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EWING MORRIS & CO. 2018 ANNUAL INVESTOR MEETING

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Toronto Reference Library, April 25, 2018 – Toronto

Remarks have been edited for clarity.

Darcy Morris:
Thank you for making the time to be here. We see lots of old friends as well as new faces. I would like to extend a special welcome to all our visitors who have travelled from outside of Toronto, as well as from the United States, to be here with us. We live in a busy, noisy world with endless demands on our time, attention and capital so we appreciate your interest in our firm. And if you are just here for the free lunch… well, we respect that too.

I am often asked why we host our meetings at the Reference Library every year and the reason is that Ewing Morris has a strong connection to the Library.

When John and I started the firm, we really did not have any money to buy books from Amazon or subscribe to the Globe and Mail or Wall Street Journal… so we leaned on the Toronto Public Library system. We would take out piles of books to help in our research process and visit our local branch to read the Wall Street Journal. The library is really part of Ewing Morris' origin story. Today, I serve on the Board of Directors for the Library Foundation and almost everyone at our firm is a card-carrying member.

It also feels right to have our meeting here. We are a Toronto-based company, with great ties to this city, and this is the place we feel connected to it the most. The Reference Library is where people of all walks of life can come to read, access information, learn and feel part of something bigger. And those are fundamental values we support at Ewing Morris as well.

So that is a little context on why we are gathered here in Beeton Hall which, by the way, is named for the former head librarian of the Reference Library, Elizabeth Beeton.

The other week, I asked one of our investors what he would like to hear at our annual meeting and he said, "I want to hear about the vision for the firm and I find case studies helpful." That is what we are going to address.

I will start off by providing an overview of the business, Randy will give a presentation on how we are investing in fixed income and John will complete our formal remarks. After that we will open up for Q&A.

We will conclude at 1:30, but we are happy to stay behind if anyone has further questions.

Today, we manage about $280 million and we remain focused primarily on investing in publicly-traded securities in North America, although we have had investment success in New Zealand, Australia and the UK as well. The family of limited partners has grown to 315.

Our investments performed well last year and we continue to find opportunities to invest in despite an expensive and competitive environment.

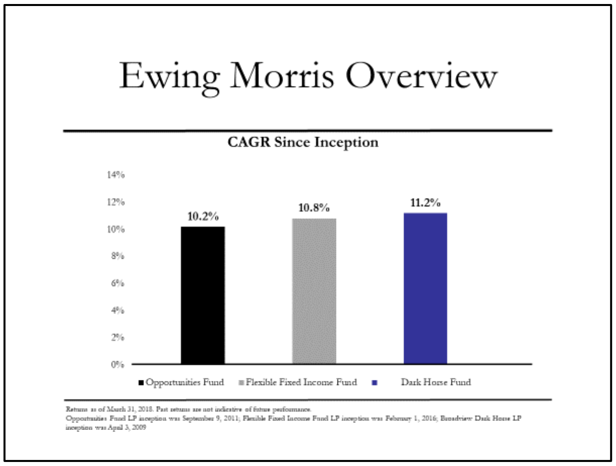
In terms of the team, we have 12 full-time people, two additional intern positions and our Advisory Board.

This year, we added strength to our team with the addition of Lee Matheson and Anthony Hammill from Broadview Capital.

We are also investing in our operations and welcome Oghale Omosa and Cynthia Chan to our team. Oghale has joined us to focus on client administration and Cynthia is our new corporate controller.

Lastly, the newest addition to our Advisory Board is Ira Gluskin who is one of the most senior and experienced investors in the country.

Our investments performed well in 2017. The Opportunities Fund returned 9%, the Flexible Fixed Income Fund returned 7% and the Dark Horse returned 12%, all net of fees and expenses. Since inception, we have compounded returns at double-digit rates net of fees across all our mandates.



When people ask about the long-term vision, or I prefer the word goal, for the firm, I usually recite our guiding principle: to continue building a firm that we would want to invest with.

Sometimes people say, "well that is sort of cliché and obvious Darcy and there is nothing really unique about your guiding principle". They are right. What is unique about building a firm is *how* you do it; how you think about the tangible considerations of the firm you want to invest with – like first-rate client service, operations, compliance and strong returns – and also how you think about intangible implications like people and culture.

