbc.com/news/business-52350082>
20. <https://www.wsj.com/articles/the-s-p-500-sets-first-record-since-february-erasing-its-coronavirus-plunge-11597781130>
21. 2015 Letter, pp. 14-15; 2016 Letter, pp. 9-11; and 2019 Letter, pp. 7-9.
22. <https://www.investopedia.com/terms/a/assetclasses.asp>
23. [https://en.wikipedia.org/wiki/It%27s\\_the\\_End\\_of\\_the\\_World\\_as\\_We\\_Know\\_It\\_\(And\\_I\\_Feel\\_Fine\)](https://en.wikipedia.org/wiki/It%27s_the_End_of_the_World_as_We_Know_It_(And_I_Feel_Fine))
24. [https://www.senate.gov/artandhistory/history/minute/Senator\\_Everett\\_Mckinley\\_Dirksen\\_Dies.htm](https://www.senate.gov/artandhistory/history/minute/Senator_Everett_Mckinley_Dirksen_Dies.htm)
25. <https://genius.com/Barenaked-ladies-if-i-had-s1000000-lyrics>
26. [https://en.wikipedia.org/wiki/CARES\\_Act](https://en.wikipedia.org/wiki/CARES_Act)
27. <https://www.cnbc.com/2021/01/21/covid-stimulus-update-biden-relief-plan-faces-republican-moderate-opposition.html>
28. [https://www.federalreserve.gov/monetarypolicy/bst\\_recenttrends.htm](https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)
29. <https://www.investopedia.com/terms/m/m2.asp>
30. <https://fred.stlouisfed.org/series/M2>
31. <https://en.wikipedia.org/wiki/Inflation>
32. 2013 Letter, pp. 16-17.
33. <https://www.usinflationcalculator.com/inflation/current-inflation-rates/>
34. All data is from Bloomberg LP except for the House Price Index (Canada) data which is from Teranet and National Bank of Canada at <https://housepriceindex.ca/2021/01/december2020/>
35. <https://www.statista.com/statistics/204447/selected-crop-values-in-the-united-states/>

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The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performances of the Funds.

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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel: 1-888-710-4242 • Fax: 1-866-722-4242 • www.portlandic.com • info@portlandic.com



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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2021

**Portland Focused Plus Fund LP**  
**Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.6%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.8%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.9%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.7%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	21.2%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.1%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-10.0%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.5%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
2021	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%

Year	Annualized Total Returns as of December 31, 2021					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
3 years	29.7%	31.0%	34.8%	32.4%	16.1%	25.9%
5 years	16.7%	17.8%	20.5%	19.0%	8.9%	18.1%
Since inception	19.2%	20.4%	23.0%	21.4%	8.4%	15.9%

Year	Cumulative Total Returns as of December 31, 2021					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
3 years	118.1%	125.0%	144.8%	132.2%	56.4%	99.8%
5 years	116.1%	127.2%	153.8%	139.0%	53.1%	129.9%
Since inception	400.2%	447.4%	567.2%	491.4%	110.3%	286.8%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.0%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.1%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-10.0%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.5%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
2021	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%

Year	Annualized Total Returns as of December 31, 2021					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
3 years	29.8%	31.2%	34.7%	32.7%	16.1%	25.9%
5 years	16.3%	17.6%	20.2%	18.9%	8.9%	18.1%
Since inception	19.2%	20.4%	23.4%	21.8%	10.5%	17.5%

Year	Cumulative Total Returns as of December 31, 2021					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
3 years	118.5%	125.9%	144.5%	133.7%	56.4%	99.8%
5 years	113.2%	124.9%	150.5%	138.0%	53.1%	129.9%
Since inception	174.4%	190.9%	234.7%	210.8%	77.7%	153.0%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012 and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportions, the performance of the Funds may not be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables are also shown in the LP's factsheet ("Fund Brief") which is updated monthly about a week after every month-end and posted to the LP's web page referenced above.

In 2021, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 17.4% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 24.9% for MSCI Canada and to a return of 26.5% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 25.7%. As a result, in 2021 the LP underperformed its benchmark indices (although the LP still enjoyed strong absolute returns). For the five years ended December 31, 2021 (I have always suggested that five years is the minimum reasonable period for measuring performance),<sup>4</sup> the LP's series F units had a cumulative return of 127.2%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 53.1% and 129.9%, respectively. A 50%/50% blend of the two indices had a return of 91.5%. As a result, for the five years ended December 31, 2021 the LP outperformed its benchmark indices. For the entire period since inception of the LP on October 31, 2012 to December 31, 2021, the LP's series F units achieved a cumulative return of 447.4%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 110.3% and 286.8%, respectively. A 50%/50% blend of the two indices had a return of 198.6%. As a result, for the cumulative period since the LP's inception, the LP outperformed its benchmark indices and deliv-

ered strong absolute returns. Accordingly, in both the five years ended December 31, 2021 and the cumulative period since the LP's inception, the LP has met its investment objective of preservation of capital and a satisfactory return. It's worth noting that the LP also offers four series of units with lower fees for larger investors, three of which series have units outstanding (series M, series P and series Q). Due to their lower fees, these latter three series have even higher returns than the series F. The different series are discussed further below.

While I'm pleased that the LP has met its investment objective over both five years and since inception, I was not satisfied with the LP's relative performance in 2021. In my opinion, this was partly due to the stock market's infatuation with very expensive information technology stocks (which the LP does not own) and disregard for the businesses in which the LP was invested (in this aspect, the recent period bore some resemblance to the technology bubble of 1999 and the early part of 2000). I'm glad to report that in early 2022, these conditions changed dramatically as what the LP did not own fell out of investor favour while what the LP did own enjoyed a return to greater favour. As a result, for the two months ended February 28, 2022, the LP had a return of 5.1%. By contrast, in the same period, MSCI Canada and MSCI USA had returns of (0.3%) and (8.5%), respectively. I believe that this strong start to the year augurs well for continued satisfactory absolute and relative long-term performance of the LP.

### **Performance of the Trust**

As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end in which the portfolios diverge materially, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the management and long-term performance of the two Funds will be similar. That is why Portland distributes the same annual letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2021, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 17.0% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 24.9% for MSCI Canada and to a return of 26.5% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 25.7%. As a result, in 2021 the Trust underperformed its benchmark indices (although the Trust still enjoyed strong absolute returns). For the five years ended December 31, 2021, the Trust's series F units had a cumulative return of 124.9%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 53.1% and 129.9%, respectively. A 50%/50% blend of the two indices had a return of 91.5%. As a result, for the five years ended December 31, 2021 the Trust outperformed its bench-

mark indices. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2021, the Trust's series F units achieved a cumulative return of 190.9%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 77.7% and 153.0%, respectively. A 50%/50% blend of the two indices had a return of 115.4%. As a result, for the cumulative period since the Trust's inception, the Trust outperformed its benchmark indices and delivered strong absolute returns. Accordingly, in both the five years ended December 31, 2021 and the cumulative period since the Trust's inception, the Trust has met its investment objective of preservation of capital and a satisfactory return. As was noted with reference to the LP, the Trust also offers four series of units with lower fees for larger investors, two of which series have units outstanding (series M and series P). Due to their lower fees, both of these latter series have even higher returns than the series F units. The different series are discussed further below. As was described above with reference to the LP, the Trust has enjoyed a strong start to 2022. Specifically, for the two months ended February 28, 2022, the Trust had a return of 5.6%. By contrast, in the same period, MSCI Canada and MSCI USA had returns of (0.3%) and (8.5%), respectively.

### Monthly Fund Updates

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Shortly after every month-end, I send out fund updates by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, net asset value per unit and net assets. When circumstances merit, these updates may also include comments on important events impacting the LP and the Trust and the investment outlook. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's prior written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from that list.

### Series of Fund Units

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The Funds have designated six series of units, five of which have units outstanding. The features of each of the series are outlined below:<sup>6</sup>

- **Series A units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 2% per annum; and a performance fee of 10% of the amount above the highest ever net asset value per unit ("High Water Mark") of the series. A trailing commission of 1% per annum is paid to financial advisors whose clients invest in series A units;
- **Series F units** have a minimum initial subscription amount of \$2,500 for accredited investors (\$150,000 for other non-individual subscribers); a management fee of 1% per annum; and a performance fee of 10% of the amount above the High Water Mark of the series;
- **Series M units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a management fee of 1% per annum. Series M units do not have a performance fee;
- **Series P units** have a minimum initial subscription amount of \$500,000 or more in respect of the Trust, or \$1,000,000 or more in respect of the LP; and a performance fee of 10% of the amount

above the High Water Mark of the series. Series P units do not have a management fee;

- **Series O units** are charged a negotiated management fee and/or performance fee payable directly to Portland. Series O units will only be issued to certain institutional or other investors. No series O units have yet been issued; and
- **Series Q units** have a minimum initial subscription amount of \$10,000,000; and a management fee of 0.75% per annum. Series Q units do not have a performance fee. The LP has issued series Q units while the Trust has not.

As can be seen in the tables on pages two and three of this letter, for the period from October 31, 2012 to December 31, 2021, the LP's series F units had a cumulative return of 447.4% while the LP's series M units and series P units had higher cumulative returns of 567.2% and 491.4%, respectively. For the period from inception of the Trust on March 31, 2016 to December 31, 2021, the Trust's series F units had a cumulative return of 190.9% whereas the Trust's series M units and series P units had higher cumulative returns of 234.7% and 210.8%, respectively.

Going forward, with respect to each of the Funds, the series P units are certain to continue to have returns greater than the series F units since the series P units have no management fee. Similarly, the series M units will have a performance greater than the series F units to the extent that the Funds earn performance fees. Thus, investors who have the means to meet the minimum initial subscription amounts for the series M and series P units are encouraged to do so in order to take advantage of the lower fees applicable to those series which will continue to enhance their long-term performance.

### **Operating Expenses**

The Funds incur operating expenses for such items as fund administration, audit fees, legal fees, and preparation of income tax returns and tax slips.<sup>7</sup> These expenses are relatively fixed (i.e., they are insensitive to a fund's asset size). That means that as a fund grows, and its operating expenses are spread over a larger asset base, the fund's operating expense ratio (i.e., the ratio of its operating expenses to its net assets) tends to decline which helps drive better fund performance.

I'm pleased to report that the LP's operating expense ratio fell from 0.18% plus applicable tax in 2020 to 0.10% plus applicable tax in 2021. That is because the LP's average net assets rose from \$48.2 million in 2020 to \$92.2 million in 2021. Similarly, the Trust's operating expense ratio fell from 0.30% plus applicable tax in 2020 to 0.23% plus applicable tax in 2021. That was because the Trust's average net assets rose from \$32.4 million in 2020 to \$57.2 million in 2021. At December 31, 2021, net assets of the LP and Trust (before subscriptions and redemptions effective on that date) were \$90.6 million and \$61.6 million, respectively (in the latter case, excluding distributions payable, almost all of which were reinvested).

While there can be no assurance that the operating expense ratios of the LP and Trust will remain

at or below their 2021 levels of 0.10% and 0.23%, respectively (in both cases, plus applicable tax), Portland remains committed to careful management of fees and expenses so as to maximize the Funds' returns.

### **Tax Management**

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The 2019 letter stated that the Funds are managed so as to try to keep unrealized gains as of any December 31 in the range of -10% to +10% of each Fund's net asset value.<sup>8</sup> Volatility in equity markets, however, particularly toward year-end, may result in unrealized capital gains (or losses) falling outside of the range of -10% to +10% of net assets, but that is the aspiration.

During 2021, there was considerable speculation that the 2021 federal budget might increase the "capital gains inclusion rate."<sup>9</sup> That is the percentage (currently 50%) of capital gains that is included in taxable income. I shared those concerns, and therefore chose to realize a substantial amount of capital gains in the LP prior to the April 19, 2021 federal budget.<sup>10</sup> That was not necessary to do in the Trust, as its investors are generally tax-deferred or tax-free registered plans. In the event, the 2021 federal budget did not change the capital gains inclusion rate (although I would not be surprised to see that happen in 2022, given that it forms part of the platform of the New Democratic Party,<sup>11</sup> on whom the minority Liberal government relies for support).

As a result of the combination of realizing many capital gains in the LP in the first four months of 2021, followed by a late-year swoon in the stock market prices of several of the LP's holdings, at December 31, 2021 the LP's net unrealized capital losses were 19% of its net assets. On the same date, the Trust's net unrealized capital losses were 7% of its net assets (adjusted for distributions payable on that date, most of which were reinvested). In practical terms, what this means is that the investors in the Funds in 2021 received taxable allocations (or distributions in the case of the Trust) which exceeded the investors' returns in 2021. The unrealized capital losses at year-end may reverse in future years, i.e., future returns may exceed the amount of taxable allocations (or distributions) in such years. Indeed, given the strong performance of the Funds in early 2022 as described above, this may be the case as soon as 2022. I expect these sorts of swings (i.e., in investment returns and taxable allocations) to approximately even out over time. That is one of the reasons that I encourage all investors in the Funds to have a time horizon of at least five years.

### **Price Is What You Pay; Value Is What You Get - Part II**

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A section of the 2015 Letter was titled after a well-known expression of legendary investor Warren Buffett: "price is what you pay; value is what you get."<sup>12</sup> By this, Buffett refers to the possible disconnect in the stock market between a company's share price (i.e., what you pay) and its intrinsic value (i.e., what you get). Recent circumstances have made it appropriate to follow up that discussion with another example.

To illustrate how wide the disparity between price and value can be, let's consider a tale of two companies. While these are actual businesses listed on the Toronto Stock Exchange, for now we'll call them Company A and Company B. A brief statistical comparison of the two companies is provided in the table below:<sup>13</sup>

<u>Selected data items (C\$ millions):</u>	<u>Company A</u>	<u>Company B</u>
Market capitalization (November 19, 2021)	\$188,112	\$268,708
Average annual net income, 2017-2021	\$12,556	\$760
Common shareholders' equity	\$91,983	\$14,371
Dividend (November 19, 2021 indicated rate)	\$6,158	\$0

The data items listed in the table are as follows:

- **Market capitalization** is the product of the stock market price per share multiplied by the most recently published number of common shares outstanding. At the date of the comparison (November 19, 2021), Company A had a market capitalization (i.e., “price”) of \$188 billion. That was considerably lower than Company B’s market capitalization of \$269 billion. By contrast, indicators of the disparity in “value” between the two businesses are listed in the remainder of the table.
- **Average annual net income** shows the average net income attributable to common shareholders for the five years ended in 2021. Despite the fact that Company A’s market capitalization was (30%) less than that of Company B, Company A had average annual net income of \$12.6 billion compared to less than \$0.8 billion for Company B. In other words, Company A’s average annual net income in the most recent five years was more than 16 times that of Company B.
- **Common shareholders’ equity** is the amount of the company’s assets (at their accounting or carrying value) minus all of the company’s liabilities. Using the most recent quarterly information available prior to the date of the comparison, Company A had common equity of \$92.0 billion while Company B had common equity of \$14.4 billion. In other words, Company A’s common shareholders’ equity was more than six times that of Company B.
- **Dividend** is the indicated rate of the company’s annual amount of common share dividends as of the date of the comparison. Company A was paying annual dividends of \$6.2 billion. Company B did not pay a dividend.

There is a popular conversation or party game that poses a dilemma in the form of a question beginning with “would you rather”.<sup>14</sup> Let’s assume, for a moment, that you just won a monstrously large lottery in the amount of \$269 billion. The condition of the prize, however, is that you must invest it into buying Company A or Company B and the only information provided to you about the two companies is the data in the table above. Would you rather buy all of Company B for \$269 billion, or all of Company A for \$188 billion and still have \$81 billion in cash to spare? Would it take you more than a few seconds to choose the latter? I think not.

Company A is Canada’s largest bank, Royal Bank of Canada (“RBC”). Company B is the Ottawa-based e-commerce company, Shopify Inc. (“Shopify”). On May 6, 2020, Shopify surpassed RBC to become Canada’s largest public company in terms of market capitalization.<sup>15</sup> Shopify continued its run at the top for more than a year, reaching its all-time high closing stock price on November 19, 2021 (the date of the comparisons in the above table).<sup>16</sup> Alas, price is what you pay; value is what you get. The implications of that phrase are explored more fully in the next two sections of this letter.

## The RBC Curse Strikes Again

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In overtaking RBC's market capitalization, Shopify joined a short list (pun intended) of other companies which have accomplished that feat since the turn of the 21<sup>st</sup> century. As was chronicled in a section of the 2015 Letter titled "The RBC Curse", the complete list, prior to the addition of Shopify, was (in chronological order): Nortel Networks Corporation; Manulife Financial Corporation; Encana Corporation; Research in Motion Limited; Potash Corporation of Saskatchewan; Barrick Gold Corporation; and Valeant Pharmaceuticals International Inc.<sup>17</sup> In various ways, all of these companies subsequently had an ignominious fall from grace and they, or their successors, are now trading at market capitalizations far below that of RBC (except for Nortel, which is no longer publicly traded as it went bankrupt). For the gory details, see the 2015 Letter. To paraphrase Groucho Marx, this is a club to which you do not want to belong.

Even when these companies surpassed RBC in market capitalization, their intrinsic values were clearly lower than that of RBC based on historical facts and established standards of value. The father of value investing, Benjamin Graham (to whom the Funds' investment objective of "over the long term, preservation of capital and a satisfactory return" pays homage) stated that "in the short run, the market is a voting machine, but in the long run, it's a weighing machine."<sup>18</sup> What Graham meant by that is that at any given moment, a stock may have a price (i.e., market capitalization) which is far above (or below) its intrinsic value because of the company's extreme popularity (or unpopularity). Over the long run, however, the stock market has an uncanny tendency to restore the market capitalization of companies to something resembling their intrinsic value. To underscore the timelessness of this tendency, Graham prefaced his classic text, *Security Analysis*, with a quotation from the Roman poet Horace: "Many shall be restored that now are fallen and many shall fall that now are in honour."<sup>19</sup> Incidentally, this propensity is one of the reasons that the Funds are such strong adherents to focused investing. It is not every day that a large, financially strong company with a long history of sales and earnings and competent, ethical management goes on sale (i.e., trades far below its intrinsic value). When that happens, the Funds seek to capitalize to the fullest extent possible by taking very large positions (sometimes exceeding 40% of net assets in individual businesses). The Funds do so in anticipation that, as so often happens, the market prices of such businesses will revert closer to their intrinsic values, providing the Funds with strong returns. Furthermore, I believe that buying such businesses at prices far below their intrinsic values offers what Graham called a "margin of safety".<sup>20</sup>

In the context of the above paragraph, what has become of Shopify? Since its intraday all-time high on November 19, 2021 to its closing price on February 28, 2022, Shopify's stock price fell by (62%). As a result, on the latter date, Shopify's market capitalization was (45%) lower than that of RBC. What changed at Shopify to cause such a sharp revaluation? In brief, not much. The biggest change in market conditions in recent months is that certain types of businesses, those with formerly very high valuations relative to their previously-reported sales and earnings, have suddenly fallen out of favour in the Wall Street fashion show. For Shopify specifically, one could say that the RBC curse strikes again.

## Short Selling

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Short selling refers to the practice of selling an asset that one doesn't own (and which thus must be borrowed from someone who does own the asset so as to deliver it to the buyer) in the hope that the asset will decline in price. At that time, the short seller may purchase the asset, close out the position and profit from the difference between the sale price and the subsequent purchase price.<sup>21</sup> The Funds have the ability to sell short.<sup>22</sup> Yet, the Funds have never engaged in short sales (with which I have considerable personal experience, most positive and one negative, from early in my career). To understand how the Funds operate, it would be worthwhile to explore this matter a little further.

As was stated in the 2013 Letter, short selling was included in the investment strategies of the Funds in order to give them investment flexibility.<sup>23</sup> That letter also noted, however, that there are two reasons to be wary of short selling. The first reason is that a long position can only go to zero, whereas the potential loss on a short sale is theoretically unlimited. The second, little-appreciated reason to be wary of short sales is that when a long position goes against you, its size gets progressively smaller, whereas when a short position goes against you, its size gets progressively larger. These two drawbacks of short sales can be both financially and emotionally debilitating. As a result, as that section of the 2013 Letter concluded, short selling in the Funds is likely to be limited in both amount and duration. As noted above, but which bears repeating, the Funds have never, in fact, engaged in short sales.

In my opinion, during much of 2021, the stock market placed unjustifiably high valuations (to put it mildly) on the "new new thing": e-commerce, electric vehicles and special purpose acquisition companies ("SPACs"), just to name a few examples. To my mind, it was a speculative mania reminiscent of the technology bubble of 1999 and early 2000, when in the market's estimation no valuation was too high for technology companies and no valuation was too low for non-technology companies. Then, as in 2021, the mania was fuelled by very easy monetary policies of the world's central banks. I found the conditions in 2021 to be so extreme that I did consider two short sales. One (that I won't mention by name) has since had its share price fall by more than 50%. The other, on which I wrote an internal memo on May 10, 2021, was Shopify.

On May 10, 2021, Shopify closed at \$1,303.28 per share. Had the Funds shorted it at that time, they would have had to endure an immediate and substantial increase in Shopify's stock price. Its intraday stock price peaked on November 19, 2021 at \$2,288.73 for a six-month gain of 76%. Shopify's stock price then began a very sharp fall, reaching a closing price on February 28, 2022 of \$879.92 for a decline from its peak of (62%). Its decline compared to its price on May 10, 2021, however, was only (32%). Thus, had the Funds shorted Shopify on May 10, 2021, they first would have had to endure a harrowing 76% increase in its stock price. In addition to being destructive to short term investment performance, the rise would have required that substantially more margin have been dedicated to supporting the short sale, thus reducing the Funds' ability to buy and hold other investments. In my opinion, when the decline in Shopify's stock price finally did come, it would not have been enough to justify the risks and negative consequences during the period that the position would have been held. That is in part because there is nothing terribly wrong with Shopify's business: it's a Canadian-based global success story, profitable, with

skilled founder-management and a very strong financial position. The latter is partly attributable to management's astute use of the period when its shares were more in favour to issue equity to raise cash. Its reset in stock market valuation has simply been in keeping with other companies of its ilk.

When considering short sales, it's important to recall the saying attributed to John Maynard Keynes: "the market can stay irrational longer than you can stay solvent."<sup>24</sup> For better or worse, I will continue to be wary of short selling and expect that most, or all, of the Funds' investments will continue to be long positions.

