

January 2018

Imagine, if you would, a grouping of 32 random parties engaged in a game of chance. Each go-around, twelve of those parties are chosen as winners and twenty were deemed to be losers. The decision is entirely random. Fairly rudimentary math would indicate that the chances of winning are 12 out of 32, or 37.5%.

The game begins. Based on simple probabilities, those who weren't lucky enough to win with their first shot shouldn't be too dejected as they were more likely to be a loser than a winner. Say there were two chances to win. Same odds, same parties involved. The odds of winning at least once have improved to approximately 61%. Said another way, a little less than half the participants are still waiting for their first victory.

These folks still on the outside looking in have suffered a touch of bad luck but still have a sizable group in the goose egg club to commiserate with. After a third shot, we've now got 76% - a fraction more than three out of every four - in the winner's circle.

Now the losers are starting to feel a tad snake-bitten. Four tries in and the group of 32 has been winnowed down to approximately 5 unlucky buggers who have yet to taste the sweet champagne of victory. Two more quick rounds and the forlorn group of non-victors (at least based on probabilities) should only include two poor souls.

After eight long contests, there should only be one solitary loser left. One more go - two at most - and mercifully, we are all expected to be winners.

So, what do we say to the sad-sack who hasn't won after 10 chances? How can we restore his or her faith in reason after the math has clearly indicated that they shouldn't still be on the outside looking in? Clearly the game is rigged, isn't it? The conversation is no easier after rounds 11 or 12 and becomes near impossible after 13. 14 and 15, *gee buddy, I really don't know what to tell you.* 16 comes and goes with still no relief.

At this point, everyone involved must be questioning whether or not the math really matters anymore. Have we stumbled upon a time when the standard constraints of logic and truth no longer apply? Have we graduated into a world unbounded by probabilities and fundamental reason? Perhaps, the paradigm *has* shifted. Perhaps, it really *is* different this time. Seems like it may be time to cast aside the shackles of absolutes. We may have only needed such things before we discovered "Alternative facts", the blockchain and driverless cars. Let's line up the coffee enemas and get these trees growing to the sky!

And then there was 17...



Not pictured: 41 year-old Toronto man crying sweet tears of joy

On New Year's Eve, after 17 straight seasons out of the NFL playoffs, the Buffalo Bills finally qualified for the post-season¹. This ended the longest such drought in professional sports. It also put to bed one of the most drawn out counter-arguments to the law of averages in modern history.

With this joyous and horrendously overdue event we turn our gaze to the stock market. It too is going through an unprecedented streak, albeit a far less miserable one. There are many ways to measure the market's disconnect from historic norms of cyclicity. For instance, the MSCI World Index has now gone 19 straight months without a 5 percent or greater pullback. That's never happened before. It has now been more than 400 days since the S&P 500 retreated 3% or more. That's never happened before. The ups and downs of the market have been replaced with the ups and *further* ups of the market.

Vigilance and caution have cost investors bigly during this elongated run-up, just as hope and optimism have brought nothing but pain for the forlorn Bills faithful. The momentum trade (long "the market", short the Bills) would seem to be more and more the obvious call with every passing year. Why am I not keeping up with the BlockWeed Small-cap growth Fund²?! Why do I keep buying jerseys for this Godforsaken team?!

¹ Those of you who want to point out the empirical differences between a random game of chance and the NFL standings can take your arguments elsewhere. While not a perfect parallel there is sufficient parity, particularly over 17 seasons, to support the metaphor....except for the Patriots who are all but guaranteed good fortune given their incessant cheating and favourable refereeing.

² Any similarities between this pretend fund and an actual fund are mere coincidence. We will also be seeking royalties when such a fund is inevitably launched.

Intellectually we all *know* that these sorts of endeavours have cycles to them and that eventually, *eventually*, fortunes reverse. The challenge is that it doesn't always *feel* like this is the case.

During the dry years, the people forgot about the rich years, and when the wet years returned, they lost all memory of the dry years. It was always that way.

*John Steinbeck
East of Eden³*

Humans are prone to overweight recent results and presume that current conditions will persist. Steinbeck's above quote relates to farmers in California's Salinas Valley during the early 1900s. It just as aptly could be said of equity investors today or Bills fans since the Music City Miracle. The longer these runs persist the more retrospect feels like certain prophecy.

With one miraculous throw and catch by a mediocre quarterback to a fantasy bust of a receiver, we were provided with a shocking break from trend. Bengals quarterback Andy Dalton, of all people, brought the rains to wash the dry years away. The outpouring of emotion that followed illustrated just how intense the reaction can be after prolonged periods of disappointment. Accustomed to nothing but losing for the better part of two decades, Bills fans had forgotten what the rich years felt like and celebrated an unspectacular 9-7 season like it was a championship parade.