We call people and culture intangibles because they are hard to quantify and hard to define. But they are important and I spend a lot of time thinking about them. In fact, people are at the top of my agenda every day.

Ewing Morris People

- ✓ Hire People Better Than Us
- ✓ Work With People We Admire

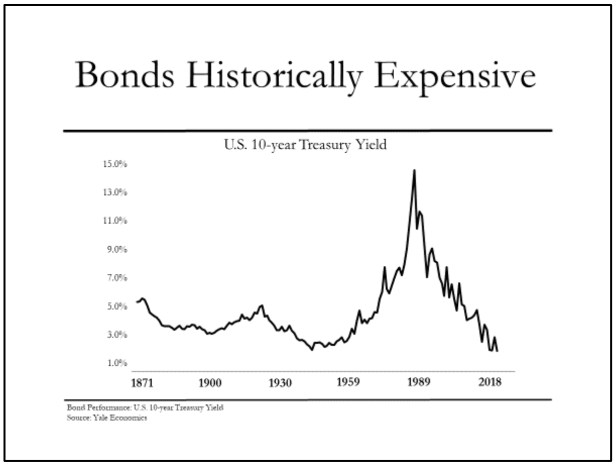
When we think about people, we look to hire people better than us and work with people we admire. In this way, the gene pool of the organization is always getting stronger and we are creating an environment where people are motivated and inspired to come to work.

We also look for people that are passionate and hard-working: people that have the mindset and dedication of a professional athlete or a craftsman, but applied to investing; and people that are okay with being pushed out of their comfort zones and having their ideas and opinions challenged by their teammates. Most importantly, we look for people that value trust and integrity.

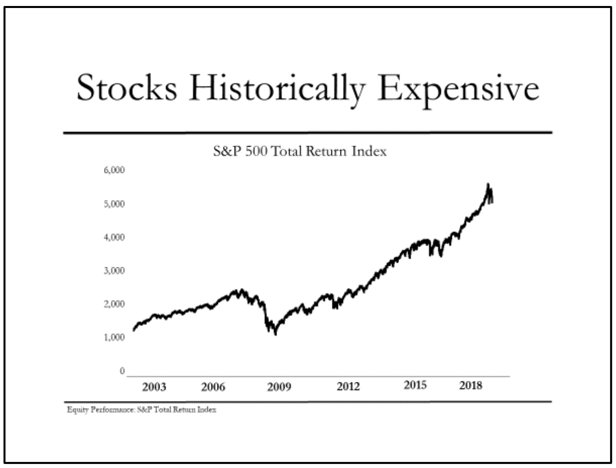
In terms of culture, what we really mean is what are the values that we try to reinforce every day? These values are meritocracy, an entrepreneurial mindset, attention to costs and transparency and candor.

At Ewing Morris, it is the strength of our people and our culture that will determine our long-term collective success. The asset management industry is hyper-competitive and our only real sustainable competitive edge is our people. It is truly our most unique differentiator.

I want to touch on our investment approach. We do not spend a lot of time trying to predict what the broad markets are going to do, but there is data that suggests both the equity and fixed income markets are currently overpriced and unattractive. Bond yields are near the low end of their 150-year range…



…and stocks have surged to levels that imply long-term weakness.



Despite this environment, our view at Ewing Morris is that there is *always* investment opportunity; sometimes you just have to hunt really hard to find it… and this happens to be one of those times.

I think if you are going to remember anything from my remarks, it is these two points:

1. We think like enterprising business owners.

2. We use our competitive advantages of size and flexibility to look for mispriced securities in niche areas of the market.