### **Big Trouble in Little China**

One of the companies owned in the Funds is the investment holding company SoftBank Group Corp. ("SoftBank"). In 2020, SoftBank contributed 7.6 percentage points to the LP's annual return in that year. In 2021, however, SoftBank detracted 3.0 percentage points from the LP's return.<sup>25</sup> In my opinion, the biggest reason for SoftBank's declining share price in 2021 was its investments in China. At December 31, 2021, investments in China accounted for 32% of SoftBank's net asset value.<sup>26</sup> SoftBank's largest single investment in China is its part ownership of e-commerce giant Alibaba Group Holding Limited ("Alibaba").<sup>27</sup>

Readers of a certain vintage may recall an action-comedy film starring Kurt Russell, *Big Trouble in Little China*. To my mind, the movie couldn't be saved either by Russell or by its leading lady, Kim Cattrall (who went on to star as Samantha in the television series and movie, *Sex and the City*). Audiences seemed to agree and in its initial release *Big Trouble in Little China* was a box office flop. Improbably (at least to me), it has gone on to become a cult classic.<sup>28</sup>

China's influence on global affairs is no longer little and its recent actions have certainly caused big trouble. Beginning in late 2020, Chinese authorities seemed to become suddenly uncomfortable with the size and influence of China's private sector. As if to leave no doubt as to who is the boss, the Chinese Communist Party, under its leader president Xi Jinping, commenced a major, multi-faceted crackdown on China's private sector. Space doesn't permit a full chronicling of its actions. Some of the major ones are as follows:

- On November 3, 2020, China suspended what would have been the world's largest initial public offering ("IPO"), that of financial technology company Ant Group, just two days before it was to occur.<sup>29</sup> Alibaba owned 33% of Ant Group and would have been one of the largest beneficiaries of the IPO. On news of the cancellation, Alibaba's stock price fell by 7%. At the time of writing this letter, the Ant Group IPO has yet to be revived.
- In April 2021, Chinese anti-monopoly regulators fined Alibaba a record amount of US\$2.8 billion.<sup>30</sup>
- Chinese ride-hailing company DiDi Global Inc. ("DiDi") completed its IPO on the New York Stock Exchange ("NYSE") on June 30, 2021.<sup>31</sup> Just days later, Chinese regulators, seemingly infuriated that DiDi had proceeded with the U.S. IPO over their objections, ordered smart phone app stores to stop offering DiDi's app.<sup>32</sup> It was then reported that Chinese regulators were considering serious, perhaps unprecedented, penalties for DiDi.<sup>33</sup> On December 2, 2021, DiDi announced that its board of directors had authorized it to delist from the NYSE and seek a listing on the Hong Kong Stock

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. See, e.g., 2013 Letter, p. 3.
5. 2016 Letter, pp. 5-6.
6. OM, pp. 6-7 and pp.13-14.
7. OM, pp. 14-15.
8. 2019 Letter, p. 7.
9. See, for example, [https://www.investmentexecutive.com/inside-track\\_/jamie-golombek/worried-about-a-possible-increase-to-the-capital-gains-inclusion-rate/](https://www.investmentexecutive.com/inside-track_/jamie-golombek/worried-about-a-possible-increase-to-the-capital-gains-inclusion-rate/)
10. [https://en.wikipedia.org/wiki/2021\\_Canadian\\_federal\\_budget](https://en.wikipedia.org/wiki/2021_Canadian_federal_budget)
11. <https://www.advisor.ca/tax/tax-news/ndp-pledges-to-raise-top-marginal-tax-rate-capital-gains-inclusion-rate/>
12. 2015 Letter, pp. 12-13.
13. In the table, market capitalizations are derived from shares outstanding from company reports and share prices from Bloomberg LP; and other data items are from company reports (for Company A’s fiscal years ended October 31 and Company B’s fiscal years ended December 31). Company B reports in US\$; its common equity and average annual net income were converted to C\$ at the rate of exchange on November 19, 2021.
14. [https://en.wikipedia.org/wiki/Would\\_you\\_rather](https://en.wikipedia.org/wiki/Would_you_rather)
15. <https://www.bnnbloomberg.ca/shopify-displaces-rbc-to-become-canada-s-most-valuable-company-1.1432436>
16. All stock price data in this and the next two sections of the letter are from Bloomberg LP.
17. 2015 Letter, pp. 13-14.
18. <https://www.goodreads.com/quotes/831517-in-the-short-run-the-market-is-a-voting-machine>
19. Horace, *Ars Poetica*, quoted at the beginning of Benjamin Graham and David L. Dodd, *Security Analysis* (McGraw-Hill, 1934 first edition).
20. <https://www.valuwalk.com/2016/12/margin-of-safety/>
21. <https://www.investopedia.com/terms/s/shortselling.asp>
22. OM, p. 3.
23. 2013 Letter, pp. 10-11.
24. <https://quoteinvestigator.com/2011/08/09/remain-solvent/>
25. Performance attribution figures are Portland’s internal calculations.
26. Presentation materials for Softbank’s results for the nine months ended December 31, 2021, slide 18.
27. *Ibid.*, slide 17.
28. [https://en.wikipedia.org/wiki/Big\\_Trouble\\_in\\_Little\\_China](https://en.wikipedia.org/wiki/Big_Trouble_in_Little_China)
29. <https://www.cnbc.com/2020/11/03/ant-group-ipo-in-shanghai-suspended.html>
30. <https://www.bbc.com/news/business-56713508>
31. <https://www.reuters.com/business/chinas-didi-raises-4-billion-us-ipo-source-2021-06-29/>
32. <https://www.cnbc.com/2021/07/04/didi-app-suspended-in-china-over-data-protection.html>
33. <https://www.bnnbloomberg.ca/china-weighs-unprecedented-penalty-for-didi-after-u-s-ipo-1.1631709>
34. <https://ir.didiglobal.com/news-and-events/news/news-details/2021/DiDi-Announces-Recent-Developments/default.aspx>
35. <https://asia.nikkei.com/Business/SoftBank2/SoftBank-s-investment-strategy-in-China-unchanged-CFO>
36. <https://www.cnbc.com/2021/07/28/uber-shares-drop-as-softbank-plans-to-sell-shares-to-cover-didi-losses.html>

The PORTLAND FOCUSED PLUS FUND LP (the "LP") and PORTLAND FOCUSED PLUS FUND (the "Trust") (collectively, the "Funds") are not publicly offered. They are only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Funds is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Funds made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performances of the Funds.

For the avoidance of doubt, MSCI is not the benchmark "administrator" for, or a "contributor", "submitter" or "supervised contributor" to, the blended returns, and the MSCI Data is not considered a "contribution" or "submission" in relation to the blended returns, as those terms may be defined in any rules, laws, regulations, legislation or international standards. MSCI Data is provided "AS IS" without warranty or liability and no copying or distribution is permitted. MSCI does not make any representation regarding the advisability of any investment or strategy and does not sponsor, promote, issue, sell or otherwise recommend or endorse any investment or strategy, including any financial products or strategies based on, tracking or otherwise utilizing any MSCI Data, models, analytics or other materials or information.

Commissions, trailing commissions, management fees and expenses all may be associated with investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or optional charges or income taxes payable by any unitholder in respect of a fund that would have reduced returns. Funds are not guaranteed, their values change frequently and past performance may not be repeated.

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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel: 1-888-710-4242 • Fax: 1-866-722-4242 • www.portlandic.com • info@portlandic.com



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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2022

**Portland Focused Plus Fund LP**  
**Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.7%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.7%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.7%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.0%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	20.3%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.4%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-9.7%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.1%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
2021	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
2022	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%

Year	Annualized Total Returns as of December 31, 2022					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%
3 years	0.3%	1.3%	3.4%	2.4%	6.5%	7.0%
5 years	5.1%	6.2%	8.1%	7.3%	5.7%	8.7%
10 years	13.0%	14.1%	16.4%	15.1%	6.9%	11.8%
Since inception	13.0%	14.1%	16.4%	15.1%	6.9%	11.8%

Year	Cumulative Total Returns as of December 31, 2022					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%
3 years	0.8%	4.0%	10.6%	7.5%	20.8%	22.4%
5 years	28.1%	34.9%	47.9%	42.1%	32.0%	52.1%
10 years	239.5%	274.6%	356.9%	308.8%	95.2%	205.6%
Since inception	245.1%	281.9%	366.2%	316.9%	96.5%	210.0%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.1%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.4%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-9.7%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.1%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
2021	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
2022	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%

Year	Annualized Total Returns as of December 31, 2022					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%
3 years	1.0%	2.1%	4.2%	3.3%	6.5%	7.0%
5 years	5.3%	6.4%	8.3%	7.6%	5.7%	8.7%
Since inception	10.2%	11.3%	13.6%	12.6%	7.8%	11.0%

Year	Cumulative Total Returns as of December 31, 2022					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%
3 years	3.0%	6.6%	13.1%	10.2%	20.8%	22.4%
5 years	29.2%	36.4%	48.7%	44.3%	32.0%	52.1%
Since inception	92.1%	106.0%	137.1%	122.6%	66.1%	102.8%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012 and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportions, the performance of the Funds may not be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables are also shown in the LP's factsheet ("Fund Brief") which is updated monthly about a week after every month-end and posted to the LP's web page referenced above.

In 2022, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of -30.2% (all performance figures for the Funds are net of fees and expenses). That compares to a return of -6.5% for MSCI Canada and to a return of -19.8% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of -13.2%. As a result, in 2022 the LP underperformed its benchmark indices. For the five years ended December 31, 2022 (I have always suggested that five years is the minimum reasonable period for measuring performance<sup>4</sup>), the LP's series F units had a cumulative return of 34.9%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 32.0% and 52.1%, respectively. A 50%/50% blend of the two indices had a return of 42.0%. As a result, for the five years ended December 31, 2022 the LP underperformed its benchmark indices. For the entire period since inception of the LP on October 31, 2012 to December 31, 2022, the LP's series F units achieved a cumulative return of 281.9%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 96.5% and 210.0%, respectively. A 50%/50% blend of the two indices had a return of 153.3%. As a result, for the full period since the LP's inception, the LP outperformed its benchmark indices.

While the LP achieved a positive return for the five years ended December 31, 2022 (and thus more than preserved capital in that period), it was the first five-year period (ending on a December 31) in which the LP did not outperform its benchmark indices. I am dissatisfied with this result (as I know that many investors are) and have taken clear, significant and decisive steps to improve investment performance. This is discussed more fully later in this letter in the first paragraph of the section titled “Back to the Future”.

### **Performance of the Trust**

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust’s investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end in which the portfolios diverge materially, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the management and long-term performance of the two Funds will be similar (as has, in fact, been the case, as is described in a later section of this letter). That is why Portland distributes the same annual letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust’s Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust’s web page referenced at the start of this letter.

In 2022, the Trust’s series F units (the highest fee series without embedded advisor compensation) had a return of -29.2% (all performance figures for the Funds are net of fees and expenses). That compares to a return of -6.5% for MSCI Canada and to a return of -19.8% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of -13.2%. As a result, in 2022 the Trust underperformed its benchmark indices. For the five years ended December 31, 2022, the Trust’s series F units had a cumulative return of 36.4%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 32.0% and 52.1%, respectively. A 50%/50% blend of the two indices had a return of 42.0%. As a result, for the five years ended December 31, 2022 the Trust underperformed its benchmark indices. For the entire period since inception of the Trust on March 31, 2016 to December 31, 2022, the Trust’s series F units achieved a cumulative return of 106.0%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 66.1% and 102.8%, respectively. A 50%/50% blend of the two indices had a return of 84.5%. As a result, for the full period since the Trust’s inception, the Trust outperformed its benchmark indices.

Similarly to the LP, the five years ended December 31, 2022 was the first five-year period (ending on a December 31) in which the Trust did not outperform its benchmark indices. Factors that affected 2022 performance, and the outlook, are discussed in detail later in this letter.

### **Monthly Fund Updates**

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Shortly after every month-end, fund updates are sent out by email for each of the LP and the

Trust. These are generally factual in nature, with data on performance, net asset value per unit and net assets. Since September 2022, these updates have included a link to a PowerPoint presentation regarding the two funds (which is also available on their web pages cited above). Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from all emails from Portland.

### Comparison of LP and Trust returns

As noted earlier, the LP and the Trust are managed virtually identically. As a result, their performances should be similar. That has been the case, as is shown in the table below.

#### Annualized Performance

<u>Periods ended December 31, 2022</u>	One year	Three years	Five years
LP	-30.2%	1.3%	6.2%
Trust	-29.2%	2.1%	6.4%
LP vs. Trust	-1.0%	-0.8%	-0.2%

As can be seen in the table, the long-term performance of the LP and Trust is similar. For example, for the five years ended December 31, 2022, the LP had a return of 6.2% per annum compared to the Trust's return of 6.4% per annum. Despite this similarity, and the fact that the Funds have always been managed so as to achieve similar performance, some investors and financial advisors sometimes believe that the performance of the Trust is much worse than that of the LP (as noted above, the Trust's performance has, in fact, been slightly better than that of the LP). I believe that this mistaken impression arises from the distributions paid annually by the Trust. This is discussed more fully in the next section of this letter.

### Distributions and Returns

The LP does not pay distributions. Mutual funds trusts (like the Trust), however, are required to distribute their net income to their investors. To do so, the Trust pays distributions on December 31 of every year. The vast majority of investors reinvest their distributions into additional units. From an accounting perspective, the market value of those additional units is added to the investor's original cost, resulting in a higher figure for "book value" (sometimes referred to as "book cost"), a figure which is commonly cited on client statements of investment firms. The accumulation of these reinvested distributions results in higher and higher figures for "book value" over time. That leads some investors (and advisors) to believe that investments in the Trust have performed more poorly than they have, because they mistakenly compare market value to "book value" which due to the reinvested distributions is not the investor's original cost.

This misapprehension is as understandable as it is widespread. In order to set the record straight, I wish to be succinct and blunt: **"book value" figures that include reinvested distributions are completely irrelevant for calculating investment performance.** Indeed, I consider the

figures, although correct from an accounting perspective, to be highly misleading. My advice to investors who hold the Trust in registered plans (which I believe constitute the vast majority of investments in the Trust) is that what they should do with figures for “book value” or “book cost” on their account statements is simply ignore them.

The fallacy of “book value” may be illustrated by imagining a hypothetical investor who invested the same amount, at the same time, in the LP and the Trust. Let’s further assume that the performance of the LP and the Trust were identical. Then, over the years, the investor’s original cost of her investment in each of the LP and the Trust would remain unchanged (and the two original costs would be the same as each other); the market values of her investments in the LP and the Trust would always be the same as each other; but while the “book value” of her investment in the LP would never change, the “book value” of her investment in the Trust would rise over time (as a result of reinvested distributions). Thus, it is understandable that the investor would compare the market values of her investments to “book value” and conclude that the LP had performed well while the Trust had performed poorly, even though the performance of the two investments in this example was identical.

The confusion caused by “book value” figures has persisted for years. For gluttons for (accounting) punishment, I described this issue in detail in a section of the 2018 Letter titled “Allocations, Distributions and Returns.”<sup>6</sup> That letter is available at the web pages cited earlier. In brief, investors in the Trust who hold units through at least one calendar year-end cannot compute their returns by comparing their market value to their “book value” on their investment statements. To derive their return, they must compare market value with original cost; use an internal rate of return function in spreadsheet software such as Excel; use the performance tables in the inside front cover of this letter, in the monthly fund briefs or on Portland’s web site; or consult the personal rates of return that brokerage firms and investment managers are required to provide to their clients annually.<sup>7</sup>

### **Capital Gains and Taxes**

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In the spring of 2021, the Funds had substantial net unrealized capital gains. At that time, there was considerable speculation that the 2021 federal budget might increase the “capital gains inclusion rate.”<sup>8</sup> That is the percentage (currently 50%) of capital gains that is included in taxable income. I shared those concerns, and therefore chose to realize a substantial amount of capital gains in the LP prior to the April 19, 2021 federal budget.<sup>9</sup> That was not necessary to do (and was not done) in the Trust, as its investors are generally tax-deferred or tax-free registered plans. In the event, the 2021 federal budget did not change the capital gains inclusion rate (although a future budget may). Also, the LP’s performance in the second half of 2021 was negative. As a result, investors in the LP were allocated considerably more in capital gains in respect of 2021 than was the change in the LP’s market value in that year.

By contrast, the LP’s 2022 tax return, although it will not be finalized until late March 2023, is expected to include substantial allocations of net capital losses. That will be because of negative

fund returns since capital gains were realized in the spring of 2021, and the realization of some capital losses in 2022. This will be the first year in the history of the LP in which it will allocate net capital losses (not net capital gains) to its investors. When investors file their tax returns for 2022, capital losses may generally be carried back up to three years by filing a form T1A, “Request for Loss Carryback”.<sup>10</sup> If an investor chooses to file the T1A form, that should result in a tax reduction in respect of the year to which the losses are carried back. Investors should consult their own tax professionals.

At December 31, 2022, the LP and Trust portfolios had net unrealized capital losses. That means that both funds are in a position to earn future capital gains without commensurate capital gains allocations to investors, as the first portion of capital gains would simply be the recovery of currently unrealized capital losses.

### **Back to the Future**

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In the 2020 letter, I noted that with the addition of another investment professional to Portland’s team, that person had begun working with me in the management of the Funds. Further, and related to this, the Funds had become more global in their investing scope.<sup>11</sup> By September 30, 2022, I concluded that those two decisions had not worked and that they had been, on balance, significantly negative to the Funds’ performances (for which I take responsibility). As a result, effective on that date, I reverted to being the sole person involved in investment decisions for the Funds. From September 30, 2022 to December 31, 2022, the returns of the LP and Trust were 12.0% and 11.3%, respectively. In January 2023, the returns of the LP and Trust were 19.6% and 19.5%, respectively. That means that for the four months from September 30, 2022 (when the change described above was made) to January 31, 2023, the returns of the LP’s and Trust’s Series F units were 33.9% and 33.1%, respectively. In the same period, the returns of MSCI Canada and MSCI USA were 13.4% and 14.0%, respectively. I’m pleased that the performances of the Funds in this most recent four-month period were strong on both an absolute basis and relative to their benchmark indices. I recognize that there is still a long way to go to return the Funds to their former highs (and beyond); that remains my aim.

Another important instance of “Back to the Future” that occurred in 2022 was the normalization of interest rates. Ever since the global financial crisis in 2008-2009, central banks had kept short-term interest rates near zero. That was despite the fact that, by as far back as 2020, inflation had been running rampant.<sup>12</sup> Finally, central banks recognized that inflation was not “transitory”, as had so often been asserted by central bankers such as the chair of the U.S. Federal Reserve Board (“Fed”), Jerome Powell.<sup>13</sup> Instead, inflation has been high and persistent, triggering a major policy shift by central banks around the world. For example, during 2022, in order to quell inflation, the Fed raised its target for the federal funds rate from a range of 0% to 0.25% to a range of 4.25% to 4.50%, a dramatic increase of 4.25%.<sup>14</sup> This trend has continued as, on February 1, 2023, the Fed raised its target for the federal funds rate by another 0.25% to its current range of 4.50% to 4.75%.<sup>15</sup> Higher interest rates tend to put downward pressure on equity prices for several reasons. One of the reasons is that stocks are no longer the only game in town as cash and fixed-income securities now offer much higher yields than they did at the beginning

of 2022. In other words, an important factor driving equity markets for the last 14 years, There Is No Alternative (widely known by its acronym, TINA), has morphed into There is A Reasonable Alternative (TARA). I do not bemoan this change. The zero interest-rate policy (which has been accorded its own acronym, ZIRP) was an unprecedented economic experiment that, in my opinion, distorted financial markets, caused misallocation of capital, punished savers and was bound to end badly eventually. Now that it has ended, it has contributed to sharply lower equity markets that have provided the Funds with several attractive investment opportunities. ZIRP, R.I.P.

Finally, another important example of “Back to the Future” is what I find to be a striking similarity between financial market conditions in the last three years and those of 1999 to 2003. In both periods, there was a craze in technology-related stocks fuelled by unique historical events (in the earlier period, it was the technology bubble fostered by the simultaneous advent of the internet and Y2K; in the recent period, it was the COVID-19 pandemic, which greatly accelerated pre-existing trends toward work-from-home, online everything and cashless payments). The technology bubbles eventually peaked (in the earlier period, the technology-heavy Nasdaq index famously peaked on March 10, 2000;<sup>16</sup> in the recent period, the widely-followed Standard & Poor’s 500 Index (“S&P 500”) peaked on January 3, 2022, although a strong case could be made that the peak in technology stocks was on February 16, 2021, which was the date of the all-time high of the Ark Innovation exchange-traded fund. I consider it to be the poster child for the recent mania).<sup>17</sup> In both periods, following the peaks, a bear market ensued, led by technology stocks but also including substantial declines in the share prices of non-technology businesses. Further, in both periods, the Fed began to increase interest rates in order to restore them to more normal levels. After protracted bear markets in both periods, the S&P 500 eventually bottomed in October of the U.S. mid-term election year (the S&P 500 low in the earlier period was on October 10, 2002 while in the current period it was on October 13, 2022). There was then a more than 17% rally in the S&P 500 (in the earlier period, the rally peaked on December 2, 2002 while in the current period the rally peaked on December 13, 2022). In the earlier period, the S&P 500 then gave up almost all of its recent gains and reached its 2003 low on March 12, 2003. That was still slightly higher than the S&P 500 had been on October 10, 2002, which was, in fact, the low for that cycle. From March 2003 until 2007, the S&P 500 enjoyed very strong returns despite that fact that during that period, the federal funds rate increased from 1.25% to 5.25%,<sup>18</sup> and the U.S. 10-year Treasury yield rose from 3.5% to 5.25% (vs. 3.7% at February 7, 2023).<sup>19</sup> As for the current period, no-one knows what will happen in the future. I describe what I believe to be a reasonable outlook in the concluding section of this letter.

### **Potential Benefits of Leverage**

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The two key strategies employed in the Funds are: i) focused investing (i.e., a limited number of companies held in large weights as a percentage of Fund net assets) and ii) leverage (i.e., prudent use of a variable amount of margin debt, intended to enhance fund returns). Leverage is so important to the management of the Funds, and so often not fully understood, that this section has been written to illustrate its potential benefits.

For a conventional investment fund that does not use leverage and is fully invested (i.e., it holds no cash), then whatever the percentage change in the value of its equity holdings, the percent-

age change in its net assets will be the same. Also, if its equity weight (i.e., total equities divided by net assets) at the beginning of a period is 100%, then its equity weight will always remain 100% no matter whether the market values of its equity holdings go up, down or sideways.

As soon as one introduces leverage into a portfolio, however, the outcomes change. Now, the equity weight of a fund will change in response to changes in the market values of its equity holdings. This is shown in the table below.

<u>Hypothetical investment fund</u>	Start of period	10% gain in equities	End of period	Change in period
Total equities (A)	\$250.00	\$25.00	\$275.00	10%
Margin debt	\$150.00	\$0.00	\$150.00	0%
Net assets (B)	\$100.00	\$25.00	\$125.00	25%
Equity weight (A/B)	250%		220%	
Additional equities to restore equity weight to 250%			\$37.50	
Portfolio after additional equities:				
Total equities (A')			\$312.50	
Margin debt			\$187.50	
Net assets (B')			\$125.00	
Equity weight (A'/B')			250%	
Additional equities as % of new net assets			30.0%	
Additional equities as % of original net assets			37.5%	

In the above example, at the start of the period, the fund has \$250 of total equities, purchased utilizing \$150 of margin debt and \$100 of net assets (i.e., the amount of the fund that is attributable to its investors) for an equity weight of 250% (i.e., \$250 of total equities divided by \$100 of net assets equals 250%). The equities are then assumed to increase in value by 10%, or \$25. The total equities now have a market value of \$275. The margin debt has remained at \$150. That means that the net assets (i.e., total equities minus margin borrowings) have also increased by \$25, to \$125. Thus, in this example, a 10% increase in the market value of equities has increased net assets by 25%. This demonstrates one potential significant advantage of using leverage, which is the potential to realize greater performance (i.e., percentage increase in net assets) than the performance of the underlying portfolio. Of course, as the saying goes, leverage works both ways. The use of leverage may accentuate negative returns (as was the case in 2022).