With images of giddy (read: drunk) Western New Yorkers jumping into snowbanks, consider how equity investors accustomed to nothing but winning, might react to a sudden and unexpected loss. Think of those staggeringly massive waves of ETF flows screeching to a halt. Do they even know how to process a redemption? Wait, we can actually *sell* stocks? Hard to believe the response would be measured and orderly. We're envisioning a spoiled child being told they can't have any dessert for the first time in their lives.

Simply put, if the Buffalo Bills can find their way into the playoffs maybe it's finally time to start thinking about hedging your bets on the stock market. Nothing lasts forever - either good times or bad - and the longer such conditions persist, the more explosive the reversal can be.

2017: Year in Review

Given the headlines, many people will associate 2017 with chaos and, perhaps, the start of the apocalypse. Conversely, we had a very solid year. This was true even before the Bills made the playoffs. To be up 12+⁴ while maintaining defensive positioning is a huge win in our books.

As we have done for the preceding eight annual letters, we will provide a review of our top five contributors and top five detractors over the year. This is intended to illustrate what worked and

³ *Oh look, Hammill read a book. Isn't he so interesting and urbane.* Shows what you know, Hammill *started* reading a book. It's like 700 pages?!

⁴ We refer to our master series net performance in all performance references, unless otherwise noted.

what didn't over the past 12 months. We typically start with the detractors so we can end the letter by telling you how smart we are.

Top 5 Detractors.

Old PSG Wind-Down Ltd.	-1.4%
Canadian small-cap software short	-1.0%
S&P TSX60 Hedge	-1.0%
Russell 2000 Value Hedge	-0.5%
Maxim Power Corp.	-0.4%

As you probably know, the market was up this year so our index hedges (insurance policies against the market actually going down) came with a fairly hefty premium. That's probably all that needs to be said about numbers 3 and 4. Number 2 is a short position in a small-cap software company that makes no money, seemingly disappoints every quarter and has meaningful insider selling. Needless to say, people seem to love this one and bid the stock higher. We have not exited the position as we hold to the antiquated notion that software companies should actually grow and produce cash flow in order to justify nosebleed valuations.

Number 1 is a decision that we would like to have back. Old PSG wind-down is what's left of Performance Sport Group having worked its way through bankruptcy proceedings. Performance Sports was the over-levered purveyor of sporting goods with its most prominent brand being Bauer Hockey. Despite the best efforts of delusional hockey parents everywhere, the company was unable to sell enough sticks, gloves or gear to support its bloated balance sheet and had to retreat to the protection of the bankruptcy courts.

It was at this point that we got involved thinking that the value of the brands would be sufficient to provide more value to the equityholders than was being quoted at the time. We were wrong. No saviour bidders appeared to pay up for the supposed trophy assets. While equityholders will likely receive something more than nothing for their claims⁵, the chances of that figure approaching our \$0.80 cost basis are about as good as the chances of Lee or Anthony being announced as Bauer's latest pitchman.

This was an example of the Dark Horse being too cute and overly nuanced at a time when simplicity was what would have brought about the best return. Guys like us will often err on being too attracted to complexity under the impression that obvious values don't actually exist. This is particularly acute during times of high valuations and mass enthusiasm where we tend to dig even deeper for hidden values. Our default thesis is that we can't add much value to crowded trades. When seemingly all trades are crowded, our approach can lead us to the odd situation that is better left alone. PSG was an unfortunate example of this.

Maxim was down a bit on the year. As our largest weighting for most of 2017 this small downturn resulted in Maxim making this list. We anticipate that with a final resolution to the AUC Loss