I am going to give a case study that illustrates our approach:

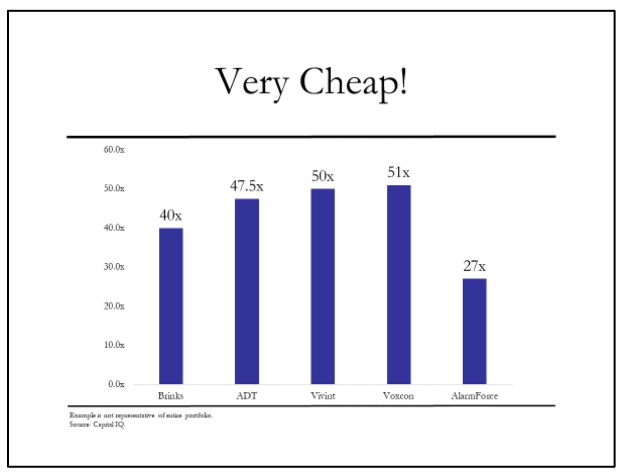
AlarmForce Industries is the low-cost provider of home security systems in Canada. At the time of our investment, the company was:

- Small, about $100 million market value.
- Neglected by Bay Street since they did not make acquisitions or issue debt.
- Orphaned – the founder, an entrepreneur named Joel Matlin, had recently left the business, leaving a leadership gap.

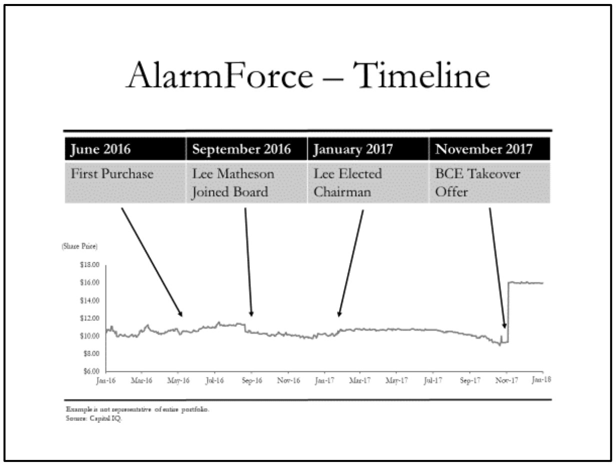
What we saw was a business with:

- Great economics. The company had a very stable subscriber base.
- Several growth opportunities through cross-selling new products and geographic expansion.
- A very cheap stock price.

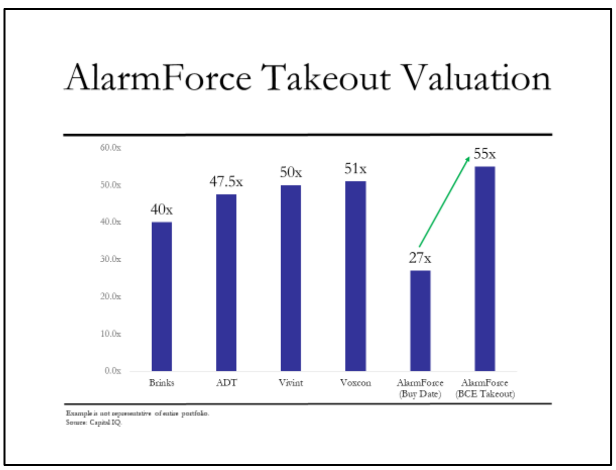
How cheap? In the home security business, the key valuation metric is recurring monthly revenue, or RMR. AlarmForce was trading at a substantial discount to comparable M&A transactions which averaged around 50x RMR. We bought AlarmForce for 27x RMR!

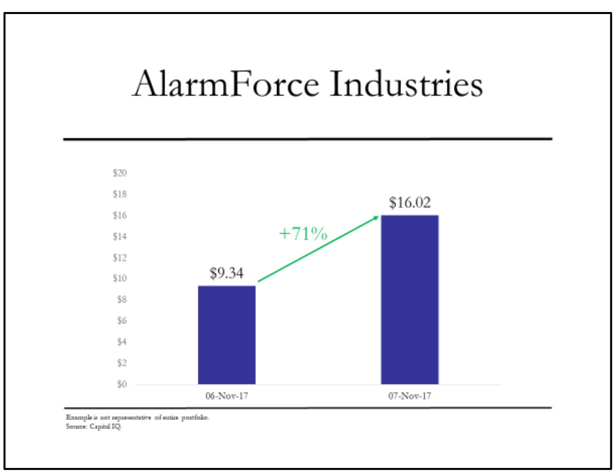


So what happened? We purchased stock around $10/share in July 2016.