Now let's pursue the matter a bit further. Note that in the above example and as shown in the table, one of the impacts of assuming a 10% increase in equity prices is that it reduced the equity weight from 250% to 220% (i.e., after the assumed gain in equities, \$275 of total equities divided by \$125 of net assets equals 220%). Let's further assume that after the initial 10% increase in equity values, the portfolio manager wished to buy enough additional equities so as to restore the original equity weight of 250%. How much additional equities would that be? A little math (multiplying the new net assets of \$125 by 2.5 then deducting the existing total equities of \$275) reveals that the answer is \$37.50 (i.e.,  $\$125 \times 2.5 - \$275 = \$37.50$ ). As shown in the table, these additional equities represent an increase to the net assets after their 10% gain of 30.0% (i.e.,  $\$37.50 / \$125.00 = 30.0\%$ ). The additional equities represent an increase to the original dollar amount of net assets of 37.5% (i.e.,  $\$37.50 / \$100.00 = 37.5\%$ ). In other words, another potential benefit of using leverage is the ability to increase the dollar value of equities held as they appreciate without requiring any further cash from investors. Instead, the additional equities are financed with additional margin debt, which use is made possible by the reduction in equity weight (i.e., leverage) that arose when the original portfolio appreciated. This ability to compound investments is a potentially powerful source of investment returns.

For the last several months, the Funds' monthly email updates have noted that the Funds have the financial capacity to increase their equity weights to 200% to 250% or more of net assets (compared to, for example, 176.3% at December 31, 2022). This would be consistent with what the Funds have done before: at December 31, 2018 the LP's equity weight was 270% while at October 31, 2020 it was 209%. Both of those instances were immediately followed by very strong performance of the Funds. Those were not coincidences (i.e., the high equity weights contributed to the subsequent strong performance). Of note, the Funds' prime broker may generally lend up to 70% loan-to-value against large capitalization equities listed in the U.S. and Canada. That means that the theoretical maximum equity weight would be 333%. For example, a portfolio comprised of \$100 of total equities, financed with \$70 of margin debt (i.e., 70% loan-to-value) and \$30 of net assets, would have an equity weight of 333% (i.e.,  $\$100 / \$30 = 333\%$ ). The reason for not buying to that maximum level is that no-one can predict the future with certainty. That is why the Funds have always operated with a significant buffer below maximum leverage to allow for the possibility of an equity market decline (that could happen at any time).

While the Funds are prepared to increase their equity weights up to 200% to 250% or more of net assets if circumstances are deemed appropriate, they have not yet done so. That has been for three reasons: i) while I like the valuations of the businesses owned in the Funds, stock prices generally are not at bargain levels; ii) the Funds have maintained considerable buying capacity in case a possible recession results in the share prices of some potential investees declining further, to more attractive levels, than has so far been the case; and, iii) most importantly, because I believe that the Funds will meet their investment objectives with their existing investments. Those investments are described more fully in the remainder of this letter.

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**Banks: 12 is the new 11**

Previous annual letters have included many positive comments about the investment merits of banks.<sup>20</sup> For example, in my estimation, banks are generally very free cash generative; have attractive returns on equity; above-average predictability; and have high barriers to entry. In addition, Canadian banks have very high standards of corporate governance. Just as importantly, they are often available for purchase at reasonable valuations that offer attractive potential total returns with, in my opinion, limited downside risk.

The single most important measure of a bank's financial strength is its common equity tier 1 capital ratio ("CET1", calculated by dividing a bank's common equity tier 1 capital by its risk-weighted assets).<sup>21</sup> In the 2017 Letter, I noted that the big five Canadian banks had increased their CET1 ratios to a then record-high weighted average of 11.0%.<sup>22</sup> The primary regulator of Canadian banks is the Office of the Superintendent of Financial Institutions ("OSFI"). On December 8, 2022, OSFI announced that a component of the required CET1 ratio, known as the Domestic Stability Buffer ("DSB"), would increase from 2.5% to 3.0% as of February 1, 2023. Further, OSFI announced that it had increased the DSB's range to a new level of 0% to 4% instead of the previous 0% to 2.5%.<sup>23</sup> Combined with the other components of required capital, the minimum CET1 requirement for Canadian banks as of February 1, 2023 is 11.0%. Given that the banks seek to always have a management buffer above the minimum regulatory requirement, especially now that OSFI has communicated that it may increase the DSB in the future by a further 1%, in my estimation Canadian banks are now seeking to achieve CET1 ratios of 12.0% or higher in the near future (rather than their previous targets of 11.0%). In the short term, achieving the target CET1 ratios of 12.0% will likely mean foregoing share buybacks and continuing with discounts on dividend reinvestment plans ("DRIPs"). I expect that, once the banks achieve their internal targets for their CET1 ratios, they will then resume share repurchases and cancel the discounts on their DRIPs. In the longer term, the change by OSFI will likely mean that in future the banks will report, on average, lower, but safer, returns on equity as compared to their historical averages.

During 2022, bank stocks fell out of investor favour. The Funds used that weakness as an opportunity to add to their bank positions. The LP's bank holdings are summarized in the table below. The first numerical column shows each holding's percentage weight of the LP's net assets at December 31, 2022 (before subscriptions and redemptions effective on that date). The Trust's weights in the banks named in the table, excluding the Trust's year-end distributions (almost all of which were reinvested), were virtually identical to those of the LP.

Banks held in the LP at Dec. 31, 2022

Company	% of LP's net assets	Dividend Yield	P/E ratio	P/B ratio	CET1 ratio
Bank of Montreal	19.6%	4.7%	9.3	1.3	16.7%
Bank of New York Mellon Corporation, The	9.0%	3.3%	9.9	1.0	11.2%
Bank of Nova Scotia, The	19.9%	6.2%	7.8	1.2	11.5%
Citigroup, Inc.	38.0%	4.5%	6.5	0.5	13.0%
Total / weighted average	86.6%	4.8%	7.8	0.9	

As can be seen in the table, at December 31, 2022, the LP had a total of 86.6% of its net assets invested in four banks. On a weighted average basis, the bank holdings had attractive valuations, such as a dividend yield of 4.8%; a price-earnings (“P/E”) ratio on 2022 earnings per share (“EPS”) of only 7.8x; and a price-book ratio (“P/B”) ratio of only 0.9x.<sup>24</sup> Further comments on each of the banks follow below (in alphabetical order):

- **Bank of Montreal** (“BMO”) completed its acquisition of Bank of the West on February 1, 2023.<sup>25</sup> I believe that the acquisition will increase BMO’s net earnings by more than the associated increase in BMO’s shares outstanding, so that the deal will be accretive to EPS. Further, it has increased BMO’s scale in the U.S. market as well as its geographic diversification. I’ve been impressed with what BMO’s chief executive officer (“CEO”), Darryl White, has accomplished since he assumed the role in 2017. As he is only 51 years old, he still has a lot of runway. At the end of fiscal year (“FY”) 2022, BMO’s CET1 ratio was an unusually high 16.7% as it raised capital to fund the Bank of the West acquisition. When BMO did an equity issue in December 2022 (in which the Funds bought more BMO shares), BMO stated that it expects to target a CET1 ratio at or above 11.5%.<sup>26</sup> At December 31, 2022, BMO traded at what I believe are attractive valuation metrics with a dividend yield of 4.7%, a P/E ratio on FY’22 EPS of 9.3x and a P/B ratio of 1.3x;
- **The Bank of New York Mellon Corporation** (“BNY Mellon”) is the world’s largest custodian bank and securities services company, with a history that dates back to its establishment in 1784 by a group that included founding father Alexander Hamilton.<sup>27</sup> BNY Mellon’s asset-light business model is, in my opinion, much lower risk than traditional banks. At December 31, 2021, 8.3% of BNY Mellon was owned by Portland’s role model, Berkshire Hathaway Inc. (led by legendary investor Warren Buffett).<sup>28</sup> At December 31, 2022, BNY Mellon traded at a dividend yield of 3.3%, a P/E ratio on 2022 EPS of 9.9x and a P/B ratio of 1.0x;
- **The Bank of Nova Scotia** (“Scotia”) is Canada’s most international bank, with substantial operations in Mexico, Chile, Peru, Colombia and a number of markets in the Caribbean and Central America.<sup>29</sup> For the 10 years ended in FY’22, the compound annual growth rate of Scotia’s EPS was 6.3%, which ranked as the second-worst among the big six Canadian banks.<sup>30</sup> Further, on September 26, 2022, Scotia announced the highly unusual decision that it would replace retiring CEO Brian Porter with an outsider, Scott Thomson, who until then had been CEO of Finning International Inc.<sup>31</sup> It is because of factors such as these that at December 31, 2022, Scotia traded at what I believe are exceptionally attractive valuation metrics with a dividend yield of 6.2%, a P/E ratio on FY’22

EPS of only 7.8x and a P/B ratio of 1.2x. In my opinion, investor sentiment regarding Scotia is so negative that if it performs poorly on fundamentals, that may already be reflected in its share price. Conversely, if Scotia's business performance improves, investors may reap the double benefit of a higher P/E ratio accorded to higher EPS, for strong resulting capital gains on top of Scotia's healthy dividend yield; and

- **Citigroup Inc.** ("Citi") is a large U.S. money centre bank which also has a substantial presence in a number of international markets. Under its CEO Jane Fraser (who assumed that role in 2021), Citi has announced its intended exit from consumer banking in many international markets. I believe that this is the correct strategy as Citi may lack the scale to be competitive in some markets compared to local players. As these exits are completed, Citi's risk-weighted assets should decline (as was the case in 2022), freeing up capital for other investments and shareholder returns. As a result of Citi's relatively poor historic performance, at December 31, 2022, Citi traded at what I believe are exceptionally attractive valuation metrics with a dividend yield of 4.5%, a P/E ratio on 2022 EPS of only 6.5x and a P/B ratio of 0.5x. I'm not alone in this assessment: in May 2022 it was revealed that Berkshire Hathaway Inc. had acquired a 2.8% stake in Citi.<sup>32</sup> As with Scotia, I believe that investor sentiment regarding Citi is so negative that if it performs poorly on fundamentals, that may already be reflected in its stock price. Conversely, if Citi's business performance improves, investors may be rewarded with strong capital gains on top of Citi's healthy dividend yield.

## Other Investments

Normally, these letters don't dwell on the Funds' individual investments. The primary reason for that is that I have found that the more one discusses individual holdings, the more one is likely to keep them in the Funds, even if changing valuations or other circumstances suggest one should do otherwise. The Funds' investment objective (i.e., to achieve, over the long term, preservation of capital and a satisfactory return) has never changed nor have the two key strategies (i.e., focus and leverage) employed to meet that objective. Those may be sacrosanct, but individual holdings are not. Holdings are always subject to change if it is deemed to be beneficial for the Funds. Nevertheless, given the declines in 2022 in both equity markets and the Funds, I thought investors might appreciate a review of all of the Funds' investee companies. The Funds' four bank holdings are summarized above; their five non-bank holdings are discussed briefly below (in order of percentage weight in the LP as of December 31, 2022, highest to lowest; the weights of these businesses in the Trust were similar). Of note, also, is that since September 2022 a PowerPoint presentation on the Funds has been updated monthly, including detailed slides on the Funds' largest holdings. The most recent version of that presentation may be found on the web pages referenced earlier in this letter.

- **CK Hutchison Holdings Limited** ("CKHH"; 35.1% of the LP's net assets at December 31, 2022). CKHH is a Hong Kong-based and Cayman Islands-registered industrial conglomerate that operates in four core segments: infrastructure, telecommunications, retail, and ports and related services.<sup>33</sup> The company is diversified by geography, with substantial operations in Europe, Asia, China and Canada (where it owns 16% of Cenovus Energy Inc. and other assets).<sup>34</sup> In 2021, CKHH had revenues of US\$36.0 billion;<sup>35</sup>
- **Great-West Lifeco Inc.** ("GWO"; 20.4% of the LP's net assets). GWO is a Canadian-based financial services holding company providing life and health insurance, retirement and investment services, asset management and reinsurance in Canada, the U.S. and Europe. In 2021, GWO had total

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. See, e.g., 2013 Letter p. 3.
5. 2016 Letter, pp. 5-6.
6. 2018 Letter, pp. 8-10.
7. The personal rate of return provided to investors by brokers and investment managers is calculated on a money-weighted basis whereas standard investment returns (such as are stated in this letter and in Portland’s monthly fund briefs) are calculated on a time-weighted basis. For the difference between these two methods, please see the 2015 Letter, pp. 5-8.
8. See, for example, [https://www.investmentexecutive.com/inside-track\\_/jamie-golombek/worried-about-a-possible-increase-to-the-capital-gains-inclusion-rate/](https://www.investmentexecutive.com/inside-track_/jamie-golombek/worried-about-a-possible-increase-to-the-capital-gains-inclusion-rate/)
9. [https://en.wikipedia.org/wiki/2021\\_Canadian\\_federal\\_budget](https://en.wikipedia.org/wiki/2021_Canadian_federal_budget)
10. <https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t1a.html>
11. See “Turning Japanese (and British and French)” section of 2020 Letter, pp. 9-10.
12. See “If I Had A Trillion Dollars” section of 2020 Letter, pp. 8-9.
13. See, e.g., <https://www.washingtonpost.com/business/2021/12/09/inflation-fed-transitory-powell/>
14. <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
15. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230201a.htm>
16. [https://en.wikipedia.org/wiki/Dot-com\\_bubble](https://en.wikipedia.org/wiki/Dot-com_bubble)
17. All stock price data in this letter are from Bloomberg LP.
18. <https://fred.stlouisfed.org/series/FEDFUNDS#0>
19. <https://www.cnbc.com/quotes/US10Y>
20. 2014 Letter, p. 15 and pp. 20-25; 2015 Letter, pp. 12-14; 2016 Letter, p. 8; 2017 Letter, p. 8; and 2018 Letter, pp. 13-14.
21. <https://www.investopedia.com/terms/c/common-equity-tier-1-cet1.asp>
22. 2017 Letter, p. 8.
23. <https://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/dsb20221208-nr.aspx>
24. The figures in the table were derived as follows (all based on stock prices as of December 31, 2022). Dividend yield is the indicated dividend rate divided by the stock price. P/E ratio is the stock price divided by earnings per share excluding specified items for the fiscal year 2022, except for Citigroup, Inc. for which the P/E ratio is based on reported earnings per share. P/B ratio is the stock price divided by book value per share for fiscal year 2022.
25. <https://newsroom.bmo.com/2023-02-01-BMO-Completes-Acquisition-of-Bank-of-the-West>
26. <https://newsroom.bmo.com/2022-12-12-Bank-of-Montreal-Announces-Offering-of-Common-Shares-for-Gross-Proceeds-of-C-3-15-Billion-following-the-increase-to-the-Domestic-Stability-Buffer>
27. [https://en.wikipedia.org/wiki/BNY\\_Mellon](https://en.wikipedia.org/wiki/BNY_Mellon)
28. Berkshire Hathaway Inc. 2021 annual report, p. 7.
29. Scotia FY’22 annual report, note 29.
30. Based on Portland’s analysis of bank earnings results.
31. <https://www.scotiabank.com/corporate/en/home/media-centre/media-centre/news-release.html?id=3915&language=en>
32. <https://www.fool.com/investing/warren-buffett-berkshire-hathaway-buy-citigroup/>
33. [https://en.wikipedia.org/wiki/CK\\_Hutchison\\_Holdings](https://en.wikipedia.org/wiki/CK_Hutchison_Holdings)
34. CKKH 2021 annual report p. 4 and Cenovus Energy Inc.’s Management Information Circular dated March 1, 2022, p. 1.
35. CKHH 2021 annual report, p. 124.

36. GWO 2021 annual report, note 31.
37. Vodafone FY'22 annual report, note 2.
38. <https://www.verizon.com/about/news/strong-wireless-service-revenue-growth-highlights-verizons-4q-and-2022-results>
39. Canadian Tire 2021 annual report, note 6.
40. <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm>
41. [https://ycharts.com/indicators/us\\_m2\\_money\\_supply](https://ycharts.com/indicators/us_m2_money_supply)
42. <https://www.barrons.com/articles/m2-money-supply-recession-51674569554>
43. Summary of Economic Projections issued December 14, 2022, figure 2, available by clicking on "Projection Materials" at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
44. [https://en.wikipedia.org/wiki/Neutral\\_rate\\_of\\_interest](https://en.wikipedia.org/wiki/Neutral_rate_of_interest)
45. <https://www.federalreserve.gov/econres/notes/feds-notes/longer-run-neutral-rates-in-major-advanced-economies-20221201.html>

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The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performances of the Funds.

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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2023

**Portland Focused Plus Fund LP**  
**Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.7%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.7%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.7%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.0%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	20.3%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.4%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-9.7%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.1%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
2021	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
2022	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%

Year	Annualized Total Returns as of December 31, 2023					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
3 years	-0.9%	0.2%	1.3%	1.3%	9.5%	8.6%
5 years	12.8%	14.0%	16.0%	15.2%	10.4%	15.2%
10 years	12.0%	13.1%	15.1%	14.2%	6.9%	11.4%
Since inception	13.7%	14.8%	16.9%	15.9%	7.4%	13.0%

Year	Cumulative Total Returns as of December 31, 2023					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
3 years	-2.7%	0.5%	4.1%	4.0%	31.2%	28.2%
5 years	82.6%	92.7%	110.2%	103.3%	64.3%	102.6%
10 years	209.8%	242.8%	307.9%	277.7%	94.6%	193.3%
Since inception	318.9%	368.8%	473.0%	417.7%	120.8%	292.1%

**Portland Focused Plus Fund**

## Performance vs. Stock Market Indices

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.1%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.4%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-9.7%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.1%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
2021	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
2022	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%

Year	Annualized Total Returns as of December 31, 2023					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
3 years	-0.5%	0.6%	1.7%	1.7%	9.5%	8.6%
5 years	13.2%	14.5%	16.3%	15.8%	10.4%	15.2%
Since inception	11.6%	12.7%	14.8%	14.0%	8.4%	12.9%

Year	Cumulative Total Returns as of December 31, 2023					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
3 years	-1.6%	1.8%	5.2%	5.3%	31.2%	28.2%
5 years	85.8%	96.4%	113.0%	107.9%	64.3%	102.6%
Since inception	133.2%	153.0%	191.5%	176.5%	86.6%	156.5%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012 and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportions, the performance of the Funds may not be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables are also shown in the LP's factsheet ("Fund Brief") which is updated monthly about a week after every month-end and posted to the LP's web page referenced above.

In 2023, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 22.8% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 12.3% for MSCI Canada and to a return of 26.5% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 19.4%. As a result, in 2023 the LP outperformed its benchmark indices. For the five years ended December 31, 2023 (I have always suggested that five years is the minimum reasonable period for measuring performance<sup>4</sup>), the LP's series F units had a cumulative return of 92.7%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 64.3% and 102.6%, respectively. A 50%/50% blend of the two indices had a return of 83.4%. As a result, for the five years ended December 31, 2023, the LP also outperformed its benchmark indices. Finally, for the entire period since inception of the LP on October 31, 2012 to December 31, 2023, the LP's series F units achieved a cumulative return of 368.8%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 120.8% and 292.1%, respectively. A 50%/50% blend of the two indi-

ces had a return of 206.5%. As a result, for the full period since the LP's inception, the LP outperformed its benchmark indices.

### Performance of the Trust

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end in which the portfolios diverge materially, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the long-term performance of the two Funds will be similar (as indeed has been the case). That is why Portland distributes the same annual letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2023, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 22.8% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 12.3% for MSCI Canada and to a return of 26.5% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 19.4%. As a result, in 2023 the Trust outperformed its benchmark indices. For the five years ended December 31, 2023, the Trust's series F units had a cumulative return of 96.4%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 64.3% and 102.6%, respectively. A 50%/50% blend of the two indices had a return of 83.4%. As a result, for the five years ended December 31, 2023, the Trust also outperformed its benchmark indices. Finally, for the entire period since inception of the Trust on March 31, 2016 to December 31, 2023, the Trust's series F units achieved a cumulative return of 153.0%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 86.6% and 156.5%, respectively. A 50%/50% blend of the two indices had a return of 121.6%. As a result, for the full period since the Trust's inception, the Trust outperformed its benchmark indices.

### Monthly Fund Updates

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Shortly after every month-end, fund updates are sent out by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, equity weight and largest holdings. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from receiving Portland emails.

### Taxes and Adjusted Cost Base of LP Units

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Benjamin Franklin (who was a hero to Charles T. ("Charlie") Munger, who is discussed later in

this letter) famously wrote that “in this world, nothing can be said to be certain, except death and taxes.”<sup>6</sup>

While taxes may be certain, there is no reason that you should pay more than required by law. In the 2018 Letter, I discussed in detail how taxes apply to investments in the LP and the Trust.<sup>7</sup> Certain events in 2023 underscored for me the advisability of recapping that discussion with respect to investors in the LP. **Please bear with me, as this is critically important.** The discussion below is not intended to constitute tax advice; investors should consult their own tax professionals.

The LP does not pay distributions. Instead, the LP allocates its income and expenses to its investors on a pro rata basis. These allocations are recorded for tax purposes on T5013 slips which are issued to investors annually in March in respect of the preceding calendar year. One of the attractive features of limited partnerships is that income earned and expenses incurred by them retain their tax character when they are attributed to investors. For example, most of the LP’s income over time has been tax-advantaged as it has been in the form of capital gains and eligible Canadian dividends (only half of capital gains are included in taxable income and eligible Canadian dividends earn significant tax credits). At the same time, the LP’s expenses (i.e., management fees, performance fees, operating expenses and interest expense on margin loans) are all fully deductible in the computation of taxable income (with the exception of foreign dividend withholding taxes, which also earn a tax credit). For tax purposes, these expense items (other than foreign withholding taxes) are all aggregated into one number (reported on the T5013 slips) called “carrying charges”. Also, in the event that the LP should have net capital losses in any year (as was the case for 2022 and I expect will be the case again for 2023), such capital losses may be carried back up to three years by filing a form T1A, “Request for Loss Carryback”,<sup>8</sup> or they may be carried forward indefinitely for application against future capital gains. Note that since the LP does not actually pay distributions, investors must have some other means to pay any taxes owing by them on their allocation of the LP’s income and expenses. In my experience, investors generally fund their LP-related tax obligations using other resources held by them or by redeeming some of their units of the LP.

Upon receiving each T5013 slip, investors should adjust the adjusted cost base (“ACB”) of the LP’s units that they own as follows:

- **increase the ACB by the amount of income items allocated.** Those items comprise interest from Canadian sources (reported in box 128 of T5013 slips); actual amount of eligible Canadian dividends (box 132); foreign dividend and interest income (boxes 135); and capital gains (box 151: if the amount in box 151 is positive (i.e., capital gains), it increases ACB; if the amount in box 151 is negative (i.e., capital losses), it decreases ACB). The requirement to increase ACB for income items allocated is stated in s. 53(1)(e)(i) of the Income Tax Act (“ITA”);<sup>9</sup> and
- **decrease the ACB by the amount of expense items allocated.** Those items comprise foreign dividend withholding tax, which Canada Revenue Agency (“CRA”) refers to as “foreign tax paid on non-business income” (boxes 171); and carrying charges (box 210). The requirement to decrease

ACB for expense items allocated is stated in s. 53(2)(c)(i) of the ITA.<sup>10</sup>

**It is imperative that investors in the LP make the above adjustments to their ACB.** Only by doing so can investors in the LP avoid double taxation. That would arise if investors paid taxes on income allocated to them on T5013 slips but not actually received by them, and then, when they eventually redeem their units, they paid too much tax because they had not adjusted their ACB for the cumulative amounts of income and expenses allocated to them.

One might ask, has there ever been any instance when CRA has reviewed and accepted the calculations of an investor who had made the adjustments referenced above to the ACB of their LP units? The answer now is “yes”. In 2023, I replied to CRA on behalf of an investor in the LP whose tax return was audited with respect to the claimed ACB of LP units that had been redeemed. I’m pleased to report that CRA concluded that no changes were required to that investor’s reported ACB or capital gains.