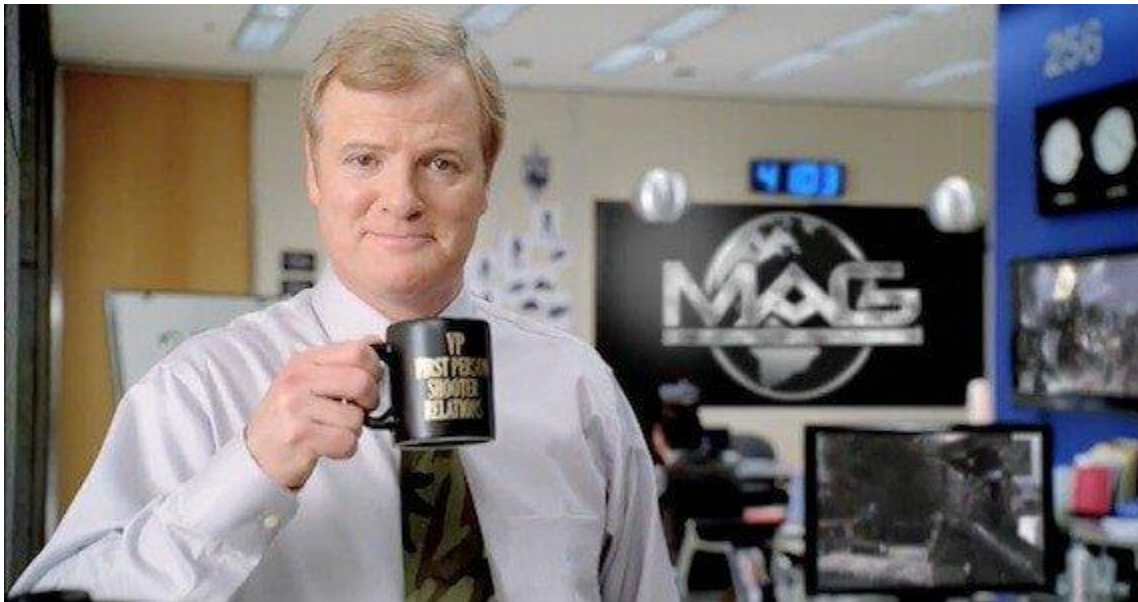
⁵ We also believe equityholders will ultimately receive more value than what was implied by PSG's last trading price.

Factor Decision⁶, 2018 will see Maxim Power finally put out to pasture. Such a move will likely move Maxim to the following list for next year.

Top 5 Contributors:

Par Technology Corp.	+3.9%
Onvia Inc.	+2.5%
Forestar Group Inc.	+1.7%
Canadian Financial Services Short	+1.5%
Genesis Land Development Corp.	+1.3%

If something sticks around for long enough, eventually it seems to garner some sort of positive attention. This seems most evident in the world of entertainment where longevity can often obscure mediocrity. We wouldn't be surprised if in a few years Matchbox 20 is inducted into the Rock n' Roll Hall of Fame and "That Guy" from all those commercials (see below) is awarded a lifetime achievement award by the Hollywood Foreign Press.



Pictured above: That Guy.

This same dynamic seemed to have positively impacted the Dark Horse in 2017. If you look at the top five contributors, you'll notice some very familiar names. These are stocks that have been around for what seems like forever, but never really did anything particularly noteworthy. Onvia, Genesis and Forestar are the portfolio's equivalent of Gary Sinise, Scott Bakula and Edward James Olmos.

⁶ If you really care about the super boring details surrounding the minutiae of power transmission pricing we can fill you in individually.

Just as a career bit actor needs that one breakthrough part to become a star, an obscure security also requires a big splash to attract a wider audience. In the case of many of this year's major contributors, including a handful not amongst our top five, that career-defining role was that of "takeout target". The Dark Horse saw a total of six holdings acquired this past year⁷.

The outsized gains from these big wins allowed the fund to post the numbers it did without any material increase to our net exposure⁸. As the beginning of this letter should make abundantly clear, our enthusiasm toward the overall opportunity set has not increased and, if anything, has waned further.

Further supporting our overall results was the absence of any huge missteps within the short book. Shorting stocks can be a serious risk to one's financial health when ridiculousness and froth are being celebrated. It is our belief that we are well into that stage of this bull market run, with many hot sectors firmly in "bath salts crazy" territory.

Once a stock reaches a point of absurdity there is no reason it can't then climb to absurdity times two or three. Being short stocks during this period of parabolic ascent can be crippling to performance. Currently, we see widespread examples of such untethered optimism. Soon enough, many of these high flyers and headline-grabbers are likely to come back down to earth. For short sellers, who typically bet against these types of stocks, that "soon enough" can't come soon enough.

Thankfully we have avoided most of this potential pain. Our short book has primarily focused on moribund businesses that even the most unscrupulous promoter couldn't turn into a "play" on some wonderful thing that will change the world. Apart from adding "Block" or "Blunt" to the company's name, there is no way to turn any of our short book into the sort of story that the market seems obsessed with right now.

Despite a fair bit of new blood in the portfolio and a very solid 2017, we still have a good portion of the Dark Horse invested in stuff that is waiting for its eventual turn in the spotlight. Lord knows, pretty much everything else has had some positive light shone on it over this unprecedented bull market.

Specifically, we would point to Maxim Power Corp. (MXG:TSX) and Terago Inc. (TGO:TSX)⁹ as likely recipients of some long overdue recognition – their "Michael Keaton in *Birdman*" moments. That sentiment may be a repeat of what has appeared in previous annual letters, but this time we *really* mean it. Heck, if an iced tea company, cigar maker and Kodak can become cryptocurrency "plays" with a simple name change, why can't an actual power producer or a data centre operator be turned into legitimate blockchain companies?¹⁰

⁷ One holding wasn't technically acquired in its entirety but had its largest asset acquired. These six positions were ONVI:NASD, FOR:NYSE, AF:TSX, RC:TSX, HGN:TSX and HOLL:OTC.