Shortly thereafter, Lee Matheson joined the board with the goal of helping to close the gap between price and value. He was then elected Chair at the following AGM in May. In November 2017, BCE Inc. purchased the company for $16/share. This equated to 55x RMR or a 71% premium to the last traded price the day before.





We hear a lot about efficient markets, but this is a good example of how you can find dramatically mispriced companies hiding in plain sight in the small cap public markets.

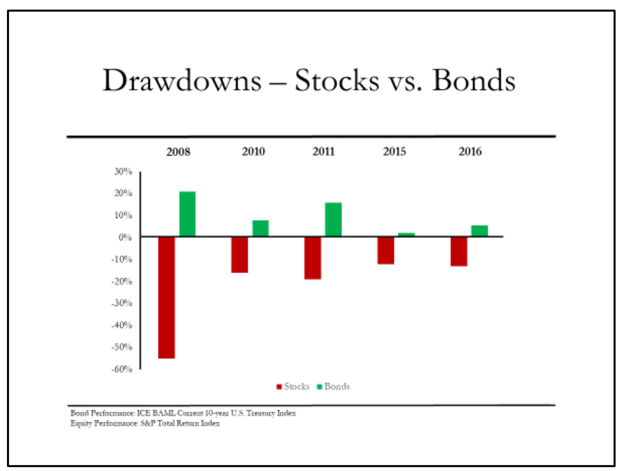
Now, I would like to conclude by talking about our fixed income investment operations. If this past quarter made you uncomfortable, then you might want to think about increasing your allocation to fixed income.

While everyone likes to say they are a long-term investor, the reality is that:

- Volatility can be uncomfortable.
- Some people rely on income from their investments to fund liabilities and living expenses.
- Some people simply want to lend money at a contractually agreed fixed rate.

These are all reasonable points, but I think investing in fixed income today requires a new perspective. And here's why:

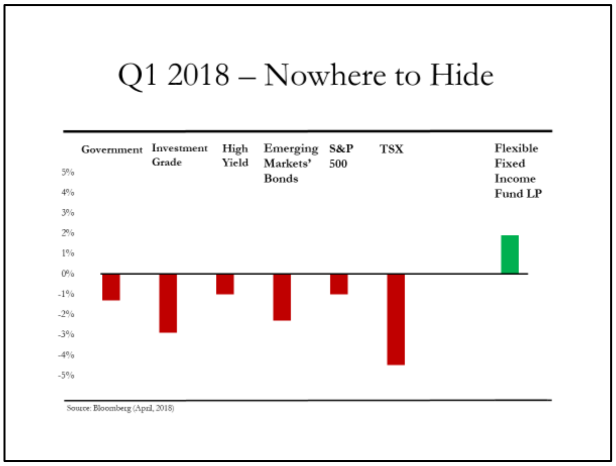
From 2008 – 2017 (including the financial crisis), there were 5 times when stocks were down greater than 10%. Each time, bonds were up and the average increase was 10%.



However, something different happened in the first quarter of 2018. The stock market was down…and so was the bond market. And there was really nowhere to hide:

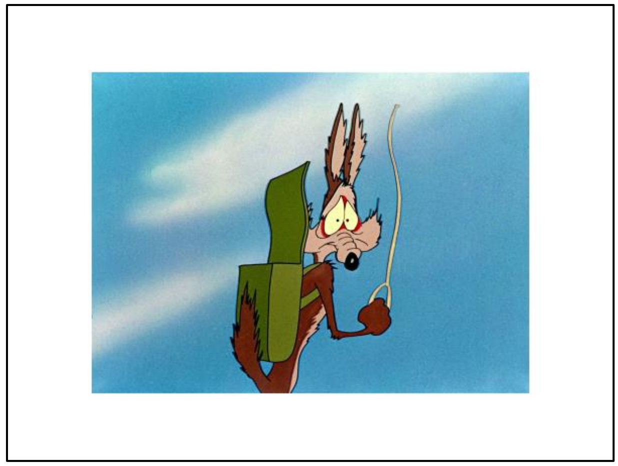
- Government bonds were down.
- Investment grade corporate bonds were down.
- High yield bonds were down.
- Emerging market bonds were down.
- The stock markets were down.