### Two-Year Performance and Market Conditions

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As noted earlier in this letter, over periods of one year, five years and since their respective inceptions, both Funds have achieved positive performance and outperformed their benchmark indices. I am keenly aware, however, that two-year performance of the Funds is negative and significantly lags their benchmark indices over that time period. The high-water mark of the LP (i.e., its highest ever net asset value per unit (“NAVPU”)) was set on January 31, 2022 (that was also the date of the Trust’s record high). Since for 11 months prior thereto (i.e., from February 28, 2021 to January 31, 2022) the LP had NAVPUs not far below its ultimate record high, investors (including me) who subscribed for Fund units during that period currently have negative returns since those subscriptions. As was described in last year’s letter, to address this situation, on September 30, 2022 I reverted to being the sole investment decision-maker for the Funds.<sup>11</sup> I’m pleased to report that from that date until December 31, 2023, the LP had a cumulative return of 37.5%. While there is still considerably more performance required to return the Funds to their record highs (and beyond), I believe that the Funds will do that with time. Reasons for that opinion are provided at the end of this letter in the “Outlook” section.

An external factor that affected the Funds in 2022 and 2023 was the significant increase in interest rates in that period. For example, at the beginning of 2022, the U.S. Federal Open Market Committee (“FOMC”) had a target for the federal funds rate of 0.00% to 0.25%.<sup>12</sup> Then, in an attempt to reduce high rates of inflation, the FOMC raised interest rates 11 times, reaching a target for the fed funds rate of 5.25% to 5.50% on July 26, 2023.<sup>13</sup> That increase in interest rates of 5.25%, together with the FOMC’s reduction of the Federal Reserve’s balance sheet and the money supply in a process known as quantitative tightening (“QT”),<sup>14</sup> had a depressing effect on asset prices, including those of stocks and bonds.

Besides interest rates, another notable market condition in 2023 was the striking performance disparity between a handful of leading businesses and the rest of the equity market. The share prices of many businesses performed poorly both in 2022 and in the first 10 months of 2023.

This fact was masked in 2023 by strong performance of a small number of U.S. technology-related stocks, a group that came to be known as the “Magnificent Seven”.<sup>15</sup> For example, while that small group of businesses drove strong performance of the market capitalization-weighted Standard & Poor’s 500 Index (“SPX”) in 2023 of 26.3%, the 2023 performance of the S&P 500 Equal Weight Index (“SPXEW”, in which, as its name implies, all companies are weighted equally) lagged far behind at 13.9%.<sup>16</sup> Indeed, until October 27, 2023, the SPXEW had negative year-to-date performance.<sup>17</sup> From that day until the end of 2023, SPXEW had very strong performance (as did the Funds in that period), resulting in its aforementioned 2023 return of 13.9%.

### TSN Turning Point

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In my opinion, October 27, 2023 marked the end of the long, grinding bear market for the average stock (i.e., represented by SPXEW, not SPX) that began in January 2022. I believe that for the average stock, October 27, 2023 was what might be termed a “TSN Turning Point”,<sup>18</sup> since which market performance has been strong. In my opinion, it is likely to remain strong for at least several years (albeit punctuated by the usual occasional and inevitable declines).

No one can predict when bear markets will bottom (or, for that matter, when bull markets will end). It’s also difficult to state conclusively, even after the fact, why bear markets ended when they did. Having said that, I believe that the bear market for the average stock ended on October 27, 2023 for the following reasons:

- Firstly, I believe that after the protracted decline, sellers were exhausted and many investors were fearful. It was “the time of maximum pessimism” that legendary investor Sir John Templeton advised was the time to buy;<sup>19</sup>
- Secondly, valuations of many businesses had fallen to levels that offered attractive total return prospects with limited risk over a longer-term horizon;
- Thirdly, on the very day of October 27, 2023, the U.S. Bureau of Economic Analysis (“BEA”) released its monthly estimate of the price index for personal consumption expenditures excluding food and energy (“core PCE”).<sup>20</sup> It is arguably the single most important inflation measure in the view of the FOMC. The BEA report showed a continued decline in year-over-year core PCE to 3.7%. That gave market participants further encouragement that the FOMC was likely finished raising interest rates for this cycle;
- Fourthly, that opinion was further affirmed just a few days later when, on November 1, 2023, the FOMC held its target rate for the federal funds rate unchanged for the second consecutive meeting;<sup>21</sup>
- Fifthly, the 10-year U.S. Treasury yield, which had risen relentlessly from its record low of 0.31% on March 9, 2020 (in the very early days of the COVID-19 pandemic) to a 16-year high of 4.99% on October 19, 2023, finally began to ease.<sup>22</sup> By October 27, 2023, the 10-year Treasury yield had fallen to 4.83%; on December 31, 2023 it closed at 3.88%. The yield on long-term government bonds is a crucial factor in equity valuations. In my opinion, it heavily influences the rates that investors use to discount future corporate cash flows and estimate the intrinsic values of businesses. Higher interest rates mean lower estimated intrinsic values and conversely lower interest rates mean higher estimated intrinsic values; and
- Sixthly, seasonality was likely a contributing factor. September and October are well known for negative equity market events. Indeed, a previous letter described these events and noted that

historically, substantially all of U.S. equity market returns (and in Canada, more than all) have been made from October 31 to August 31, with September and October proving much more difficult.<sup>23</sup> Knowing this history, investors likely became more willing to invest in equities by late October.

The six ingredients above, when combined, proved to be a powerful cocktail that helped restore what acclaimed economist and investor John Maynard Keynes referred to as the market's "animal spirits."<sup>24</sup>

As stocks weakened during the late summer and early fall of 2023, the Funds substantially increased their equity weights (i.e., total equities divided by net assets, so that any amount above 100% is financed with margin borrowings). That was to take advantage of the more attractive equity prices. For example, the LP's equity weight increased from 142.1% on July 31, 2023 to its 2023 high of 206.3% on October 31, 2023 (the Trust's equity weights on both dates were similar). That positioned the Funds well to achieve very strong performance in the final two months of 2023 as equity market conditions improved. From October 31, 2023 to December 31, 2023, the LP's Series F Units and the Trust's Series F Units had returns of 41.5% and 41.1%, respectively.

### March Madness

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The year 2023 witnessed dramatic upheaval in the U.S. banking industry, particularly in March. Since the Funds have investments in some U.S. and Canadian banks, it's worth reviewing developments in the U.S. industry.

Some of the major U.S. banking industry events in 2023 included:

- On March 10, 2023, the U.S. Federal Deposit Insurance Corporation ("FDIC") announced that it had closed Silicon Valley Bank ("SVB"). As of December 31, 2022, SVB had total assets of US\$209.0 billion and deposits of US\$175.4 billion;<sup>25</sup>
- On March 12, 2023, the FDIC announced that it had closed Signature Bank ("Signature"). As of December 31, 2022, Signature had total assets of US\$110.4 billion and deposits of US\$88.6 billion;<sup>26</sup> and
- On May 1, 2023, the FDIC announced that it had closed First Republic Bank ("First Republic"). As of April 13, 2023, First Republic had total assets of US\$229.1 billion and deposits of US\$103.9 billion.<sup>27</sup>

In my opinion, the collapse of these three banks was due to abject failure of both management and regulation.

In terms of management, it seems that the banks that failed never asked themselves the question, "what if interest rates go up?" That is evident from how they managed their securities portfolios. U.S. banks generally group their securities into three accounting "buckets": trading securities, which are generally small and which are marked-to-market every quarter with resulting gains and losses immediately reflected in income; available-for-sale ("AFS") securities, which are also marked-to-market every quarter with gains and losses reflected in a component of shareholders' equity known as accumulated other comprehensive income ("AOCI"); and held-to-maturity

(“HTM”) securities, which are not marked-to-market and whose unrealized gains and losses are simply mentioned on the balance sheet or are shown in a note to the financial statements.<sup>28</sup> During the COVID-19 pandemic, as bank deposits swelled from government support payments, and the growth in deposits exceeded issuance of new loans, banks invested much of the increased deposits into securities. As short-term securities issued by the U.S. government were then yielding close to zero, many banks reached for yield by buying large amounts of mortgage-backed securities (“MBS”) with inherently long durations (i.e., very long periods until their eventual full repayment). As interest rates rose in 2022 and 2023, the market values of MBS declined sharply. No matter which securities bucket the MBS were placed in, financial statement readers were able to discern that the unrealized losses were vast and, in some cases, exceeded regulatory capital. That triggered a crisis of confidence in such banks and withdrawals of deposits, which the failed banks were unable to fund since their securities losses were so large. Hence, the FDIC closed such banks and covered their securities losses by levying a special assessment on the remaining banks.<sup>29</sup> Nor were the failed banks alone: at the end of the third quarter of 2023 (the most recent data available at time of writing), unrealized securities losses among U.S. banks were \$683.9 billion.<sup>30</sup> In my opinion, unrealized securities losses in the U.S. banking industry will only be recovered by: i) lower long-term interest rates (which, as noted in the “TSN Turning Point” section above, has been happening since October 19, 2023); and ii) time (i.e., the so-called “pull to par” as these securities approach their eventual maturity dates). In my estimation, that process will take a further five to 10 years.

In terms of regulation, there is an enormous and critical difference between the regulations applicable to large U.S. banks versus smaller, regional banks (such as those that failed in 2023). Large U.S. banks are required to include unrealized gains (and losses) on AFS securities in their regulatory capital; smaller banks (those with assets of less than US\$250 billion) are not.<sup>31</sup> Further, no banks are required to include unrealized gains (and losses) on HTM securities in their regulatory capital.<sup>32</sup> In my opinion, this huge difference in regulatory treatment for AFS securities based on bank size encourages risk-taking by smaller banks that was the primary cause of the three U.S. bank failures in 2023. Currently out for comment by U.S. bank regulators is a sweeping set of proposals to implement what is known as Basel III Endgame (“B3E”). While the final form of the B3E regulations is not yet known, in my opinion it is virtually certain to require any bank with assets of greater than US\$100 billion to include gains and losses on AFS securities in their regulatory capital.<sup>33</sup> That regulatory change, if implemented, should rein in risk-taking by smaller banks and improve the safety and soundness of the U.S. banking industry.

As at December 31, 2023, the Funds held positions in six banks (two domiciled in the U.S. and four in Canada). All of these banks are required to include unrealized gains (and losses) on their AFS securities in their regulatory capital. Further, in our estimation, even if these banks were also required to include unrealized gains (and losses) on their HTM securities in their regulatory capital (which the relevant bank regulators are not proposing), their capital ratios would still exceed their regulatory minimums. Banks held in the Funds are discussed in more detail in the next section of this letter.

Despite its seriousness, the recent U.S. regional banking crisis was not without its lighter moments. For example, at the 2023 annual general meeting of Berkshire Hathaway Inc. (“Berkshire”), held only a few weeks after the worst moments of the crisis, a shareholder asked a question about U.S. banking regulation. At the start of his reply, Berkshire’s chief executive officer (“CEO”), uber-capitalist Warren Buffett, placed a premade sign in front of himself stating “available for sale.” Buffett then placed a sign in front of Berkshire’s 99-year-old vice chairman, Charlie Munger, stating “held-to-maturity.”<sup>34</sup>

### Banks - 12 is still the new 11

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This and the next section of this letter review the businesses held in the funds at December 31, 2023. Please note that nothing in this letter should be taken to be an investment recommendation in respect of any business. Holdings in the Funds can and will change. Having said that, investors in the Funds may find the following discussion to be a useful guide to some of the factors that are considered in choosing the Funds’ investments.

Previous annual letters have included many positive comments about the investment merits of banks.<sup>35</sup> For example, in my estimation, banks are generally very free cash generative; have attractive returns on equity; above-average predictability; and have high barriers to entry. In addition, Canadian banks have very high standards of corporate governance. Just as importantly, they are often available for purchase at reasonable valuations that offer attractive potential total returns with, in my opinion, limited downside risk.

The single most important measure of a bank’s financial strength is its common equity tier 1 capital ratio (“CET1”, calculated by dividing a bank’s common equity tier 1 capital by its risk-weighted assets).<sup>36</sup> The 2022 Letter discussed how in December 2022, the Office of the Superintendent of Financial Institutions (“OSFI”, the primary regulator of Canadian banks) had imposed a sharp increase in required CET1 capital ratios to 11.0% and indicated that it might raise the required CET1 ratio again in the future.<sup>37</sup> As a result, I then estimated that Canadian banks, which always seek to have a management buffer above the minimum regulatory requirement and which had previously sought to achieve CET1 ratios of 11.0%, would instead seek to achieve CET1 ratios of 12.0% or higher. On June 20, 2023, OSFI did, in fact, raise required CET1 ratios by another 0.5% to 11.5%.<sup>38</sup> On December 8, 2023, however, OSFI maintained the required CET1 ratio at 11.5%, and stated that it “recognizes the prudent approach to capital management taken by the Boards of Directors of Canada’s systemically important banks, all of which have produced CET1 ratios exceeding 12%”.<sup>39</sup> Canadian banks will thus likely continue to target CET1 ratios of 12.0%. In practical terms, what this means is that, after a prolonged period of having to manage their businesses to achieve ever-higher capital ratios, bank managements should now be able to devote more resources to more shareholder-friendly initiatives, including internal growth, dividend growth and share repurchases. In addition, I expect that in 2024, all of the Canadian banks that have not already done so will cancel the discounts on their dividend reinvestment plans. Those discounts have resulted in higher common shares outstanding that have been a headwind to achieving earnings and dividend growth in per-share terms.

The LP's bank holdings are summarized in the table below. The first numerical column shows each holding's percentage weight of the LP's net assets at December 31, 2023 (before subscriptions and redemptions effective on that date). The Trust's weights in the banks named in the table, excluding the Trust's year-end distributions (almost all of which were reinvested), were virtually identical to those of the LP.

Banks held in the LP at Dec. 31, 2023

Company	% of LP's net assets	Dividend Yield	P/E ratio	P/B ratio	CET1 ratio
Bank of Montreal	11.5%	4.6%	11.2x	1.3x	12.5%
Bank of New York Mellon Corporation, The	8.8%	3.2%	10.3x	1.1x	11.6%
Bank of Nova Scotia, The	17.8%	6.6%	9.9x	1.1x	13.0%
Canadian Imperial Bank of Commerce	19.0%	5.6%	9.5x	1.2x	12.4%
Citigroup, Inc.	28.7%	4.1%	12.7x	0.5x	13.3%
Toronto-Dominion Bank, The	4.9%	4.8%	10.7x	1.5x	14.4%
Total / weighted average	90.7%	4.9%	10.9x	1.0x	

As can be seen in the table, at December 31, 2023, the LP had a total of 90.7% of its net assets invested in six banks. On a weighted average basis, the bank holdings had attractive valuations, such as a dividend yield of 4.9%; a price-earnings ("P/E") ratio on 2023 earnings per share ("EPS") of 10.9x; and a price-book ("P/B") ratio of only 1.0x.<sup>40</sup> Brief comments on each of the banks follow below (in alphabetical order):

- **Bank of Montreal** ("BMO") completed its acquisition of Bank of the West on February 1, 2023.<sup>41</sup> I believe that the acquisition will increase BMO's net earnings by more than the associated increase in BMO's shares outstanding, so that the deal will be accretive to EPS. Further, it has increased BMO's scale in the U.S. market as well as its geographic diversification;
- **The Bank of New York Mellon Corporation** ("BNY Mellon") is one of the world's largest custodian bank and securities services companies, with a history that dates back to its establishment in 1784 by a group that included founding father Alexander Hamilton.<sup>42</sup> BNY Mellon's asset-light business model is, in my opinion, much lower risk than traditional banks;
- **The Bank of Nova Scotia** ("Scotia") is Canada's most international bank, with substantial operations in Mexico, Chile, Peru, Colombia and a number of markets in the Caribbean and Central America.<sup>43</sup> On December 13, 2023, Scotia's CEO Scott Thomson laid out Scotia's strategy to improve its financial performance.<sup>44</sup> If Scotia's business performance improves, investors may reap the double benefit of a higher P/E ratio accorded to higher EPS, for strong resulting capital gains on top of Scotia's healthy dividend yield;

- **Canadian Imperial Bank of Commerce** (“CIBC”) has been led by CEO Victor Dodig since 2014. In my opinion, he has done a good job in navigating CIBC through some difficult times (such as the COVID-19 pandemic) while largely avoiding the mistakes which plagued CIBC in the past and which continue to be reflected in its comparatively low valuation;
- **Citigroup Inc.** (“Citi”) is a large U.S. money centre bank which also has a substantial presence in a number of international markets. As with Scotia, I believe that investor sentiment regarding Citi is so negative that if its business performance improves, investors may be rewarded with strong capital gains on top of Citi’s healthy dividend yield. At September 30, 2023 (the latest data available at time of writing), 2.9% of Citi was owned by Portland’s role model, Berkshire (led by legendary investor Warren Buffett);<sup>45</sup> and
- **The Toronto-Dominion Bank** (“TD”) has a substantial presence in both Canada and the U.S. and has an outstanding long-term track record. In 2023, TD was unable to secure regulatory approval for its proposed acquisition of First Horizon Corporation, leading to that deal’s termination.<sup>46</sup> TD was left in an enviably strong financial position, so that in FY’23 it repurchased \$4.3 billion of its own common shares.<sup>47</sup>

### Other Investments

The Funds’ five non-bank holdings are discussed briefly below (in order of percentage weight in the LP, highest to lowest; the weights of these businesses in the Trust were similar). Together, these five businesses accounted for 81.5% of the LP’s net assets. In addition to their expected returns, these companies provide the Funds with diversification by company, industry sector and geography.

- **AT&T Inc.** (“AT&T”; 22.2% of the LP’s net assets at December 31, 2023). AT&T is one of the largest telecommunications companies in the United States, providing both wireless and wireline services and products to consumers and businesses. In 2023, AT&T had revenues of US\$122.4 billion;<sup>48</sup>
- **Verizon Communications Inc.** (“Verizon”; 21.7% of the LP’s net assets). Verizon is also one of the largest telecommunications companies in the United States. In 2023, Verizon had revenues of US\$134.0 billion;<sup>49</sup>
- **CK Hutchison Holdings Limited** (“CKHH”; 14.7% of the LP’s net assets). CKHH is a Hong Kong-based and Cayman Islands-registered industrial conglomerate that operates in four core segments: infrastructure, telecommunications, retail, and ports and related services.<sup>50</sup> The company is diversified by geography, with substantial operations in Europe, Asia, China and Canada (where it owns 17% of Cenovus Energy Inc. and other assets).<sup>51</sup> In 2022 (the latest year available at time of writing), CKHH had revenues of US\$33.7 billion;<sup>52</sup>
- **CVS Health Corporation** (“CVS”; 13.7% of the LP’s net assets). CVS is an American healthcare company that owns CVS Pharmacy, a retail pharmacy chain; CVS Caremark, a pharmacy benefits manager; and Aetna, a health insurance provider, as well as other healthcare businesses.<sup>53</sup> In 2022 (the latest year available at time of writing), CVS had revenues of US\$322.5 billion;<sup>54</sup> and
- **Magna International Inc.** (“Magna”; 9.1% of the LP’s net assets). Magna is one of the world’s largest automotive parts manufacturers. In 2022 (the latest year available at time of writing), Magna had total revenues of US\$37.8 billion.<sup>55</sup>

## In Memoriam: Charles T. Munger

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On November 28, 2023, the world marked the passing of Berkshire's vice chairman, Charlie Munger, at the age of 99. Charlie, as he was widely and affectionately known, was just one month shy of what would have been his 100th birthday.<sup>56</sup>

I believe that Charlie had at least two major influences on Warren Buffett: to invest in excellent businesses (as Charlie said, "a great business at a fair price is superior to a fair business at a great price"<sup>57</sup>); and to concentrate his investment holdings (in Charlie's words, "you don't need a ton of good ideas; you need a couple of ideas that make a ton"<sup>58</sup>). Charlie was certain that Buffett would come around to the superiority of Charlie's opinions; he told Buffett that he'd eventually agree "because you're smart and I'm right."<sup>59</sup>

It would be impossible to fully relate herein Charlie's many quips and his worldly wisdom. For those interested, I highly recommend *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*.<sup>60</sup> The following is just a small sampling.

### *Focused investing:*

"The idea that very smart people with investment skills should have hugely diversified portfolios is madness."<sup>61</sup>

"A few opportunities will come. You've got to learn how to recognize them when they come and not make too minor a trip to the pie counter when the opportunity's available."<sup>62</sup>

"Make fewer decisions; make better decisions."<sup>63</sup>

### *Combining good investments with speculations:*

"If you mix raisins with turds, they're still turds."<sup>64</sup>

### *Leverage:*

"Lever up when you're sure your right."<sup>65</sup>

"Berkshire could easily be worth twice what it is now, and the extra risk we would have taken would have been practically nothing. All we had to do was use a little more leverage that was easily available."<sup>66</sup>

"If Warren and I had owned Berkshire without any shareholders that we knew, we would have made more; we would have used more leverage."<sup>67</sup>

### *Temperament:*

“The fretful disposition is an enemy of long-term performance.”<sup>68</sup>

*Mentors:*

“You’re not restricted to living people in choosing your mentors. Some of the very best people are dead.”<sup>69</sup>

*Capitalism versus socialism:*

“I like inequality a lot more than I like poverty.”<sup>70</sup>

*Artificial intelligence:*

“I like the idea of using artificial intelligence because we’re so short of the real kind.”<sup>71</sup>

“I am personally skeptical of some of the hype that has gone into artificial intelligence. I think old-fashioned intelligence works pretty well.”<sup>72</sup>

Without Charlie, Berkshire’s annual meetings will never be the same. Charlie Munger is gone, but he will never be forgotten.

In Charlie’s oft-used words: “I have nothing to add.”