⁸ Net exposure for the year ranged between 40-55% on a net dollar long basis.

⁹ This may already be happening with Terago. The stock has appreciated substantially in recent days.

¹⁰ Trick question. There are no legitimate blockchain companies. Don't @ me!

Looking Ahead: FOMO Can't Hurt Me, FOMO Can't Hurt Me

Life is complicated and people are generally busy. As such we develop short cuts to get through our days without getting bogged down in the in-depth analysis of every situation we find ourselves in. For instance, when Anthony meets a new person he asks them what their second favourite Spin Doctors song is? If they have an answer, he knows to avoid that person. After all, anyone who can name two Spin Doctors song is not someone you want to associate with in any way.

The same dynamic applies to investing. There are a few quick questions we can ask to determine whether or not a prospective investment is worth further interest. Can we get our heads around the base economics of the business? Are there some precedent transactions or comparable assets that we can use to handicap intrinsic value? Has the business been around for more than a few weeks? These sorts of questions provide us an efficient filter to winnow down the investing universe to a manageable set of investable names.

We've beat around the bush a bit in this letter regarding the many manias making headlines these days. Our inboxes are brimming with notices of new listing in cryptocurrencies, weed, lithium, artificial intelligence or some alchemy of them¹¹. In the absolute bare minimum of time that securities regulators demand, sell-side reports follow heralding the life-changing aspects of these newfangled industries and how each company will be a major beneficiary of said changes.

So, what's our take on these hot new issues and revolutionary industries? If we had to guess, we'd predict that most will end up more popular with class-action lawyers than with investors. So, what's our play? We don't have one and you don't need one either. A wonderful thing about investing is that you can simply say "I have no clue" or "I don't care" and go on with your day. With a quick screen along the lines of the questions mentioned earlier, we can deem these heavily promoted stories uninvestable and hone our focus on situations where we have a comparative analytical advantage.

There is this image, perpetuated mostly by the entertainment industry, of the successful fund manager having intimate knowledge of every stock on every exchange. This fallacy is further propped up by BNN and CNBC interviews where callers bombard the guest with questions on every security under the sun. Through the magic of "pre-screening" and generic catch-all responses ("Great company", "terrific management team", "should continue to execute"...) the talking head appears to be a walking encyclopedia of investing insight.

It is our belief that this desire to be the jack of all trades (and ultimately the master of none) is driven as much by a fear of missing out (or "FOMO" in twitter speak) than any rational thought. Being everywhere, no matter how thinly that spreads your acumen and capital, is a remedy to FOMO. FOMO, however, is not really a thing – it is an unproductive emotion with no tangible cost. Its remedy is simply to ignore it.

Our fund's assets under management are a little more than \$60 million. To say that is a drop in the bucket is being generous to buckets. It's a drop in the *ocean*. Such a modest asset base allows us to

¹¹ Weed Robots may never exist, but mark our words, there will be a Venture-listed company promoting them.

ignore most everything while still managing a reasonably diversified portfolio. We *miss out* all the time. We, in fact, excel at *missing out*. We have tangible fears that are productive and help us deliver for our clients. We fear that the market may actually go down one of these days. We fear investing in idiotic promotes with no legitimate business models that eventually go to zero. We fear telling our investors that our decisions have resulted in them losing money.

So next time the guy sharpening your kid's skates is telling you why Ethereum is the only thing you need to own or your buddy's Dad calls you a moron for not being all-in on driverless buses, try to remember this phrase: FOMO can't hurt me, FOMO can't hurt me. Like other unproductive feelings it's only damaging if you act on it. FOMO by itself is of no consequence. Most likely the only thing you're MO on is a great deal of volatility followed by a shout-out on @bagholderquotes. We'll leave Mr. Market's Wild Rides to others and would implore our readers to do the same. In 2018, there are plenty of legitimate things to fear. Missing out is not one of them.

Thanks again for all you support in 2017 and all the best in the new year.

Anthony Hammill

Lee Matheson

About Ewing Morris:

Ewing Morris & Co. Investment Partners Ltd. is a value driven Canadian investment firm established in September 2011 by John Ewing and Darcy Morris. Our aim is to achieve preservation and growth of capital for our limited partners by focusing on inefficient markets. We do this by relying on fundamental analysis, high conviction and the use of flexible capital. We manage equity and credit strategies with a focus on North American small-capitalization companies and high yield bonds. We manage investments for individuals as well as charitable organizations, institutions and corporations.

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