However, the Ewing Morris Flexible Fixed Income Fund was up 2%.



We are reluctant to trumpet short-term results (and you should be wary when someone does), but we think the first quarter of 2018 is pretty remarkable and deserves attention.

There is a significant risk that the conventional wisdom of a 60/40 split between large cap equities and traditional bonds *used* to be good advice. In today's world, with the threat of rising inflation and interest rates, we are not convinced that traditional asset allocations are going to provide the safety you might be expecting - kind of like when Wile E. Coyote runs off a cliff and pulls his chute.

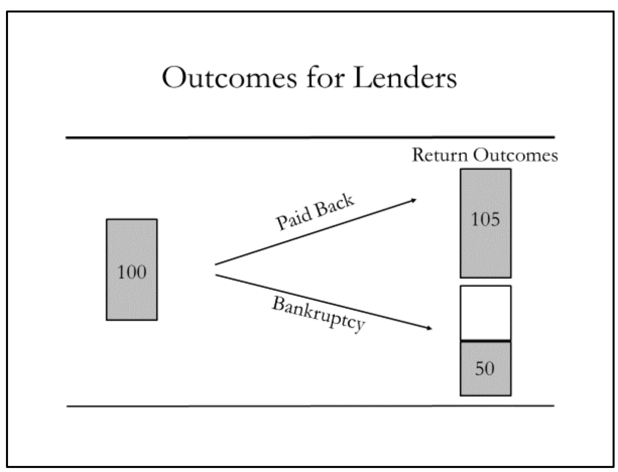


Now to expand on how we use our advantages of size and flexibility to deliver a different outcome in the fixed income markets, here is Randy "the Road Runner" Steuart.

Randy Steuart:
To Darcy's point, the bond market appears to have very serious challenges ahead of it and it is important that you know two things about our fixed income operation:

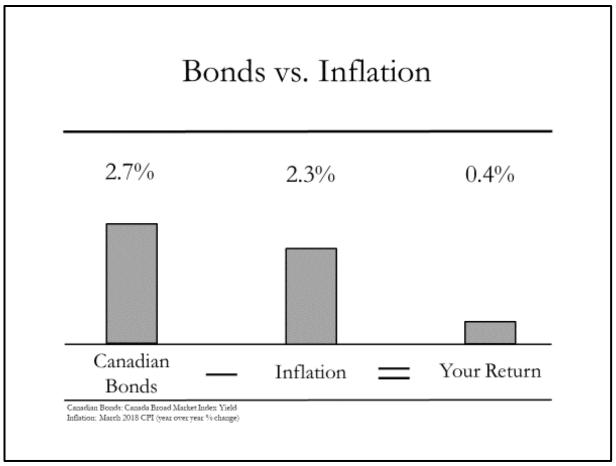
The first is that our portfolio looks nothing like the market; and secondly, we have the flexibility to go wherever, in fixed income, that the risks are not.

Before we dive into how we do this, since it is April, I want to talk about hockey to frame how we think about risk in fixed income. In hockey, a shot on net can result in either a save or a goal. Bond investments work the same way.



Either you get your money back, with interest, or the company goes bankrupt, and you get half of your money back. There is no such thing as a "big win" in fixed income. My job is all about avoiding losses. Just like hockey players do not care much about *how* a goalie keeps pucks out of the net, but just that their goalie *does* keep pucks out of the net. This attitude is probably the same for you.

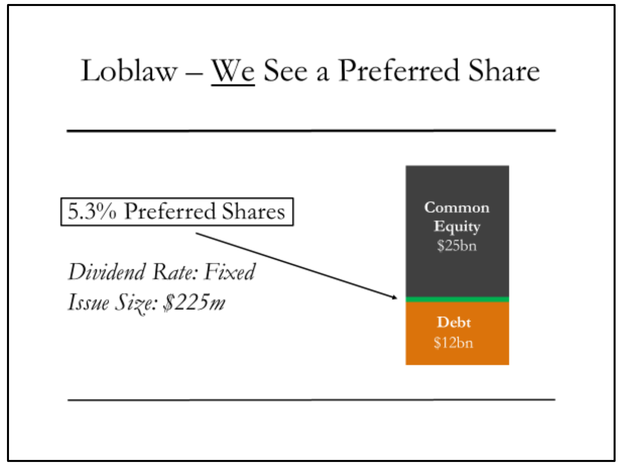
You simply want us to earn 5-7% returns over time and protect you against loss in whatever way that is actually effective.