**Outlook**

I believe that future long-term returns of the Funds will continue to be positive, partly for the following reasons:

- **Lower rates of inflation.** The year-over-year change in the core PCE price index has already declined from its post-pandemic peak of 5.2% for the year ended September 30, 2022 to 2.9% for the year ended December 31, 2023 (the most recent data reported).<sup>73</sup> I believe that it will continue to decline and will reach the Federal Reserve’s target of 2.0% by about mid-2024.<sup>74</sup> I expect core PCE to continue to decline primarily because of base effects (i.e., previously-reported high rates on inflation will drop out of the 12-month data) and the delayed impact of monetary policy (i.e., the full effect of higher interest rates and QT in slowing the economy and reducing price increases have likely not yet been felt as monetary policy acts with a long and variable lag);
- **Lower interest rates.** I believe that, once core PCE has fallen to about 2%, the FOMC will begin to reduce its target for the federal funds rate. In that process, an important consideration will be the so-called neutral rate of interest (i.e., that level of interest rates that supports the economy at full employment while keeping inflation constant). Estimates vary, but FOMC participants appear to believe that the neutral real (i.e., after inflation) rate of interest, known to policy wonks as  $r^*$  (r-star), is in the range of 0.5% to 1.0%.<sup>75</sup> Adding in the Federal Reserve’s 2% inflation target suggests that the FOMC will ultimately seek to target a nominal federal funds rate in the range of 2.5% to 3.0%. Given that the FOMC’s target rate for the federal funds rate is currently 5.25% to 5.50%, I believe that U.S. interest rates will likely be cut by 2.5% or more between mid-2024 and the end of 2025. A similar trajectory is likely to be followed in Canada. These expected interest rate cuts will, in my opinion, be very beneficial both to economic growth and to equity market valuations;

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. See, e.g., 2013 Letter p. 3.
5. 2016 Letter, pp. 5-6.
6. [https://en.wikipedia.org/wiki/Death\\_and\\_taxes\\_\(idiom\)](https://en.wikipedia.org/wiki/Death_and_taxes_(idiom))
7. 2018 Letter, pp. 8-10.
8. <https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t1a.html>
9. <https://laws-lois.justice.gc.ca/eng/acts/l-3.3/section-53.html>
10. Ibid.
11. 2022 Letter, pp. 7-8.
12. See minutes of the FOMC meeting of January 25-26, 2022 available at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
13. <https://www.forbes.com/advisor/investing/fed-funds-rate-history/>
14. [https://en.wikipedia.org/wiki/Quantitative\\_tightening](https://en.wikipedia.org/wiki/Quantitative_tightening)
15. <https://www.theglobeandmail.com/investing/markets/inside-the-market/article-is-the-dominance-of-apple-amazon-and-the-other-magnificent-seven/>
16. See fact sheets available at <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview> and <https://www.spglobal.com/spdji/en/indices/equity/sp-500-equal-weight-index/#overview>, respectively.
17. Source: Bloomberg LP.
18. The term “TSN Turning Point” was first used by Canada’s The Sports Network (TSN) to describe the moment that most influenced the outcome of a sports game. It has since become generalized to refer to a significant or life-changing event. See <https://www.urbandictionary.com/define.php?term=The%20TSN%20Turning%20Point>
19. <https://www.oreilly.com/library/view/buying-at-the/9780137084463/pr02.html>
20. <https://www.bea.gov/news/2023/personal-income-and-outlays-september-2023>
21. See minutes of the FOMC meeting of October 31 to November 1, 2023 available at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
22. Source for the 10-year Treasury yield data is Bloomberg LP and <https://www.cnbc.com/quotes/US10Y>
23. 2014 Letter, pp. 27-30.
24. <https://www.investopedia.com/terms/a/animal-spirits.asp>
25. <https://www.fdic.gov/news/press-releases/2023/pr23016.html>
26. <https://www.fdic.gov/news/press-releases/2023/pr23018.html>
27. <https://www.fdic.gov/news/press-releases/2023/pr23034.html>
28. See, e.g., <https://www.wsj.com/articles/banks-investors-revive-push-for-changes-to-securities-accounting-after-svb-collapse-99caa9ce>
29. <https://www.fdic.gov/news/financial-institution-letters/2023/fil23058.html>
30. FDIC Third Quarter 2023 Quarterly Banking Profile, p.4, available at <https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/index.html>
31. Federal Reserve Bank of Kansas City, “The Implications of Unrealized Losses for Banks”, Second Quarter 2023, p. 8.
32. Ibid.
33. Ernst & Young LLP, “Basel III Endgame”, September 2023, p. 1, [https://www.ey.com/en\\_us/banking-capital-markets/basel-iii-endgame-what-you-need-to-know](https://www.ey.com/en_us/banking-capital-markets/basel-iii-endgame-what-you-need-to-know)
34. Berkshire Hathaway 2023 annual general meeting, afternoon session, minute 1:00, available at <https://buffett.cnbc.com/video/2023/05/08/afternoon-session---2023-meeting.html>
35. 2014 Letter, p. 15 and pp. 20-25; 2015 Letter, pp. 12-14; 2016 Letter, p. 8; 2017 Letter, p. 8; 2018 Letter,

- pp. 13-14; and 2022 Letter, pp. 11-13.
36. <https://www.investopedia.com/terms/c/common-equity-tier-1-cet1.asp>
  37. 2022 Letter, p. 11.
  38. <https://www.osfi-bsif.gc.ca/en/news/osfi-reinforces-resilience-canadas-financial-system-sets-domestic-stability-buffer-35>
  39. [https://www.osfi-bsif.gc.ca/en/news/osfi-maintains-domestic-stability-buffer-3\\_5](https://www.osfi-bsif.gc.ca/en/news/osfi-maintains-domestic-stability-buffer-3_5)
  40. The figures in the table were derived as follows (all based on stock prices as of December 31, 2023). Dividend yield is the indicated dividend rate divided by the stock price. P/E ratio is the stock price divided by earnings per share excluding specified items for the fiscal year 2023, except for Citigroup, Inc. for which the P/E ratio is based on reported earnings per share. P/B ratio is the stock price divided by book value per share for fiscal year 2023.
  41. <https://newsroom.bmo.com/2023-02-01-BMO-Completes-Acquisition-of-Bank-of-the-West>
  42. [https://en.wikipedia.org/wiki/BNY\\_Mellon](https://en.wikipedia.org/wiki/BNY_Mellon)
  43. Scotia FY'23 annual report, note 29.
  44. <https://www.scotiabank.com/ca/en/about/investors-shareholders/investor-day.html>
  45. <https://www.sec.gov/Archives/edgar/data/1067983/000095012323011029/0000950123-23-011029-index.htm>
  46. <https://stories.td.com/ca/en/news/2023-05-04-td-bank-and-first-horizon-mutually-agree-to-terminate-merger>
  47. TD FY'23 annual report, note 20.
  48. <https://investors.att.com/financial-reports/quarterly-earnings/2023>
  49. <https://www.verizon.com/about/investors/quarterly-reports/4q-2023-earnings-conference-call-webcast>
  50. [https://en.wikipedia.org/wiki/CK\\_Hutchison\\_Holdings](https://en.wikipedia.org/wiki/CK_Hutchison_Holdings)
  51. CKKH 2022 annual report p. 4 and Cenovus Energy Inc.'s Management Information Circular dated March 1, 2023, p. 5.
  52. CKHH 2022 annual report, p. 126.
  53. [https://en.wikipedia.org/wiki/CVS\\_Health](https://en.wikipedia.org/wiki/CVS_Health)
  54. <https://investors.cvshealth.com/investors/events-and-presentations/default.aspx>
  55. Magna 2022 annual report, p. 33.
  56. [https://en.wikipedia.org/wiki/Charlie\\_Munger](https://en.wikipedia.org/wiki/Charlie_Munger)
  57. Peter D. Kaufman, editor, Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger (PCA Publication, 2005), p. 57.
  58. Berkshire annual meeting, May 6, 2006, as transcribed by the author.
  59. The author has heard Munger (and Buffett) recite this line more than once although doesn't know the exact occasions.
  60. Kaufman, op. cit.
  61. Berkshire annual meeting, May 1, 2004, as transcribed by the author.
  62. CNBC interview with Charlie Munger on November 14, 2023, hour 1:44, available at <https://buffett.cnbc.com/video/2023/12/05/charlie-mungers-final-cnbc-interview.html>
  63. The author heard Munger state this line at a Berkshire annual meeting but doesn't know the year.
  64. Berkshire annual meeting, April 29, 200, as transcribed by the author.
  65. CNBC interview with Charlie Munger on November 14, 2023, hour 1:01, available at <https://buffett.cnbc.com/video/2023/12/05/charlie-mungers-final-cnbc-interview.html>
  66. Ibid., hour 1:02.
  67. Ibid., hour 1:02.
  68. Berkshire annual meeting, May 3, 2003, as transcribed by the author.
  69. Berkshire annual meeting, May 5, 2007, as transcribed by the author.
  70. CNBC, op. cit., hour 1:05.
  71. Berkshire annual meeting, April 30, 2016, as transcribed by the author.
  72. Berkshire annual meeting, May 6, 2023, hour 0:37, available at <https://buffett.cnbc.com/video/2023/05/08/morning-session---2023-meeting.html>

73. <https://www.bea.gov/news/2024/personal-income-and-outlays-december-2023>
74. The Federal Reserve has often stated that its inflation objective is 2%. See, e.g., <https://www.reuters.com/markets/us/feds-waller-says-us-within-striking-distance-inflation-goal-2024-01-16/>
75. <https://www.brookings.edu/articles/the-hutchins-center-explains-the-neutral-rate-of-interest/>
76. 2022 Letter, pp. 9-11.

The Portland Focused Plus Fund LP (the "LP") and Portland Focused Plus Fund (the "Trust") (collectively, the "Funds") are not publicly offered. They are only available under Offering Memorandum and other exemptions to investors who meet certain eligibility or minimum purchase requirements such as "accredited investors". Information herein pertaining to the Funds is solely for the purpose of providing information and is not to be construed as a public offering in any jurisdiction of Canada. The offering of Units of the Funds made pursuant to an Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

The Manager believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performances of the Funds.

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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2024

**Portland Focused Plus Fund LP**  
**Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.7%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.7%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.7%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.0%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	20.3%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.4%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-9.7%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.1%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
2021	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
2022	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
2024	17.5%	18.6%	19.0%	19.5%	22.0%	24.6%

Year	Annualized Total Returns as of December 31, 2024					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	17.5%	18.6%	19.0%	19.5%	22.0%	24.6%
3 years	-0.5%	0.5%	0.7%	1.5%	8.6%	8.1%
5 years	7.5%	8.7%	10.1%	9.8%	10.6%	14.0%
10 years	12.2%	13.3%	15.1%	14.4%	7.9%	12.5%
Since inception	14.0%	15.1%	17.1%	16.2%	8.5%	13.9%

Year	Cumulative Total Returns as of December 31, 2024					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	17.5%	18.6%	19.0%	19.5%	22.0%	24.6%
3 years	-1.6%	1.6%	2.2%	4.6%	28.1%	26.3%
5 years	43.7%	51.5%	61.7%	59.5%	65.6%	92.8%
10 years	214.8%	248.3%	308.5%	284.3%	114.6%	224.3%
Since inception	392.3%	456.1%	581.7%	518.9%	169.4%	388.5%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.1%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.4%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-9.7%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.1%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
2021	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
2022	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
2024	17.8%	19.1%	19.3%	20.2%	22.0%	24.6%

Year	Annualized Total Returns as of December 31, 2024					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	17.8%	19.1%	19.3%	20.2%	22.0%	24.6%
3 years	0.0%	1.2%	1.3%	2.2%	8.6%	8.1%
5 years	8.1%	9.3%	10.6%	10.5%	10.6%	14.0%
Since inception	12.2%	13.4%	15.3%	14.7%	9.9%	14.2%

Year	Cumulative Total Returns as of December 31, 2024					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	17.8%	19.1%	19.3%	20.2%	22.0%	24.6%
3 years	0.1%	3.6%	3.9%	6.9%	28.1%	26.3%
5 years	47.3%	55.9%	65.8%	64.5%	65.6%	92.8%
Since inception	174.6%	201.4%	247.6%	232.3%	127.7%	219.6%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012, and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same proportions, the performance of the Funds may not be directly comparable to the benchmarks. In

addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables are also shown in the LP's factsheet ("Fund Brief") which is updated monthly about a week after every month-end and posted to the LP's web page referenced above.

In 2024, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 18.6% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 22.0% for MSCI Canada and to a return of 24.6% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 23.3%. As a result, in 2024 the LP underperformed its benchmark indices. For the five years ended December 31, 2024 (I have always suggested that five years is the minimum reasonable period for measuring performance<sup>4</sup>), the LP's series F units had a cumulative return of 51.5%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 65.6% and 92.8%, respectively. A 50%/50% blend of the two indices had a return of 79.2%. As a result, for the five years ended December 31, 2024, the LP underperformed its benchmark indices. For the 10 years ended December 31, 2024, the LP's series F units had a cumulative return of 248.3%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 114.6% and 224.3%, respectively. A 50%/50% blend of the two indices had a return of 169.4%. As a result, for the 10 years ended December 31, 2024, the LP outperformed its benchmark indices. Finally, for the entire period since inception of the LP on October 31, 2012, to December 31, 2024, the LP's series F

units achieved a cumulative return of 456.1%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 169.4% and 388.5%, respectively. A 50%/50% blend of the two indices had a return of 279.0%. As a result, for the full period since the LP's inception, the LP outperformed its benchmark indices.

### Performance of the Trust

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end in which the portfolios diverge materially, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the long-term performance of the two Funds will be similar (as indeed has been the case). That is why Portland distributes the same annual letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2024, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 19.1% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 22.0% for MSCI Canada and to a return of 24.6% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 23.3%. As a result, in 2024 the Trust underperformed its benchmark indices. For the five years ended December 31, 2024, the Trust's series F units had a cumulative return of 55.9%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 65.6% and 92.8%, respectively. A 50%/50% blend of the two indices had a return of 79.2%. As a result, for the five years ended December 31, 2024, the Trust underperformed its benchmark indices. Finally, for the entire period since inception of the Trust on March 31, 2016, to December 31, 2024, the Trust's series F units achieved a cumulative return of 201.4%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 127.7% and 219.6%, respectively. A 50%/50% blend of the two indices had a return of 173.7%. As a result, for the full period since the Trust's inception, the Trust outperformed its blended benchmark indices.

### Monthly Fund Updates

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Shortly after every month-end, fund updates are sent out by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, equity weight and largest holdings. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from receiving Portland emails.

## Recent Performance

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As noted earlier in this letter, over 10 years and since its inception, the LP has achieved positive performance and outperformed its benchmark indices. Similarly, since its inception, the Trust has achieved positive performance and outperformed its benchmark indices. Over periods of one year and five years, however, the performance of both Funds, while positive, underperformed their benchmark indices.

The Funds' five-year records are a continuing legacy of the poor performance of the Funds from about mid-2021 to September 30, 2022. As was described in the 2022 Letter, to address that situation, on September 30, 2022, I reverted to being the sole investment decision-maker for the Funds.<sup>6</sup> From that date until December 31, 2024, the cumulative returns of the series F units of the LP and Trust were 63.1% and 62.9%, respectively. While more performance is required in order for the Funds to return to outperformance of their benchmarks over five-year periods, I believe that the Funds will do that with time. Some reasons for that opinion are provided later in this letter in the "Investments" and "Outlook" sections.

On November 30, 2024, the series F units of both Funds achieved record highs (in the case of the LP, which is measured by net asset value per unit; in the case of the Trust, which is measured by value of \$10,000 invested at inception). The previous record highs had been set on January 31, 2022. Fund performance in 2024 ended with declines in December in conjunction with equity markets which were negative in that month. Some of the factors that influenced markets in 2024 are discussed below. [Note that in the month ended January 31, 2025, performances of the series F units of the LP and Trust were 9.8% and 10.1%, respectively, recouping almost all of their December 2024 declines.]

## Market Conditions and Equity Weight

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In my opinion, some of the notable features of financial markets in 2024 were:

- *Declining short-term interest rates.* Commencing in June, the Bank of Canada ("BoC") reduced its target for the overnight rate from a cycle peak of 5.0% to 3.25% by the end of 2024, a cumulative reduction of 1.75%.<sup>7</sup> Also, starting in September, the U.S. Federal Open Market Committee ("FOMC") reduced its target for the federal funds rate from a cycle peak of 5.25% to 5.50% to a new range of 4.25% to 4.50% by the end of 2024, a cumulative reduction of 1.00%.<sup>8</sup>
- *Increasing long-term interest rates.* The yield to maturity of the 10-year Government of Canada bond rose slightly from 3.11% at December 31, 2023 to 3.23% at December 31, 2024.<sup>9</sup> More importantly, the yield on the 10-year U.S. Treasury bond rose from 3.86% at December 31, 2023 to 4.58% at December 31, 2024. The combined effect of lower short-term interest rates and higher long-term interest rates is that in both Canada and the U.S., yield curves are now positive (i.e., long-term rates are higher than short-term rates).<sup>10</sup> That follows a prolonged period of inverted yield curves (i.e., short-term rates higher than long-term rates) when both central banks had raised short-term interest rates to seek to quell inflation.
- *Lower inflation rates.* In Canada, the year-over-year change in the Consumer Price Index ("CPI") fell from 3.4% in December 2023 to 1.9% in December 2024.<sup>11</sup> In the U.S., however, the preferred inflation gauge of the Federal Reserve ("Fed"), the personal consumption expenditures price index

excluding food and energy (“core PCE”), fell only slightly from 2.9% in December 2023 to 2.8% in December 2024.<sup>12</sup> That remained well above the Fed’s inflation target of 2.0%.<sup>13</sup>

- *Outperformance (again) of mega-capitalization companies.* The 2023 letter noted how the common stocks of the very largest businesses vastly outperformed the broader stock market in that year.<sup>14</sup> That phenomenon repeated in 2024 as the performance (in US\$) of the market capitalization-weighted Standard & Poor’s 500 Index (“SPX”) was 25.0% while the performance of the S&P 500 Equal Weight Index (“SPXEW”, in which, as its name implies, all companies are weighted equally) lagged far behind at 13.0%.<sup>15</sup>
- *U.S. federal elections.* On November 5, 2024, these elections resulted in control by the Republican Party of all three of the executive and legislative branches of the U.S. government (i.e., the presidency, Senate and House of Representatives).<sup>16</sup> Markets appear to believe that this will result in stronger economic growth and reduced regulatory burden, with perhaps higher inflation.

The stock market euphoria at the outcome of the U.S. federal elections appeared to wear off in December as equity markets declined and, as noted above, faced competition from higher long-term interest rates. In addition, the tragic murder that month of a prominent health care executive exacerbated a selloff in the common stock prices of large health care insurance companies.<sup>17</sup>

My monthly email updates have long spoken of the willingness to increase the Funds’ equity weights (i.e., common equities as a percentage of net assets) to 200% to 250% or more (anything greater than 100% is financed with margin borrowings). This was done in December, as the Funds took advantage of lower stock prices for equities in general, and for U.S. health care insurers in particular, to increase equity weights significantly. The LP’s equity weight increased from 172.2% at December 31, 2023, to 234.0% at December 31, 2024 (the Trust’s equity weights were similar, as adjusted for distributions paid at both year-ends, most of which were reinvested).

#### Favourite/Long Shot Bias (aka March Madness Redux)

Before reviewing the Funds’ investments, it’s worthwhile to consider a persistent feature of human behaviour.

Studies have shown that in horse racing (and investing), there is a favourite/long shot bias.<sup>18</sup> That is to say, bettors tend to under-bet favourites (resulting in foregone profits) and over-bet long shots (resulting in losses). One reason cited for this irrational behaviour is bettors’ overestimation of the chances that long shot bets will win. In addition, bettors may derive utility merely from the hope associated with holding a ticket on a long shot (such as a lottery). Also, it may be perceived as more “fun” to pick a long shot to win over a favourite and this has more bragging rights.<sup>19</sup>

One of the sections of the 2023 Letter was titled “March Madness”.<sup>20</sup> It discussed the 2023 U.S. regional banking crisis that began in March of that year. The title also drew its name from the annual U.S. National College Athletic Association (NCAA) college basketball tournament. In that competition, the nation’s top 64 teams compete in a single-game elimination format to determine the ultimate winner.<sup>21</sup> Betting on the outcome of the 63 games needed to determine the winner has become a national (and international) pastime. On the eve of the 2024 competition, I was invited to enter a March Madness pool. Since I hadn’t read the pool rules (and had failed to ask

for them) that favoured long shots (at least in the early rounds), and I was very busy at the time, I quickly and naively made my selections with a heavy emphasis on higher-ranked teams. After the first day of competition, my position in the pool was dead last (42nd out of 42 entrants). But then, a funny thing happened on the way to the national championship. The higher-ranked teams kept winning...and winning...and winning. In the end, two teams that had been top-ranked in their respective regions, the University of Connecticut (UConn) and Purdue University (led by Toronto's Zach Edey), met in the title game. The pre-tournament favourite and defending champion UConn Huskies prevailed. That resulted in an epic (for me) come-from-behind pool victory. Winning a March Madness pool? \$600. Bragging rights for a year? Priceless.

The favourite/long shot bias has significant investment implications. As has been the case in the Funds, I believe that equity investments should emphasize "favourites": well-established, financially strong businesses that are leaders in their industries. As the time-tested expression goes, "the race is not always to the swift, nor the battle to the strong, but that is the way to bet."<sup>22</sup> In that context, the Funds' investments are reviewed in the next section of this letter.

## Investments

The LP's investments are summarized in the table below (the businesses held in the Trust were identical and its individual and aggregate equity weights were very similar). Holdings can and will change if it is deemed to be in the best interests of the Funds. Nevertheless, a brief review of the Funds' investee companies may serve to underscore their high quality, strong financial positions and attractive valuations. The table lists the LP's holdings in descending order of percentage weight in the LP. The price/earnings ("P/E") ratio is each company's stock price at December 31, 2024, divided by Refinitiv mean estimated fully diluted earnings per share excluding specified items ("EPS") for fiscal year 2024 (estimates as of January 31, 2025), or actual EPS for those companies that have by that date already reported their fiscal year 2024 results. Dividend yield is the ratio of indicated annualized dividend rate at December 31, 2024, divided by each company's stock price on that date.

### LP investments at December 31, 2024

Company	% of LP's net assets	P/E ratio	Dividend Yield
Cigna Group, The	26.2%	10.1	2.0%
South Bow Corporation	24.9%	12.5	8.5%
Kraft Heinz Company, The	21.5%	10.2	5.2%
Toronto-Dominion Bank, The	21.4%	9.8	5.5%
Verizon Communications Inc.	20.2%	8.7	6.8%
Elevance Health, Inc.	19.8%	11.2	1.8%
Magna International Inc.	19.8%	8.0	4.5%
Bank of Nova Scotia, The	19.4%	11.9	5.5%

Nutrien Ltd.	16.3%	12.5	4.8%
CK Hutchison Holdings Limited	14.8%	6.8	5.9%
AT&T Inc.	11.0%	10.1	4.9%
Citigroup Inc.	10.4%	11.9	3.2%
CVS Health Corporation	8.2%	8.7	5.9%
Total / weighted average	234.0%	10.3	5.0%

At December 31, 2024, the weighted average P/E ratio of the LP's holdings was only 10.3x while their weighted average dividend yield was 5.0%. While many other factors are considered when selecting the Funds' investments, I believe that these two metrics are generally very important. In my opinion, these valuations are attractive and support my belief that the Funds are well-positioned to meet their investment objective over the long term.

A brief summary of each business follows (in the same order as in the table, i.e., largest portfolio weight to smallest weight).

- **The Cigna Group** ("Cigna") is a U.S.-based health insurance company that offers medical, dental, disability, life and accident insurance. In 2024, its sales were US\$247.1 billion.<sup>23</sup> Led by chief executive officer ("CEO") David Cordani since 2009, the company has an excellent long-term record. For example, in the decade that ended in 2024, Cigna's EPS increased by 268%.<sup>24</sup> The December 2024 weakness in the share prices of U.S. health insurers described earlier in this letter gave the Funds the opportunity to acquire a large investment within the Funds in Cigna on what I believe were very attractive terms.
- **South Bow Corporation** ("South Bow") was spun out of TC Energy Corporation ("TC") on October 1, 2024.<sup>25</sup> South Bow comprises TC's former liquids pipelines business, with its principal asset being the Keystone oil pipeline. I believe that South Bow is not widely known in the investment community (for example, South Bow has not yet released its first set of financial results since its spinoff). I believe that over time, given South Bow's relatively high dividend yield compared to other investments in the Funds of 8.5% and its high business predictability, it will be accorded a higher stock market valuation. If so, it should continue to generate attractive total returns.
- **The Kraft Heinz Company** ("Kraft Heinz") was formed in 2015 by the merger of Kraft Foods Group and the H.J. Heinz Co. Together, the company includes many of America's most iconic consumer packaged goods brands, including *Heinz* (ketchup), *Kraft* (macaroni and cheese), *Oscar Meyer*, *Classico*, *Velveeta*, *Philadelphia*, *Maxwell House* and many others.<sup>26</sup> In my opinion, now that leverage resulting from the merger has been reduced to a satisfactory level, Kraft Heinz is in a position to substantially and accretively repurchase shares, in addition to its healthy dividend yield. Kraft Heinz is 26.8%-owned by Warren Buffett's Berkshire Hathaway Inc.<sup>27</sup>
- **The Toronto-Dominion Bank** ("TD") had long been one of Canada's leading and top-performing banks. As has been well-publicized, in 2024 TD took a financial charge of (\$4.2) billion to resolve regulatory investigations into its anti-money laundering practices.<sup>28</sup> This has resulted in a depressed valuation for TD's shares which I believe is a buying opportunity. TD remains in a strong financial position. Also, its business performance is expected to improve under its new CEO-elect, Raymond Chun, who assumed the office on February 1, 2025.<sup>29</sup>
- **Verizon Communications Inc.** ("Verizon") is one of the largest telecommunications companies in the

United States, providing both wireless and wireline services to consumers and businesses. In 2024, Verizon had revenues of US\$134.8 billion.<sup>30</sup>

- **Elevance Health, Inc.** (“Elevance”), formerly named Anthem, Inc., is one of the largest health care benefits companies in the United States.<sup>31</sup> As with Cigna, the weakness in the share prices of U.S. health care companies in late 2024 created an opportunity to make an investment in Elevance at a price that I believe offers substantial total return potential with limited downside risk. In 2024, Elevance had total revenues of US\$177.0 billion.<sup>32</sup>
- **Magna International Inc.** (“Magna”) is one of the world’s largest automotive parts manufacturers. The company is highly diversified by customer, product and geography. In 2023 (the latest year available at time of writing), Magna had total revenues of US\$42.8 billion.<sup>33</sup>
- **The Bank of Nova Scotia** (“Scotia”) is Canada’s most international bank, with substantial operations in Mexico, Chile, Peru, Colombia and a number of markets in the Caribbean and Central America.<sup>34</sup> Scotia’s strategy includes divesting non-core markets and focusing on banking and asset management in North America.<sup>35</sup> As its financial performance improves, investors may reap the double benefit of a higher P/E ratio accorded to higher EPS, for strong resulting capital gains on top of Scotia’s healthy dividend yield.
- **Nutrien Ltd.** (“Nutrien”), which is based in Saskatchewan, is the world’s largest provider of crop inputs and services.<sup>36</sup> Crop inputs are potash, nitrogen and phosphate, while Nutrien Ag Solutions has retail facilities in the U.S., Canada and other markets. In 2023 (the latest year available at time of writing), Nutrien had total revenues of US\$29.1 billion.<sup>37</sup>
- **CK Hutchison Holdings Limited** (“CKHH”) is a Hong Kong-based and Cayman Islands-registered industrial conglomerate that operates in four core segments: infrastructure, telecommunications, retail, and ports and related services.<sup>38</sup> The company is diversified by geography, with substantial operations in Europe, Asia, China and Canada (where it owns 17% of Cenovus Energy Inc. and other assets).<sup>39</sup> In 2023 (the latest year available at time of writing), CKHH had revenues of US\$35.3 billion.<sup>40</sup>
- **AT&T Inc.** (“AT&T”) is one of the largest telecommunications companies in the United States, providing both wireless and wireline services and products to consumers and businesses. In 2024, AT&T had revenues of US\$122.3 billion.<sup>41</sup>
- **Citigroup Inc.** (“Citi”) is a large U.S. money centre bank which also has a substantial presence in a number of international markets. Its shares performed very strongly in 2024 as investor sentiment regarding Citi improved as it executed on its strategy to divest consumer operations in non-core international markets, increased its earnings and strengthened its financial position.<sup>42</sup>
- **CVS Health Corporation** (“CVS”) is a U.S. healthcare company that owns CVS Pharmacy, a retail pharmacy chain; CVS Caremark, a pharmacy benefits manager; and Aetna, a health insurance provider, as well as other healthcare businesses.<sup>43</sup> In 2023 (the latest year available at time of writing), CVS had revenues of US\$357.8 billion.<sup>44</sup>

## 10 Years Down, 40 More Years to Go

In the 2014 Letter, I had the audacity (foolhardiness?) to provide 50-year return forecasts for selected major asset classes.<sup>45</sup> The purpose of the exercise was to provide guidance to hypothetical 18-year-olds, who would thus have 50-year time horizons until their retirements at age 68, as to how to invest their Tax-Free Savings Accounts (“TFSA”) and what their long-term returns might

be. The forecasts were reviewed at the five-year mark (in the 2019 Letter).<sup>46</sup> Since 2024 marks 10 years since the original forecasts, this is an appropriate time to review again how actual experience has compared to the forecasts. Actual results will differ from forecasts and the differences could be material.

In the table below and the discussion that follows, “ETF” refers to exchange-traded funds, which are generally low-cost investment funds whose performance is intended to closely track their benchmark indices. The table summarizes the 50-year return forecasts made in the 2014 Letter, with a starting point of December 31, 2014, and the actual returns for the 10 years ended December 31, 2024.<sup>47</sup>

Asset class annualized total returns

Forecast vs. actual returns  
10 years ended 2024

	50-year forecast at end of 2014	Actual, 10 years ended 2024
S&P/TSX Canadian banks index	8.50%	10.05%
S&P 500 Index, US\$	6.00%	13.10%
S&P 500 Index ETF, C\$	5.59%	14.95%
Canadian bond index ETF	2.67%	1.82%
Cash	2.50%	1.59%
Inflation	2.00%	2.62%

I consider that the three most important projections (all with a 50-year time horizon from the end of 2014 to the end of 2064) that the 2014 Letter tried to convey were as follows:

- Among the three major asset classes, stocks would outperform bonds which would outperform cash. Indeed, the 2014 Letter summarized that view by stating that “a reasonable base-case forecast suggests that over the long term, equities will continue to provide higher returns than fixed income or cash, probably by a wide margin.”<sup>48</sup>
- Canadian bank stocks would provide total returns of 8.5% per annum; and
- Canadian bank stocks would outperform the S&P 500 Index.

How have things been working out so far? Well, in the words of Meat Loaf, “two out of three ain’t bad”.<sup>49</sup> First, and in my opinion most importantly, the rank ordering of returns of the three major asset classes has been as predicted (i.e., stocks have outperformed bonds which have outperformed cash). Second, the Canadian banks have had annualized total returns of 10.05% per annum, slightly better than (although not far off) the predicted 50-year return of 8.50% per annum. Third, contrary to the forecast in the 2014 Letter, the S&P 500 Index in US\$ has enjoyed even stronger returns than have the Canadian banks, and its returns in Canadian dollars (C\$) have been even stronger. I stand by the asset class return forecasts stated in the 2014 Letter. I don’t intend to update them as they were purposefully planned to be very long-term. With that

said, the following briefly reviews each of the six items included in the table.

- *Canadian banks.* I continue to believe that banks provide a fertile ground for potentially profitable investment. Reasons for that opinion include that banks are highly cash generative, have high barriers to entry and, in my opinion, have their strongest-ever financial positions. Also, banks often trade at attractive valuations relative to earnings and with significant dividend yields. Having said that, however, banks have recently enjoyed very strong returns and, in my opinion, many of them are currently not offering sufficiently attractive combinations of risk and reward to merit investment. That is why the LP's portfolio weight in Canadian and U.S. banks combined has been reduced from 90.7% of net assets at December 31, 2023, to 51.3% at December 31, 2024.<sup>50</sup>
- *S&P 500 Index in US\$.* The annualized 50-year return of the S&P 500 Index was forecast to be 6.00% but the 10-year return has been a dramatically higher 13.10%. That difference has been both because earnings growth has been stronger than expected and valuation (i.e., the market's P/E multiple) is higher than was forecast. Reasons for higher-than-expected earnings growth include very easy monetary policy during the COVID-19 pandemic, which debased currencies (more on that below) and resulted in increased earnings in nominal terms. Reasons for the high-than-expected P/E multiple include conservatism in the initial forecast (I was trying to assert that equities would be the best-performing asset class even under conservative assumptions) and the recent investor enthusiasm for anything involved with artificial intelligence (AI). Indeed, as has been well-documented and was mentioned earlier in this letter, the recent strength in market capitalization-weighted U.S. equity indices owes much to a small number of mega-capitalization technology-oriented companies that have enjoyed tremendous earnings growth and trade at historically high valuations.<sup>51</sup> While these factors have led some pundits to predict that S&P 500 returns in the next decade will be very low,<sup>52</sup> I believe that there a number of businesses that are still attractively priced. It is from investment in such businesses that the Funds expect to achieve satisfactory long-term returns.
- *S&P 500 Index in C\$ (and the decline of the Canadian dollar).* For the 10 years ended December 31, 2024, the S&P 500 Index ETF in C\$ returned 14.95% per annum compared to 13.10% for the S&P 500 Index in US\$. The difference in returns was primarily attributable to the decline in the value of the Canadian dollar in terms of its U.S. counterpart. On December 31, 2014, the C\$ traded at US\$0.8617; by December 31, 2024, it had fallen to US\$0.6957, for a cumulative decline in the decade of (19.3%).<sup>53</sup> That has boosted the return of all US\$-denominated assets when such returns are translated into C\$. In my view, the largest reason for the decline in the value of the C\$ in the past decade (for the 50-year horizon I had expected it to be flat at US\$0.86) has been the election in 2015 of a Canadian federal government, that has remained in office to this day, that has implemented what I believe to be terrible economic policies. For example, on their watch, the net debt of the Government of Canada has almost doubled from \$687.7 billion at October 31, 2015 (the month the government was elected), to \$1,342.3 billion at March 31, 2024 (the latest data available);<sup>54</sup> the federal budgetary balance has deteriorated from a *surplus* of \$1.9 billion in the fiscal year ended March 31, 2015, to a deficit of \$61.9 billion in the fiscal year ended March 31, 2024;<sup>55</sup> tax rates have increased significantly;<sup>56</sup> and the government has passed a number of bills that have discouraged investment in oil and gas production, one of Canada's largest industries.<sup>57</sup> This has contributed to a stagnant economy: for example, on a per-person basis, the Canadian economy has shrunk for the last six quarters in a row.<sup>58</sup> All of this has not gone unnoticed in foreign exchange markets. I believe that the C\$ is currently undervalued with respect to the US\$. Having said that, it may take a change in the government (which I expect to occur with a federal election in May 2025),

and better economic policies, in order for the C\$ to appreciate in value.

- *Canadian bond index ETT.* I thought that the returns of bond ETFs would be lousy, with a predicted 50-year annualized return of only 2.67%, and over the 10-year period they've been even worse, with an actual return of only 1.82%. The 2014 Letter did expect bond returns to be initially lower than the 50-year forecast, stating "implicitly, the forecast assumes that the capital losses that would initially be suffered by bondholders as interest rates rose would be more than offset over the 50-year investment horizon by the higher interest rates then available for reinvesting bond coupons and maturities."<sup>59</sup> That is what has occurred. The reason that the 2014 Letter made a reasonably accurate prediction of bond returns is that, especially compared to equities, it's relatively easy to predict what bond returns will be over the long term. For any particular bond with a fixed maturity date, its return to that maturity date will be approximately equal to its yield to maturity at the time that it is purchased. So, the future returns of bond ETFs, if held for a long period of time, are likely to be similar to their yield to maturity at the time of purchase minus their management expense ratio. Using that method, in my opinion, the future long-term returns of bonds will continue to be inferior to that of carefully chosen equities. Unlike equities, which have the opportunity for sustained capital appreciation, the long-term return of any particular bond has a ceiling (equal to its yield to maturity at the time of purchase), but it has no floor (since it has credit risk and, in the event of default, a bond could become worthless).
- *Cash.* I thought that the returns of cash would also be lousy, with a predicted 50-year annualized return of only 2.50%. Over the 10-year period they've been even worse, with an actual return of only 1.59%. Given that the returns on cash are currently about 3%,<sup>60</sup> over time that should result in the returns of cash since 2014 approaching that year's 50-year forecast.
- *Inflation.* The 2024 Letter noted that for the 25 years ended December 31, 2024, Canada's annualized rate of CPI inflation was 1.99%.<sup>61</sup> That was almost identical to the BoC's inflation control target, adopted in 1991, of 2.00%.<sup>62</sup> It thus seemed reasonable to predict, as the 2014 Letter did, that future inflation would average 2.00%.<sup>63</sup> Unfortunately, the BoC has since missed its inflation target by a wide margin. The rate of CPI inflation for the 10 years ended December 31, 2024, was 2.62%. While that may not seem like much of a difference compared to the BoC's target of 2.00%, when compounded over a decade it has had the cumulative effect of substantially raising Canadians' cost of living. In my opinion, the BoC's failure to meet its inflation control target has been compounded by its failure to take responsibility. The BoC has the tools needed to do its job, including setting short-term interest rates and control of the money supply. Instead of blaming external factors like the COVID-19 pandemic and global supply chains, the BoC should admit that its own policies, namely ultra-low interest rates and money printing (known as quantitative easing, or "QE"),<sup>64</sup> have caused the BoC to miss its inflation target. The implications of doing so have been profound. For example, the table shows that in the last decade, the annualized returns of both bonds (+1.82%) and cash (+1.59%) were below the rate of inflation (+2.62%). *In other words, over the full decade, investors in both bonds and cash lost money in real (i.e., inflation-adjusted) terms, even before considering the impact of taxes.* Bonds and cash are commonly (although mistakenly, in my view) thought to be low-risk asset classes. For the last decade, however, instead of providing risk-free returns, bonds and cash have provided return-free risk.

Given the BoC's sorry track record over the past decade, all investors, including me, must plan for the possibility that the future long-term rate of inflation will be higher than the BoC's target of 2.00%. In fact, inflation is so important that one prominent member of the investment industry

has been trying to convince the Ontario Securities Commission that asset managers should report their returns net of inflation.<sup>65</sup> While that seems unlikely to happen, I have always emphasized that investors should focus on their after-tax, real (i.e., inflation-adjusted) returns.<sup>66</sup> If investors generally and fully understood the ravages that taxation and inflation wreak on nominal asset values and returns, I believe that they would hold much less than they do in supposedly safe investments like bonds and cash (and conversely much more in equities). In the words of the German polymath Goethe, “the dangers of life are infinite, and among them is safety.”<sup>67</sup>

Long-term projections such as those in the table above were used to devise the Funds’ investment strategy, which might be described as “triple long”, i.e.: i) be long equities (in investment parlance, being “long” means to own an asset); ii) be even longer in equities than is permitted by one’s net assets, by using leverage; and iii) have a long-term investment horizon. Adherence to this philosophy has delivered the Funds’ strong returns since their inceptions; I believe that it will continue to do so over the long term.

Finally, at the beginning of this section, it was stated that the purpose of the 50-year forecasts in the 2014 Letter was to guide investors who had then just turned 18 (the minimum age for having a TFSA) on how to invest their TFSA. The 2014 Letter showed how an investor who made his first TFSA contribution at the end of 2014, who thereafter made the maximum TFSA contribution at the beginning of every year, and who earned a compound annual rate of return of 8.5% (which was the long-term rate of return then estimated for Canadian bank stocks), would by the end of 2064 build a TFSA with a value of \$5.52 million (equivalent to \$2.05 million in real (i.e., inflation-adjusted) 2014 dollars).<sup>68</sup> I’m pleased to report that I know of an actual TFSA, created in 2014, that at the end of 2024 (at its 10-year mark) has exceeded the forecast market values (for the 10-year mark) of the hypothetical TFSA described in the 2014 Letter. That has been because the actual TFSA, which in recent years has been entirely invested in the Trust, has achieved higher annualized returns than the 8.5% used as an example in the 2024 Letter. Thus, with 10 years or 20% of the original 50-year horizon having expired, that investor is on track to be able to fund a comfortable retirement from his TFSA alone. In short: be long and carry on.

### Capital Gains Taxation

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The 2024 Canadian federal budget proposed an increase in the capital gains inclusion rate (i.e., that percentage of capital gains that is included in taxable income) from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized in any year that exceed \$250,000 for individuals, for capital gains realized on or after June 25, 2024.<sup>69</sup>

The legislation to give effect to the proposed capital gains tax changes had not yet passed into law, however, before the prime minister prorogued Parliament until March 24, 2025. That brought all legislative activity to an end until then.<sup>70</sup> In view of that and the considerable uncertainty about how taxpayers should prepare and file their tax returns, on January 31, 2025, the Government of Canada announced that the effective date for the proposed capital gains tax changes had been deferred from June 25, 2024, to January 1, 2026.<sup>71</sup>

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. See, e.g., 2013 Letter p. 3.
5. 2016 Letter, pp. 5-6.
6. 2022 Letter, pp. 7-8.
7. <https://www.bankofcanada.ca/core-functions/monetary-policy/key-interest-rate/>
8. <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
9. Bond yield data in this paragraph for 2023 and 2024 are from Refinitiv Eikon.
10. Current yield data is from <https://www.marketwatch.com/>
11. <https://www150.statcan.gc.ca/n1/daily-quotidien/250121/dq250121a-eng.htm>
12. <https://www.bea.gov/data/income-saving/personal-income>
13. <https://www.federalreserve.gov/economy-at-a-glance-inflation-pce.htm>
14. 2023 Letter, p. 7.
15. See factsheets available at <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview> and <https://www.spglobal.com/spdji/en/indices/equity/sp-500-equal-weight-index/#overview>, respectively.
16. <https://newsinteractives.cbc.ca/elections/us/2024/results/>
17. <https://www.cnbc.com/2024/12/10/insurance-stocks-down-since-unitedhealthcare-ceo-brian-thompson-killing.html>
18. [https://en.wikipedia.org/wiki/Favourite-longshot\\_bias](https://en.wikipedia.org/wiki/Favourite-longshot_bias)
19. Hodges, S.D., Tompkins, R.G. & Ziemba, W.T. “The Favorite / Long-shot Bias in S&P 500 and FTSE 100 Index Futures Options: The Return to Bets and the Cost of Insurance.” EFA 2003 Annual Conference Paper no. 135, 23 July 2003, p. 2.
20. 2023 Letter, pp. 8-10.
21. Officially, there are 68 teams initially. Eight teams compete in the “First Four” games, thus reducing the field to 64 teams (on which betting pools are typically based). See [https://en.wikipedia.org/wiki/NCAA\\_Division\\_I\\_men%27s\\_basketball\\_tournament](https://en.wikipedia.org/wiki/NCAA_Division_I_men%27s_basketball_tournament)
22. <https://quoteinvestigator.com/2015/06/04/race-swift/>
23. <https://investors.thecignagroup.com/financials/quarterly-results/default.aspx>
24. 2024 adjusted EPS of \$27.33 is cited at the webpage immediately above. 2014 EPS of \$7.43 is from Value Line Investment Survey.
25. <https://www.tcenergy.com/investors/liquids-spinoff/>
26. <https://www.kraftheinzcompany.com/brands.html>
27. Kraft Heinz March 22, 2024, proxy statement, p. 56, available at <https://ir.kraftheinzcompany.com/financials/sec-filings>
28. See TD’s Q4/FY’24 press release, p.5, available at <https://www.td.com/ca/en/about-td/for-investors/investor-relations/financial-information/financial-reports/quarterly-results>
29. <https://stories.td.com/ca/en/news/2025-01-17-td-bank-group-accelerates-ceo-transition-3b-announces-board-an>
30. <https://www.verizon.com/about/investors/quarterly-reports/4q-2024-earnings-business-update>
31. Value Line Investment Survey.
32. <https://ir.elevancehealth.com/investors/default.aspx>
33. <https://www.magna.com/stories/news-press-release/2024/magna-announces-fourth-quarter-2023-results-and-2024-outlook>
34. Scotia FY’24 annual report, note 30.
35. <https://www.scotiabank.com/ca/en/about/investors-shareholders/investor-day.html>
36. Nutrien 2023 annual report, note 1.

37. <https://www.nutrien.com/investors/financial-reporting>
38. [https://en.wikipedia.org/wiki/CK\\_Hutchison\\_Holdings](https://en.wikipedia.org/wiki/CK_Hutchison_Holdings)
39. CKKH 2023 annual report p. 4 and Cenovus Energy Inc.'s Management Information Circular dated March 6, 2024, p. 5.
40. CKKH 2023 annual report, p. 132.
41. <https://investors.att.com/financial-reports/quarterly-earnings/2024>
42. <https://www.citigroup.com/global/investors/quarterly-earnings>
43. [https://en.wikipedia.org/wiki/CVS\\_Health](https://en.wikipedia.org/wiki/CVS_Health)
44. <https://www.cvshealth.com/news/company-news/cvs-health-reports-fourth-quarter-results.html>
45. 2024 Letter, pp. 16-27 (especially the table on pp. 25-26).
46. 2019 Letter, pp. 9-11.
47. Actual returns have been sourced as follows. The returns of the S&P/TSX Canadian banks index and the S&P 500 Index in US\$ are from S&P Dow Jones Indices (a division of S&P Global). The returns of the S&P 500 Index ETF in Canadian dollars (C\$) are those of the iShares Core S&P 500 Index ETF (symbol XUS). The returns of the Canadian bond index ETF are those of the iShares Core Canadian Universe Bond Index ETF (symbol XBB); the returns of another large bond ETF, the BMO Aggregate Bond Index ETF (symbol ZAG), were very similar. The returns for cash are those of the iShares Premium Money Market ETF (symbol CMR), which to my knowledge is the largest ETF investing exclusively in cash and short-term cash equivalents that has a track record of at least 10 years. The annual inflation rate is according to the Bank of Canada's inflation calculator at <https://www.bankofcanada.ca/rates/related/inflation-calculator/>
48. 2014 Letter, p. 16.
49. [https://en.wikipedia.org/wiki/Two\\_Out\\_of\\_Three\\_Ain%27t\\_Bad](https://en.wikipedia.org/wiki/Two_Out_of_Three_Ain%27t_Bad)
50. The source is Portland's internally produced valuations, prior to subscriptions and redemptions on the respective dates. The Trust's weights in banks were similar.
51. [https://www.cnn.com/2024/12/31/magnificent-7-stocks-responsible-for-more-than-half-of-the-sp-500s-2024-gain.html?\\_source=newsletter%7Cprocomm%7Cpropulse%7C20241231](https://www.cnn.com/2024/12/31/magnificent-7-stocks-responsible-for-more-than-half-of-the-sp-500s-2024-gain.html?_source=newsletter%7Cprocomm%7Cpropulse%7C20241231)
52. See, for example, [https://markets.businessinsider.com/news/stocks/stock-market-outlook-sp500-future-returns-decade-forecast-goldman-sachs-2024-10?utm\\_medium=referral&utm\\_source=yahoo.com](https://markets.businessinsider.com/news/stocks/stock-market-outlook-sp500-future-returns-decade-forecast-goldman-sachs-2024-10?utm_medium=referral&utm_source=yahoo.com)
53. CIBC Mellon Global Securities Services Company.
54. <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1010000201&cubeTimeFrame.startMonth=12&cubeTimeFrame.startYear=2014&cubeTimeFrame.endMonth=12&cubeTimeFrame.endYear=2024&referencePeriods=20141201%2C20241201>
55. Annual Financial Report of the Government of Canada, 2023-24, p. 10.
56. For example, the highest individual federal income tax rate has been increased from 29% to 33%; corporate income tax rates have been increased for financial institutions; a new tax has been imposed on share buybacks; alternative minimum tax calculations have changed to make them more punitive; a federal "carbon tax" has been imposed; and the federal government has proposed to increase the capital gains inclusion rate from 50% to 66.67%.
57. For example, Bill C-48 ("*Oil Tanker Moratorium Act*"), which banned oil tankers from British Columbia's north coast (but not from ports in vote-rich Québec); Bill C-69 ("*Impact Assessment Act*"), which has become known as the "No More Pipelines Act"; and Bill C-59, which passed amendments to the *Competition Act* which made it illegal for businesses to make statements with which anyone may disagree (see <https://www.justice.gc.ca/eng/csj-sjc/pl/charter-charte/c59.html> and <https://calgaryherald.com/opinion/columnists/varcoe-an-egregious-overstep-private-sector-launches-lawsuit-against-ottawas-bill-c-59> ).
58. <https://ca.finance.yahoo.com/news/statistics-canada-release-third-quarter-090008421.html>
59. 2014 Letter, pp. 26-27.
60. For example, on January 29, 2025, the BoC reduced its target for the overnight rate by 0.25%, from 3.25% to 3.00%. See <https://www.bankofcanada.ca/2025/01/fad-press-release-2025-01-29/>
61. 2014 Letter, p. 26.
62. <https://www.bankofcanada.ca/rates/indicators/key-variables/inflation-control-target/>

63. 2014 Letter, p. 27.
64. [https://en.wikipedia.org/wiki/Quantitative\\_easing#:~:text=Quantitative%20easing%20\(QE\)%20is%20a,order%20to%20stimulate%20economic%20activity](https://en.wikipedia.org/wiki/Quantitative_easing#:~:text=Quantitative%20easing%20(QE)%20is%20a,order%20to%20stimulate%20economic%20activity).
65. <https://www.theglobeandmail.com/investing/markets/inside-the-market/article-former-bay-street-executive-leads-push-to-require-firms-to-account-for/>
66. See, for example, the inaugural 2013 Letter, pp. 15-17.
67. <https://www.leadershipnow.com/risktakingquotes.html>
68. 2014 Letter, pp. 32-34.
69. <https://www.canada.ca/en/department-finance/news/2024/06/capital-gains-inclusion-rate.html>
70. <https://www.theglobeandmail.com/investing/personal-finance/article-uncertain-fate-of-capital-gains-tax-hike-leaves-taxpayers-facing-two/>
71. <https://www.canada.ca/en/department-finance/news/2025/01/government-of-canada-announces-deferral-in-implementation-of-change-to-capital-gains-inclusion-rate.html>
72. <https://financialpost.com/personal-finance/taxes/why-complicated-tax-form-when-capital-gains-unchanged>
73. 2023 Letter, pp. 14-15.
74. <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
75. 2022 Letter, pp. 9-11.

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Offering Memorandum and the information contained herein is a summary only and is qualified by the more detailed information in the Offering Memorandum.

Portland believes the following risks may impact the Funds' performance: concentration, leverage, currency and exchange rate risk and equity risk. Please read the "Risk Factors" section in the Offering Memorandum for a more detailed description of all the relevant risks.

Since the Funds do not necessarily invest in the same securities as the benchmark or in the same proportion, the performance of the Funds may not be directly comparable to the benchmark. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only, and is not an indication of performances of the Funds.

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# Portland Focused Plus Fund LP Portland Focused Plus Fund

ANNUAL LETTER TO INVESTORS

FOR THE YEAR ENDED DECEMBER 31, 2025

**Portland Focused Plus Fund LP**  
**Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2012 (from Oct. 31)	1.7%	1.9%	2.0%	2.0%	0.7%	1.4%
2013	33.0%	34.1%	37.7%	34.4%	12.7%	31.8%
2014	15.6%	16.8%	18.8%	17.5%	10.7%	12.7%
2015	6.5%	7.5%	8.3%	8.5%	-9.0%	0.7%
2016	39.0%	40.4%	45.5%	41.6%	20.3%	10.9%
2017	16.4%	17.5%	19.9%	18.6%	8.4%	21.2%
2018	-14.8%	-14.0%	-13.5%	-13.2%	-9.7%	-5.0%
2019	49.3%	50.8%	54.7%	52.4%	21.1%	30.9%
2020	25.8%	27.1%	30.6%	28.3%	3.5%	20.7%
2021	16.1%	17.4%	21.2%	18.8%	24.9%	26.5%
2022	-31.0%	-30.2%	-30.1%	-29.5%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
2024	17.5%	18.6%	19.0%	19.5%	22.0%	24.6%
2025	41.5%	42.7%	47.4%	44.2%	30.1%	17.3%

Year	Annualized Total Returns as of December 31, 2025					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	41.5%	42.7%	47.4%	44.2%	30.1%	17.3%
3 years	26.4%	27.6%	29.2%	28.9%	21.3%	22.7%
5 years	10.1%	11.2%	12.8%	12.4%	15.8%	13.4%
10 years	15.4%	16.5%	18.7%	17.7%	11.9%	14.2%
Since inception	15.9%	17.0%	19.2%	18.1%	10.0%	14.2%

Year	Cumulative Total Returns as of December 31, 2025					
	Portland Focused Plus Fund LP				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	41.5%	42.7%	47.4%	44.2%	30.1%	17.3%
3 years	101.9%	107.9%	115.5%	114.1%	78.3%	84.9%
5 years	61.7%	70.2%	82.5%	79.3%	108.2%	87.4%
10 years	318.3%	362.5%	456.2%	410.8%	206.9%	277.8%
Since inception	596.7%	693.8%	904.8%	792.5%	250.5%	473.1%

**Portland Focused Plus Fund  
Performance vs. Stock Market Indices**

Year	Calendar Total Returns					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
2016 (from Mar. 31)	28.7%	29.3%	33.6%	30.6%	16.1%	10.0%
2017	15.5%	16.7%	19.4%	18.1%	8.4%	21.2%
2018	-15.6%	-14.7%	-14.2%	-13.8%	-9.7%	-5.0%
2019	48.5%	50.1%	53.2%	51.8%	21.1%	30.9%
2020	27.2%	28.6%	32.2%	30.0%	3.5%	20.7%
2021	15.7%	17.0%	20.8%	18.4%	24.9%	26.5%
2022	-30.0%	-29.2%	-29.1%	-28.4%	-6.5%	-19.8%
2023	21.4%	22.8%	22.9%	24.2%	12.3%	26.5%
2024	17.8%	19.1%	19.3%	20.2%	22.0%	24.6%
2025	41.9%	42.8%	47.4%	44.3%	30.1%	17.3%

Year	Annualized Total Returns as of December 31, 2025					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	41.9%	42.8%	47.4%	44.3%	30.1%	17.3%
3 years	26.6%	27.9%	29.3%	29.2%	21.3%	22.7%
5 years	10.4%	11.6%	13.1%	12.8%	15.8%	13.4%
Since inception	15.0%	16.1%	18.2%	17.4%	11.8%	14.5%

Year	Cumulative Total Returns as of December 31, 2025					
	Portland Focused Plus Fund				MSCI Canada Index	MSCI USA Index (US\$)
	Series A	Series F	Series M	Series P		
1 year	41.9%	42.8%	47.4%	44.3%	30.1%	17.3%
3 years	102.9%	109.0%	116.1%	115.4%	78.3%	84.9%
5 years	64.4%	73.2%	85.0%	82.7%	108.2%	87.4%
Since inception	289.6%	330.5%	412.5%	379.6%	196.2%	274.9%

## Notes:

The inception dates of the Portland Focused Plus Fund LP and Portland Focused Plus Fund were October 31, 2012, and March 31, 2016, respectively. Performances for the Portland Focused Plus Fund LP and Portland Focused Plus Fund are net returns after all fees and expenses (and taxes thereon) have been deducted. The MSCI USA Index is shown in U.S. dollars rather than in Canadian dollars since the Funds generally hedge their U.S. dollar exposure. Since the Funds do not necessarily invest in the same securities as the benchmarks or in the same

proportions, the performance of the Funds may not be directly comparable to the benchmarks. In addition, the Funds' returns reflect the use of leverage. The use of benchmarks is for illustrative purposes only and is not an indication of the performance of the Funds.

**Portfolio manager's letter\* to investors in the Portland Focused Plus Fund LP (the "LP") and the Portland Focused Plus Fund (the "Trust") (jointly, the "Funds"):**

This letter describes how the Funds are managed and why they are managed that way. The letter also discusses topics of general interest to investors and is intended to serve as a useful reference for current and prospective investors in the Funds.<sup>1</sup>

**Previous Letters**

Previous annual letters to investors in the Funds are available on the web site of Portland Investment Counsel Inc. ("Portland") at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) for the LP and at [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust) for the Trust. Important subject areas regarding investing and portfolio management were discussed in detail in those letters. The remarks were intended to be of a lasting nature; this letter does not update or revise them. Investors are strongly encouraged to read those previous letters.

**Investment Objective**

As stated in the Funds' Offering Memorandum dated October 25, 2018 ("OM"), the investment objective of each Fund is "to achieve, over the long term, preservation of capital and a satisfactory return."<sup>2</sup> In order to gauge whether the performance of the Funds has been satisfactory, investors should compare the long-term performance of the Funds to a 50%/50% average of the returns of the MSCI Canada Index ("MSCI Canada") and the MSCI USA Index ("MSCI USA") in U.S. dollars ("US\$").<sup>3</sup>

**Performance of the LP**

The performance of the LP and that of its two benchmark stock market indices is shown in the tables on the inside front cover of this letter. The performance tables are also shown in the LP's factsheet ("Fund Brief") which is updated monthly about a week after every month-end and posted to the LP's web page referenced above.

In 2025, the LP's series F units (the highest fee series without embedded advisor compensation) had a return of 42.7% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 30.1% for MSCI Canada and to a return of 17.3% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 23.7%. As a result, in 2025 the LP outperformed its benchmark indices. For the five years ended December 31, 2025 (I have always suggested that five years is the minimum reasonable period for measuring performance<sup>4</sup>), the LP's series F units had a cumulative return of 70.2%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 108.2% and 87.4%, respectively. A 50%/50% blend of the two indices had a return of 97.8%. As a result, for the five years ended December 31, 2025, the LP underperformed its benchmark indices. For the 10 years ended December 31, 2025, the LP's series F units had a cumulative return of 362.5%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 206.9% and 277.8%, respectively. A 50%/50% blend of the two indices had a return of 242.4%. As a result, for the 10 years ended December 31, 2025, the LP outperformed its benchmark indices. Finally, for the entire period since inception of the LP on October 31, 2012, to December 31, 2025, the LP's series F

units achieved a cumulative return of 693.8%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 250.5% and 473.1%, respectively. A 50%/50% blend of the two indices had a return of 361.8%. As a result, for the full period since the LP's inception, the LP outperformed its benchmark indices.

### Performance of the Trust

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As discussed in detail in the 2016 Letter, with very limited exceptions, the LP is intended for non-registered investment accounts; the Trust is intended for registered investment accounts and for non-Canadians.<sup>5</sup> The Trust's investments are managed in a virtually identical manner to those of the LP. Each of the Funds experience monthly cash flows arising from subscriptions and redemptions. Shortly after every month-end in which the portfolios diverge materially, the Funds make such portfolio transactions as are necessary to harmonize their respective portfolios. As a result, investors should expect that the long-term performance of the two Funds will be similar (as indeed has been the case). That is why Portland distributes the same annual letter to investors in both the LP and the Trust.

The performance of the Trust and that of its two benchmark stock market indices is shown in the tables on page three of this letter. The Trust's Fund Brief, which shows performance updated to the latest month-end, may be found at the Trust's web page referenced at the start of this letter.

In 2025, the Trust's series F units (the highest fee series without embedded advisor compensation) had a return of 42.8% (all performance figures for the Funds are net of fees and expenses). That compares to a return of 30.1% for MSCI Canada and to a return of 17.3% for MSCI USA in US\$. A 50%/50% blend of the two indices had a return of 23.7%. As a result, in 2025 the Trust outperformed its benchmark indices. For the five years ended December 31, 2025, the Trust's series F units had a cumulative return of 73.2%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 108.2% and 87.4%, respectively. A 50%/50% blend of the two indices had a return of 97.8%. As a result, for the five years ended December 31, 2025, the Trust underperformed its benchmark indices. Finally, for the entire period since inception of the Trust on March 31, 2016, to December 31, 2025, the Trust's series F units achieved a cumulative return of 330.5%. That compares to cumulative returns for MSCI Canada and MSCI USA in the same period of 196.2% and 274.9%, respectively. A 50%/50% blend of the two indices had a return of 235.6%. As a result, for the full period since the Trust's inception, the Trust outperformed its benchmark indices.

### Monthly Fund Updates

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Shortly after every month-end, fund updates are sent out by email for each of the LP and the Trust. These are generally factual in nature, with data on performance, equity weight and largest holdings. Canada's Anti-Spam Legislation restricts Portland's ability to add anyone's email address to the list to receive these updates without that person's written consent. If you wish to receive the monthly email updates for either the LP, the Trust, or both, please send an email to that effect to me at [info@portlandic.com](mailto:info@portlandic.com). At the bottom of every email update there is an "unsubscribe" button that you may click on to be removed from receiving Portland emails.

### Canadian Hedge Fund Awards

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I'm please to report that the LP was a winner of two 2025 Canadian Hedge Fund Awards. The awards, both in the Equity Focused category, were for achieving 2<sup>nd</sup> place, Best 1-Year Return; and 2<sup>nd</sup> place, Best 10-year return.<sup>6</sup> Often, investment funds have excellent returns confined to the recent past, with much worse returns over longer-term periods (if they exist at all). Conversely, some funds had excellent returns many years in the past, with much poorer returns recently. In that context, it's gratifying for the LP to have received recognition for its excellent performance over both short-term (one-year) and longer-term (10-year) periods.

### Recent Performance and Market Conditions

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As noted above, performance of the Funds in 2025 was strong. Indeed, both Funds closed on December 31, 2025, at record highs (in the case of the LP, that is measured by net asset value per unit; in the case of the Trust, that is measured by the value of \$10,000 invested at inception). There is an old (and wise) expression, however: don't confuse genius with a rising market.

Since October 31, 2023, when the Funds had their performance lows during the last bear market cycle, stock market performance has been very strong. That has greatly helped to boost returns of the Funds. Indeed, from October 31, 2023, to December 31, 2025, the series F units of the LP and Trust had cumulative returns of 139.7% and 140.1%, respectively.

In my opinion, valuations of stock markets in Canada and the United States are currently at high levels based on a variety of traditional valuation measures. Those measures include earnings, dividends, book value, market capitalization to gross domestic product ("GDP"), and the relationship of earnings yields (i.e., the inverse of the widely followed price/earnings ratio) to longer-term interest rates. Measures of market sentiment also appear to be in ebullient territory. This combination of high valuations and bullish sentiment suggests to me that caution is warranted.

### Equity Weight

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I often cite the Funds' equity weights in these letters and in marketing materials. My preferred method of calculating equity weight is total equities divided by net assets. Expressed that way, any figure over 100% indicates that the Funds' equity positions are financed in part with margin borrowings, while any figure for equity weight under 100% indicates that the Funds are in a net cash position. Given my comments above regarding equity market conditions, you will not be surprised to read that over the course of 2025, the Funds reduced their equity weights substantially. Specifically, the LP's equity weight declined from 234.0% at December 31, 2024, to 87.6% at December 31, 2025 (the Trust's equity weights were similar, as adjusted for its distributions payable at both year-ends, substantially all of which were reinvested into additional Trust units). There is no doubt that in reducing equity weights so greatly I have left money on the table compared to the even-stronger returns that would have been enjoyed had the Funds kept larger equity weights. I often think, however, of words attributed to the first Baron Rothschild when he was asked for the secret of his stock market success: "I never buy at the bottom, and I always sell too soon."<sup>7</sup>

It is a core strategy of the Funds to have very focused portfolios (hence their names).<sup>8</sup> As a result, investing their portfolios doesn't require broad-based inexpensive valuations; a limited number of attractively valued companies will suffice. Nevertheless, in my opinion, it is much harder to find attractively valued investments under current market conditions. Further, long experience (I've now been employed in the investment business for 43 years) suggests that if there is equity market weakness, it will be broad-based, so that it is prudent not to have too large an equity weight. Having a lower equity weight may serve to both limit negative performance when there is equity market weakness and enable the Funds to add to equities on favourable terms if conditions are deemed appropriate to do so.

An important, and in my view insufficiently appreciated, attribute of the Funds is their ability to widely vary their equity weights, while keeping significant exposure to equities (given that I have long stated my view that equities would provide the best long-term returns among the three major traditional asset classes of equities, bonds and cash).<sup>9</sup> Conventional Canadian public mutual funds may not use leverage and alternative public mutual funds are limited in their ability to use leverage. Thus, when equity market valuations are high, their portfolio managers are faced with a quandary. Do they keep the equity weights of their funds at 100%, knowing that they will have full exposure to a stock market decline and that they will not then be able to be a net buyer of equities should they fall to more attractive levels? Or do they reduce the equity weights of their funds far below 100%, investing the proceeds in cash equivalents, which may result in lagging performance in a phenomenon known as "cash drag?"<sup>10</sup> These decisions are notoriously difficult to get right. Conversely, when I deem it appropriate to be more defensive, the equity weights of the Funds may be reduced to as low as 100% without resulting in any cash drag. Yet the Funds retain the ability (through their use of leverage) to greatly increase their equity weights should opportunities arise. Indeed, as noted above, the LP's equity weight was 234.0% as recently as December 31, 2024. I am prepared to increase equity weights in the Funds significantly, to 250% or more of net assets, if circumstances warrant.<sup>11</sup> I believe that, given time, the Funds will again increase their equity investments significantly. Such additional investments will only be made if they are expected to help meet the Funds' investment objective: to achieve, over the long term, preservation of capital and a satisfactory return.

#### Taxes and Adjusted Cost Base of LP Units

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In the 2018 and 2023 Letters, I discussed in detail how taxes apply to investments in the LP and the Trust.<sup>12</sup>

I have also tried to highlight key tax matters in many presentations to financial advisors. Nevertheless, I remain very concerned, based on communications that I've had with advisors and investors, that many investors may not be completing their tax returns properly. Failure to do so may result in substantial *overpayment* of taxes compared to those taxes that are actually due. So, this section repeats the tax information provided in the 2018 and 2023 letters, with additional context and a numerical example. **For investors in the LP, if you only read one section of this letter, let this one be it.** Conversely, if you are an investor in only the Trust, you may skip this section. The discussion below is not intended to constitute tax advice; investors should consult their own tax professionals.

I have always prepared and filed my own personal tax returns. 45 years ago, I would pick up a fairly simple paper tax package at the local post office, complete the return by hand and mail it. Those days are long gone. Unfortunately, the same computers that have greatly improved our lives in so many ways have also enabled what are, in my opinion, incompetent and rapacious governments to vastly increase the complexity of the income tax system (more on that in the next section of this letter). These days, of necessity given how complicated the *Income Tax Act* (“ITA”) has become, tax returns are almost all filed using tax software. As Hamlet said, and as explained below, “there’s the rub.”<sup>13</sup>

If you sell an investment security in a non-registered plan (i.e., an open account), you are required to report that disposition, and the resulting capital gain (or loss), on your income tax return. In bygone days, the fields in the tax returns would all be blank. It would be up to taxpayers to determine the correct amounts and enter them into their returns. Investment firms began sending information on securities dispositions to the Canada Revenue Agency (“CRA”) on T5008 slips (“Statement of Securities Transactions”) commencing with the 2005 tax year.<sup>14</sup> Originally, investment firms generally only reported the “proceeds of disposition” (box 21 of the T5008 slip) and not the “cost or book value” (box 20) since the cost was either not known or not tracked by many investment firms.<sup>15</sup> Over time, investment firms began also to report figures in box 20 for “cost or book value.” Unfortunately, I believe that many investors (and tax professionals) are not aware of, or do not heed, CRA’s warning below which appears on its website (and is also stated, in very fine print, on the back page of T5008 slips themselves):

**Box 20** - The amount in box 20 may or may not reflect your adjusted cost base (ACB) for the purpose of determining the gain or loss from the disposition of the security. You are required to make the adjustments, as needed, to the amount indicated in box 20, at the time of determining and reporting your gain or loss from the disposition.<sup>16</sup>

Indeed, as discussed more fully below, for investors who redeem units in the LP and thus receive T5008 slips, **the amounts shown in Box 20 are the original cost of their LP units, which amounts are generally not their adjusted cost base (“ACB”) of such units for tax purposes.**

This problem of investors misunderstanding the amounts in box 20 of the T5008 slips has been greatly exacerbated by another phenomenon made possible by today’s computers: “Auto-fill My Return.” This so-called service, which is now widely used, enables individual taxpayers and professional tax preparers to automatically populate the tax information that CRA has on file (including T5008 slips) directly into tax returns. The problem is that, despite the clear warning stated by CRA itself that “cost or book value” may or may not be ACB, tax software (at least a top seller that I use) assumes that it is and copies the amount from box 20 directly into the field for ACB. The only ways that I know to prevent this problem are : i) not to use Auto-fill My Return (which may cause many other tax filing mistakes, especially for professional tax preparers), or at least

not use it to import T5008 slips; or ii) after using Auto-fill My Return, overwrite the tax software (if possible) so as to enter the correct amount for ACB into securities dispositions.

In my opinion, purveyors of tax software should not be allowed to automatically copy amounts from box 20 of T5008 slips into ACB fields for capital gains calculations. Alternatively, it should be possible to hold them financially responsible (through class action lawsuits) for the vast tax overpayments that may arise from the use of their software. This practice (of copying box 20 amounts into ACB fields) has been aided and abetted by CRA which, in my opinion, either isn't aware of the issue, doesn't understand it or doesn't care (because it likely results, in the aggregate, in substantial overpayment of taxes).

In my experience, among the at least five parties who may be involved in compiling tax information (i.e., taxpayer, investment firm, financial advisor, tax lawyer and tax accountant), each of them thinks that determining ACB is someone else's responsibility. Please allow me to very clear: determining ACB is the taxpayer's responsibility. The rest of this section describes why you must make adjustments to original cost in order to determine the ACB of your LP units, and how to do so.

The LP does not pay distributions. Instead, the LP allocates its income and expenses to its investors on a pro rata basis. These allocations are recorded for tax purposes on T5013 slips which are issued to investors annually in March in respect of the preceding calendar year. One of the attractive features of limited partnerships is that income earned and expenses incurred by them retain their tax character when they are attributed to investors. For example, most of the LP's income over time has been tax-advantaged as it has been in the form of capital gains and eligible Canadian dividends (only half of capital gains are included in taxable income and eligible Canadian dividends earn significant tax credits). At the same time, the LP's expenses (i.e., management fees, performance fees, operating expenses and interest expense on margin loans) are all fully deductible in the computation of taxable income (with the exception of foreign dividend withholding taxes, which also earn a tax credit). For tax purposes, these expense items (other than foreign withholding taxes) are all aggregated into one number (reported on the T5013 slips) called "carrying charges". Also, if the LP should have net capital losses in any year, such capital losses may be carried back up to three years by filing a form T1A, "Request for Loss Carryback,"<sup>17</sup> or they may be carried forward indefinitely for application against future capital gains. Note that since the LP does not actually pay distributions, investors must have some other means to pay any taxes owing by them on their allocation of the LP's income and expenses. In my experience, investors generally fund their LP-related tax obligations using other resources held by them or by redeeming some of their LP units.

Upon receiving each T5013 slip, investors should adjust the ACB of the LP units that they own as follows:

- **increase the ACB by the amount of income items allocated.** Those items comprise interest from Canadian sources (reported in box 128 of T5013 slips); actual amount of eligible Canadian dividends (box 132); foreign dividend and interest income (boxes 135); and capital gains (box 151: if the amount in box 151 is positive (i.e., capital gains), it increases ACB; if the amount in box 151 is negative (i.e., capital losses), it decreases ACB). The requirement to increase ACB for income items allocated is stated in s. 53(1)(e)(i) of the ITA;<sup>18</sup> and
- **decrease the ACB by the amount of expense items allocated.** Those items comprise foreign dividend withholding tax, which CRA refers to as “foreign tax paid on non-business income” (box 171); and carrying charges (box 210). The requirement to decrease ACB for expense items allocated is stated in s. 53(2)(c)(i) of the ITA.<sup>19</sup>

**It is imperative that investors in the LP make the adjustments described above to their ACB.**

Only by doing so can investors in the LP avoid double taxation. That would arise if investors paid taxes on income allocated to them on T5013 slips but not actually received by them, and then, when they eventually redeem their units, they paid too much tax because they had not adjusted their ACB for the cumulative amounts of income and expenses allocated to them.

This may be illustrated by the following example. The numbers below are hypothetical, although they’ve been chosen so that the net T5013 allocations bear at least a vague resemblance to what I expect the LP’s actual T5013 allocations will look like when they’re issued in March 2026.

<u>Portland Focused Plus Fund LP</u>		Increase (decrease)
Hypothetical example of investment, T5013 allocations and ACB	T5013 Box Number	in ACB
Subscription on December 31, 2024 (A)		\$100,000
Increase (decrease) in ACB from 2025 T5013 alloca- tions:		
Interest from Canadian sources	128	\$1,000
Actual amount of eligible Canadian dividends	132	\$6,000
Foreign dividend income	135	\$4,000
Capital gains (losses)	151	\$40,000
Foreign tax paid on non-business income	171	(\$600)
Carrying charges	210	(\$10,400)
Total increase in ACB in 2025 (B)		\$40,000
ACB on December 31, 2025 (A+B)		\$140,000

The following are the required adjustments to ACB in the above example:

- On December 31, 2024, the investor subscribes for \$100,000 of the LP’s series F units. On that date, the investor’s “cost or book value” and ACB are the same, i.e., \$100,000.
- The investor is not allocated any income in respect of 2024 as they were not an investor for any part of that year.
- The investor holds the LP units for all of 2025. In March 2026, they would be issued a T5013 slip

allocating their share of the LP's income and expenses for 2025. Using the hypothetical example in the table, their ACB would be increased by allocations on the T5013 slip as follows: \$1,000 for interest income (box 128); \$6,000 for actual amount of eligible Canadian dividends (box 132); \$4,000 for foreign dividend income (box 135); and \$40,000 for capital gains (box 151). The investor's ACB would be decreased by (\$600) of foreign tax paid on non-business income (box 171); and by (\$10,400) of carrying charges (box 210).

- The net amount of the T5013 allocations in respect of 2025 in the example is +\$40,000. As a result, the investor's ACB at the end of 2025 is \$140,000 (i.e., their original cost of \$100,000 plus the net T5013 allocations for 2025 of \$40,000 for a total ACB of \$140,000).

If the investor continued to hold their units for additional years, they would receive a T5013 slip in respect of each year. They would then determine their ACB in the same manner: start with the ACB as of the prior year-end (after adjustment for the T5013 allocations in respect of that and all previous years) then adjust the ACB for T5013 allocations in the most recent year.

Let's assume, though, that the investor redeemed all of their LP units on the December 31, 2025, valuation date. The settlement date for that redemption would be one week later (i.e., in early January 2026). So, the redemption would be reported on a T5008 slip for 2026 (to be issued in early 2027). Note that such investor would not receive a T5013 slip for 2026 as they would be deemed not to have owned the units for any part of that year. Further assume that the redemption proceeds as of the December 31, 2025, valuation date were \$142,700 (which would have been the actual result had this hypothetical investment been real, since the return of the LP's series F units in 2025 was 42.7%). On that investor's T5008 slip for 2026, the amount in box 21 ("proceeds of disposition") would be \$142,700 (no problem there) but the amount in box 20 ("cost or book value") would be \$100,000 *because that was the investor's original cost*. As noted above, however, the investor's ACB was \$140,000. If such investor correctly reported proceeds of \$142,700 and their ACB of \$140,000, then their capital gain in 2026 would be the difference, i.e., \$2,700. If, however, the investor mistakenly reported their original cost of \$100,000 (as would be reported in box 20) as their ACB, then their reported capital gain would be \$42,700, or \$40,000 higher than it should be (because of failing to adjust original cost for their T5013 allocations in order to determine ACB). At time of writing, the top marginal income tax rate on capital gains in Ontario is 26.76% (or higher; see next section).<sup>20</sup> That means that this hypothetical investor, who failed to make the required adjustments to their ACB, would overpay their taxes (assuming that they were in the top tax bracket) by \$10,704 (i.e., \$40,000 x 26.76% = \$10,704). **As this example demonstrates, it is imperative that investors in LP units adjust their ACB for allocations on T5013 slips issued to them and ensure that such ACBs (not original cost) are correctly entered into their tax returns in respect of years in which they redeem units.**

#### Alternative Minimum Tax

After the exhaustive (and exhausting?) preceding discussion of ACB, you might think that this letter must be done discussing tax. But wait, there's more!

On March 28, 2023, the federal Liberal government, under Prime Minister Justin Trudeau and

his Minister of Finance Chrystia Freeland, tabled the 2023 federal budget. The government dubbed it “A Made-in-Canada Plan.”<sup>21</sup> The title of the summary of the budget by the Funds’ legal counsel, Borden Ladner Gervais LLP (“BLG”) was, “A masterclass in increasing taxes without increasing rates.”<sup>22</sup> In my opinion, as damning as BLG’s assessment was, it was too kind. The 2023 budget did, in fact, substantially increase tax rates (as discussed further below). As BLG itself notes, the budget did so by making substantial changes to increase the Alternative Minimum Tax (“AMT”).

For those unfamiliar, AMT is an alternative income tax calculation applicable to individuals and trusts which, for federal tax purposes, is calculated on the 10-page form T691.<sup>23</sup> Governments sometimes state that the purpose of AMT is to ensure that higher income taxpayers, who might legally have little or no tax owing under the regular tax system (through the use of deductions and credits that the government itself has deemed fit to pass into tax law), pay at least some minimum tax rate. Many Canadians may not know that Canada even has an AMT as, before the 2023 budget, the AMT applied to a small number of taxpayers. Also, tax software typically does not even show the AMT in tax returns unless the AMT is applicable. If that is the case (i.e., if the AMT tax calculation results in a higher amount of tax owing than the amount of tax determined under the regular tax method), then the excess tax paid may be carried forward for up to seven years and recovered in any years in which the AMT tax amount is lower than that under the regular tax method.

The 2023 budget made significant changes to the AMT. In particular, it:

- Increased the AMT tax rate from 15.0% to 20.5%; and
- Changed the law so that only 50% (formerly 100%) of many expenses incurred to earn income (such as interest expense on money borrowed to earn investment income) is deductible.

In my opinion, both of these changes are outrageous. In the case of the increase in the AMT tax rate, it results in an increase in the tax rate on capital gains in an underhanded manner (buried in the AMT rather than in the regular tax calculation). And the other change means that all income is taxed but the government only permits deduction of half of the expenses incurred to generate that income. In my opinion, that should be an affront to all fair-minded people. The AMT changes were effective commencing with the 2024 tax year, for which Canadians filed their tax returns in the spring of 2025 (which is why I am writing about AMT in this 2025 letter).

A comparison of the tax rate (for 2024) on capital gains between the regular tax method and AMT, for an Ontario taxpayer in the highest tax bracket, is shown in the following table:

<u>Capital gains tax rates</u> (highest tax bracket)	Regular	AMT	AMT vs. regular
Federal	16.50%	20.50%	4.00%
Ontario	10.26%	11.80%	1.54%
Total	26.76%	32.30%	5.54%

In the above table, the source for the regular tax rates is TaxTips.ca (<https://www.taxtips.ca/index.html>), which I believe is an excellent source of tax rate information. In the AMT column, the source for the federal tax rate is the aforementioned form T691. The source for the Ontario AMT tax rate (and therefore the combined federal/Ontario AMT tax rate) is me, based on my review of 2024 tax calculations. This highlights one of the many shortcomings of AMT: its lack of transparency. I'm not aware of any published tax tables that show the provincial, and combined federal/provincial, AMT tax rates. For example, as noted in the table (and as discussed in the preceding section of this letter), the top regular method tax rate on capital gains in Ontario is 26.76%. Conversely, the top AMT tax rate on capital gains in Ontario is a much higher 32.30%.

The criticisms of AMT (with which I concur) include that it results in punitively high taxes that are complex and not transparent. Further, historically many taxpayers subject to AMT have been able to recover it in a future year, anyway, so that the net AMT tax paid in such cases is nil. For these reasons, one of Canada's foremost tax experts, Kim Moody of Moodys Tax Law, has stated that the AMT "is an example of silly taxation policy creating complexity and it needs to be abolished."<sup>24</sup> I certainly agree. Where I may differ with Moody, though, is that with the 2023 changes to the AMT, it may be much harder and less likely for those taxpayers who pay AMT to recover it in a future year than was previously the case.

There is a basic exemption in the AMT calculation so that it only applies to taxpayers (in 2024) with "net adjusted taxable incomes" of more than \$173,205.<sup>25</sup> Some may think that, since they don't have income above \$173,205 (as most Canadians don't), that they're not affected by these AMT changes. Nothing could be further from the truth. According to Moody, in 2021, the top 1% of income earners paid 22.5% of all federal and provincial income taxes.<sup>26</sup> According to the Fraser Institute, in 2024 the top 20% of income-earning families (those with incomes above \$243,157) paid 62.7% of federal and provincial personal income taxes and 54.2% of total taxes (including sales taxes, payroll taxes, property taxes, etc.).<sup>27</sup> If these AMT changes cause an exodus of higher income earners from Canada (as I believe is occurring) or simply cause them to retire or otherwise change their behaviour since their tax rates are now so high that it discourages work and investment, personal income tax collection could be materially adversely affected. Those revenues accrue to the federal and provincial governments and are used in part to fund essential social services, health care and education. So, these recent AMT tax changes affect us all. In the words of the English poet John Donne, "send not to know for whom the bell tolls, it tolls for thee."<sup>28</sup>

If you would like a more lighthearted take on how government policies often backfire, and how beyond a certain point (which I think we've passed in Canada) higher tax rates may actually result in lower tax revenue (and conversely lower tax rates may result in higher tax revenue), I recommend economist, lawyer, comedian and actor Ben Stein's performance as an economics teacher in the iconic film *Ferris Bueller's Day Off*, available at a link in the endnote to this sentence.<sup>29</sup>

You may be wondering, since these letters are primarily about investing, why have I devoted so

much space herein to discussing taxes? As noted in the section above, one reason is so that investors in the LP will determine their ACBs correctly so that they do not overpay their taxes. Another, more general, reason, is that for many (if not most) Canadians, taxes will be by far their largest single lifetime expense. I have always stated that investors should consider their returns after tax and inflation.<sup>30</sup> So, understanding tax is essential to achieving successful, long-term investment results. Finally, taxes have a profound impact on economic growth, investment and the health of the job market. In my opinion, a simple and sensible tax regime attracts investment and results in growth and jobs. Conversely, an extraordinarily complex and high-tax regime such as Canada's discourages growth and results in economic stagnation and fewer job prospects. For example, from 2015 to 2025, Canada's real GDP per capita increased from \$57,597 to \$60,071, a paltry compound annual growth rate during that last (and lost) decade of only 0.4%.<sup>31</sup> As multiple commentators have noted, this performance is Canada's worst since the 1930s (during the Great Depression)<sup>32</sup> and is the worst in the G7 group of countries, by far.<sup>33</sup>

#### Another Day, Another Donald (aka I Never Promised You a Rose Garden)

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After equity markets closed on April 2, 2025, U.S. President Donald Trump made his "Liberation Day" (so-called "reciprocal") tariff announcement at the White House Rose Garden.<sup>34</sup>

The announcement included shockingly high tariffs imposed on virtually every country in the world. Trump stated that the tariff rates were justified using a formula that was widely (and in my opinion, correctly) disparaged. As was described at the time (with a nod to a recent Academy Award-winning film), Trump's global tariff war amounted to attacking "Everyone, Everywhere, All at Once." The Trump tariff announcement caused turmoil in stock, bond, foreign exchange and commodity markets, as illustrated by the following:

- The flagship U.S. equity benchmark, the Standard & Poor's 500 Index ("S&P 500"), plunged from its close on April 2, 2025, of 5670.97 to a low of 4835.04 on April 7, 2025, a decline of (14.7%);<sup>35</sup>
- The U.S. 10-year Treasury bond yield first fell from 4.20% on April 1, 2025, to 4.00% on April 4, 2025, seemingly as investors became concerned that the tariffs would slow the U.S. economy. Then, just a week later, the 10-year bond yield soared to 4.50% on April 11, 2025, on concerns that foreigners might sour on holding U.S. assets and on unconfirmed media reports that China might be reducing its holding of the bonds;
- The U.S. dollar index ("DXY", a measure of the value of the U.S. dollar relative to a basket of foreign currencies),<sup>36</sup> fell from 104.26 on April 1, 2025, to 98.28 on April 21, 2025, a decline of (5.7%). That brought the decline in DXY compared to its two-year high of 110.18 on January 13, 2025, shortly before Trump's inauguration, to (10.8%); and
- The price of a barrel of West Texas Intermediate ("WTI") crude oil fell from US\$71.71 on April 2, 2025, to as low as US\$55.12 on April 9, 2025, a decline of (23.1%). That brought the decline in WTI compared to its 2025 high of US\$80.59 on January 16, 2025, also shortly before Trump's inauguration, to (31.6%).

The turmoil described above did not go unnoticed. In particular, it seems that the White House grew concerned about the rising 10-year Treasury yield and whether the bond market could be relied upon to continue to finance the massive U.S. budget deficits. Whatever the reason (Trump later stated that some market participants had become "yippy"),<sup>37</sup> on April 9, 2025, Trump announced a three-month pause on the "reciprocal" tariffs for all countries except China. The result was that that day, the S&P 500 screamed higher by 9.5%, tied for its 8<sup>th</sup>-largest single-day gain in history.<sup>38</sup>

## Notes

1. In this letter, all opinions are those of, and the words “I”, “me”, “my” and “mine” refer to, the Funds’ portfolio manager and the letter’s author, James H. Cole.
2. Portland Focused Plus Funds Offering Memorandum, October 25, 2018, p. 3. The OM is available at [https://portlandic.com/focused\\_plus\\_LP](https://portlandic.com/focused_plus_LP) and [https://portlandic.com/focused\\_plus\\_trust](https://portlandic.com/focused_plus_trust).
3. For a discussion, see 2013 Letter, p. 3.
4. See, e.g., 2013 Letter p. 3.
5. 2016 Letter, pp. 5-6.
6. <https://alternativeiq.com/canadian-hedge-fund-awards/> A total of 291 Canadian Hedge Funds were included in the 2025 CHFA program. The awards are based solely on quantitative performance data to June 30, 2025, with Fundata Canada managing the collection and tabulation of the data to determine the winners. There is no nomination process or subjective assessment in identifying the winning hedge funds.
7. Lefèvre, Edwin. *Reminiscences of a Stock Operator* (originally published in 1923; John Wiley & Sons, Inc. edition, 2010), p. 264. The book chronicles the life of legendary trader Jesse Livermore, who attributes the quotation to Baron Rothschild. See also <https://www.goodreads.com/quotes/10187745-old-baron-rothschild-s-recipe-for-wealth-winning-applies-with-greater>
8. The Funds’ two core investment strategies are focused investing in a limited number of long securities positions, and leverage by purchasing securities on margin. See OM, p. 3.
9. See, for example, 2014 Letter p. 16 and p. 27.
10. <https://www.onedayinjuly.com/what-is-cash-drag-and-why-is-it-important>
11. The theoretical maximum equity weight, if all equities owned were eligible for the lowest margin requirement of 30%, would be 333% (i.e., 100% of net assets divided by a 30% margin requirement equals 333%).
12. 2018 Letter, pp. 8-10, and 2023 Letter, pp. 5-6.
13. William Shakespeare’s Hamlet, Act 3, Scene 1.
14. Google “what year did investment firms have to start reporting securities dispositions to Canada Revenue Agency” for a summary generated by the Google Gemini artificial intelligence assistant.
15. <https://www.advisor.ca/tax/tax-news/report-everything/>
16. <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/tax-slips/understand-your-tax-slips/t5-slips/t5008-statement-securities-transactions-slip-information-individuals.html>
17. <https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t1a.html>
18. <https://laws-lois.justice.gc.ca/eng/acts/l-3.3/section-53.html>
19. Ibid.
20. <https://www.taxtips.ca/taxrates/on.htm>
21. <https://www.budget.canada.ca/2023/home-accueil-en.html>
22. [https://www.blg.com/en/insights/2023/03/federal-budget-2023?utm\\_medium=email&utm\\_source=crm-list&utm\\_campaign=tax-insight#msdyntrid=qkm\\_keCmxMVwsBZfJV-Ns5gl6wNhQ8hEVmpjHVAcIJs](https://www.blg.com/en/insights/2023/03/federal-budget-2023?utm_medium=email&utm_source=crm-list&utm_campaign=tax-insight#msdyntrid=qkm_keCmxMVwsBZfJV-Ns5gl6wNhQ8hEVmpjHVAcIJs)
23. <https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t691.html>
24. <https://financialpost.com/personal-finance/taxes/time-alternative-minimum-tax-put-aside-good-everyone>
25. Form T691, line 95.
26. <https://financialpost.com/personal-finance/taxes/more-people-discovering-rich-eyes-of-liberals>
27. <https://www.fraserinstitute.org/studies/measuring-progressivity-in-canadas-tax-system-2024>
28. [https://www.yourdailyoem.com/listpoem.jsp?poem\\_id=2118](https://www.yourdailyoem.com/listpoem.jsp?poem_id=2118)
29. [https://www.google.com/search?q=ben+stein+ferris+bueller&rlz=1C1GCEA\\_enCA1197CA1198&oq=ben+stein+ferris+bueller&gs\\_lcrp=EgZjaHJvbWUqDwgAEAAyQxjAhiABBiKBTIPCAAQABhDGOMCGIAEGIoFMgwIA RAuGEMYgAQYigUyDQgCEAAyKQIYgAQYigUyBwgDEAAyGAAyDQgEEAAyKQIYgAQYigUyDAgFEAAyQxiABBiKBTINCAyQABiRAhiABBiKBTIICAcQABgWGB4yCAGIEAAyFhgeMggiCRAAGBYHtIBCTg3NjBqMGoxNagCC LACAfEW8-X-6fdo1XxVvVPI\\_un3aNV&sourceid=chrome&ie=UTF-8#fpstate=ive&vld=cid:09b681d8,vid:AyAh2IQXF8,st:0](https://www.google.com/search?q=ben+stein+ferris+bueller&rlz=1C1GCEA_enCA1197CA1198&oq=ben+stein+ferris+bueller&gs_lcrp=EgZjaHJvbWUqDwgAEAAyQxjAhiABBiKBTIPCAAQABhDGOMCGIAEGIoFMgwIA RAuGEMYgAQYigUyDQgCEAAyKQIYgAQYigUyBwgDEAAyGAAyDQgEEAAyKQIYgAQYigUyDAgFEAAyQxiABBiKBTINCAyQABiRAhiABBiKBTIICAcQABgWGB4yCAGIEAAyFhgeMggiCRAAGBYHtIBCTg3NjBqMGoxNagCC LACAfEW8-X-6fdo1XxVvVPI_un3aNV&sourceid=chrome&ie=UTF-8#fpstate=ive&vld=cid:09b681d8,vid:AyAh2IQXF8,st:0)

30. See, e.g., 2024 Letter p. 13 and 2013 letter, pp. 15-17.
31. <https://www.theglobeandmail.com/business/article-economy-stronger-footing-trade-war-statscan-revisions-show/#:~:text=According%20to%20Statistics%20Canada%2C%20the%20Canadian%20economy,in-%20each%20of%20the%20last%20three%20years>
32. <https://financialpost.com/opinion/canada-worst-decade-real-economic-growth-since-1930s>
33. See the PDF of an article published by National Bank of Canada that may be found by googling “Canada real GDP stagnated for a decade” and clicking on the link under “National Bank.”
34. <https://www.youtube.com/watch?v=uXa2FyPLYFI>
35. All market data in this section is from Refinitiv (part of the London Stock Exchange Group), CNBC or other sources deemed to be reliable.
36. [https://en.wikipedia.org/wiki/U.S.\\_Dollar\\_Index#:~:text=US%20Dollar%20Index%20\(DXY\)](https://en.wikipedia.org/wiki/U.S._Dollar_Index#:~:text=US%20Dollar%20Index%20(DXY))
37. <https://www.wsj.com/livecoverage/stock-market-trump-tariffs-trade-war-04-09-25/card/trump-says-he-did-tariff-pause-because-yippee-reaction-4Y6So9Q4WhgSOvWY8li1>
38. [https://en.wikipedia.org/wiki/List\\_of\\_largest\\_daily\\_changes\\_in\\_the\\_S%26P\\_500\\_Index](https://en.wikipedia.org/wiki/List_of_largest_daily_changes_in_the_S%26P_500_Index)
39. [https://en.wikipedia.org/wiki/Trump\\_Always\\_Chickens\\_Out](https://en.wikipedia.org/wiki/Trump_Always_Chickens_Out)
40. <https://www.federalreserve.gov/newsevents/speech/powell20260111a.htm>
41. <https://www.cnn.com/2026/01/17/europe/protesters-denmark-greenland-trump-intl>
42. <https://www.berkshirehathaway.com/news/2025news.html>
43. 2018 Letter, pp. 15-16.
44. 2023 Letter, pp. 13-14.
45. <https://bit.ly/45kMajr>
46. The announcement of the TV special is at <https://www.cnbc.com/video/2026/01/12/warren-buffett-a-life-and-legacy-premieres-tuesday-january-13-at-7-p-m-et.html>. I have been unable to find an official replay of the TV special itself, although a (likely unauthorized) replay is available in two segments: <https://www.youtube.com/watch?v=wC7-Deljx3g> and <https://www.youtube.com/watch?v=kCwpQ3Kzh6U>
47. <https://www.youtube.com/watch?v=JG3uvOICo50>
48. *Warren Buffett: A Life and Legacy*, minutes 32-36.
49. Buffett has said this, or a similar statement, many times. One example is minute 3 of the video at <https://www.youtube.com/watch?v=PEPrpSCZkeU>
50. Graham, Benjamin and Dodd, David L. *Security Analysis* (originally published in 1934 by The McGraw-Hill Companies, Inc.).
51. Graham, Benjamin. *The Intelligent Investor* (originally published in 1949).
52. Williams, John Burr. *The Theory of Investment Value* (originally published in 1938 by Harvard University Press).
53. Fisher, Philip. *Common Stocks and Uncommon Profits* (originally published in 1958 by Harper & Brothers).
54. Munger’s investment philosophy is articulated in the authorized book about him: Kaufman, Peter D., editor. *Poor Charlie’s Almanack: The Wit and Wisdom of Charles T. Munger* (2005, PCA Publication, L.L.C.).
55. <https://finance.yahoo.com/news/warren-buffetts-investment-tip-better-203104925.html>
56. Berkshire 2024 annual report, p. 15.
57. Berkshire press release dated November 10, 2025, “Thanksgiving Message from Warren Buffett,” pp. 7-8, available at <https://www.berkshirehathaway.com/news/2025news.html>

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