With the average bond in Canada yielding under 3%, a lot of fixed income struggles to even match the rate of inflation, and this is a really big problem. We think the solution to this starts with being flexible.

To show you what I mean, let us look at two of our portfolio investments.

First, Loblaw. I think you are all familiar with Loblaw – Canada's biggest grocery retailer and the owner of Shoppers Drug Mart. When the bond market looks at Loblaw, it sees an Investment Grade Credit (BBB-rated) with 17 bonds to choose from that yield between 2 and 4.5%. Most investors have not noticed what we have found …



…this little security that is nestled between the debt and the equity. This is Loblaw's 5.3% Fixed Rate Preferred Share. It is the only preferred Loblaw has and it is pretty small compared to the $12 billion of debt and $25 billion of market cap which are the two focal points for investors.

If you were to ask fixed income investors what they think about preferred shares, a lot of them would tell you they do not like them. Why?

1. The dividend payment is optional.

2. It ranks behind debt in a bankruptcy.

3. There is no specific date you can expect to be paid back.

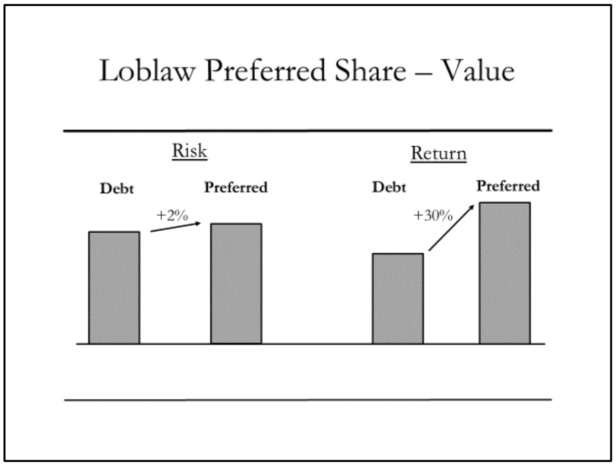
Here is what *we* see at Loblaw.

First, we do not think the dividend is optional at all. Loblaw is not allowed to pay dividends to shareholders until they pay us first. The important thing to note here is that the Weston family earns more than $100 million annually from Loblaw's dividend. Now, I don't earn $100 million a year, but, if I did and it went away, I think I would be pretty upset.

Second, we do not think bankruptcy is very likely given the nature of the business itself and the substantial equity capitalization at the company.

Third, we do not mind the maturity…if you have a good deal, why would you want it to end – and this is a great deal.

In exchange for adding 2% to the debt load, by investing in the preferreds, we are receiving 30% more income than the bonds.



On top of that, this income is in the form of dividends, not interest, so the tax rate on that income is a lot better too. In terms of earning stable 5-7% returns at investment grade quality companies, this little security has been a great place to hide in the last year.

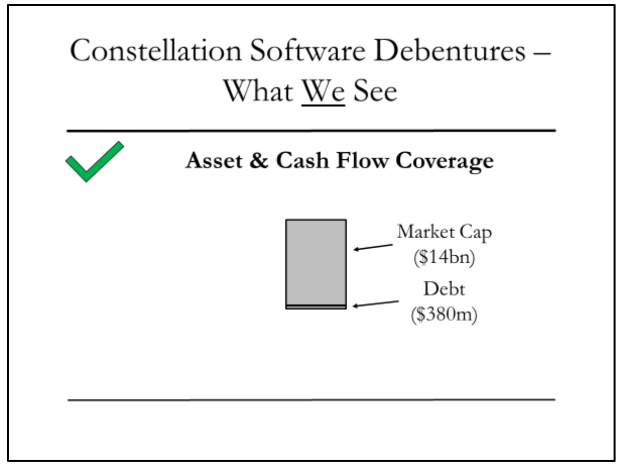
My second example is Constellation Software which is a diversified enterprise software business. The fixed income market is largely unaware that this bond even exists, but if they were to stumble upon it, here is probably what they would see:

1. A low priority debt ranking.

2. An acquisitive company – which is usually bad for lenders.

3. They would see a 2040 maturity – which is a long time to wait, especially for a tech company.

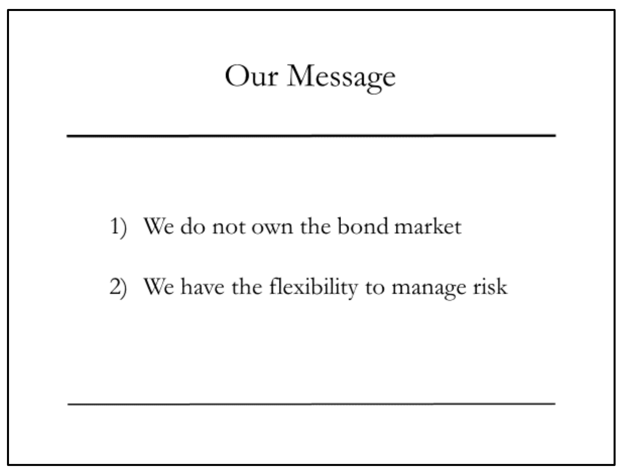
However, we see a debt-free company. Cash ($490 million) actually exceeds debt ($380 million).



We see substantial asset and cash flow coverage, which is really evidenced by the US$14 billion in market cap at the company.

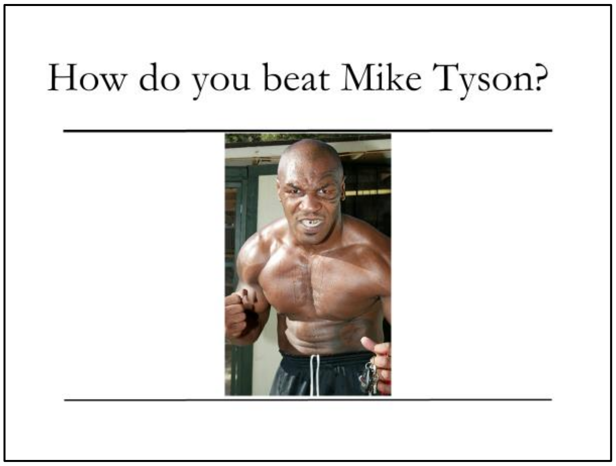
We also see a CEO we know well, Mark Leonard, who has always been very conservative with debt.

Lastly – we love the long maturity. Here is why: The bond's coupon resets every year based on inflation *plus* six and a half percent. This year, it is paying 8.1%. If you have a deal like that, you want to hold onto it for as long as you can.



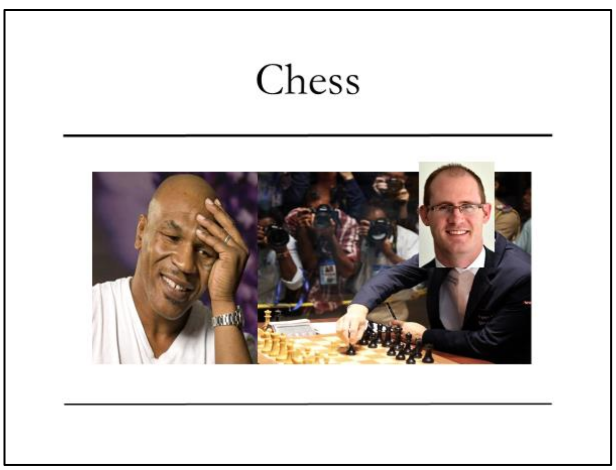
I hope these two portfolio case studies demonstrate the messages I communicated at the outset of this presentation, which is that we have created a collection of unique securities to produce a portfolio that looks nothing like the market and that, in doing so, we have exercised our advantages of size and flexibility to find securities that should provide a solid return with low risk. With that, I will turn it over to John.

John Ewing:
I want each of you to imagine that you have just been challenged to go head-to-head…with Mike Tyson.

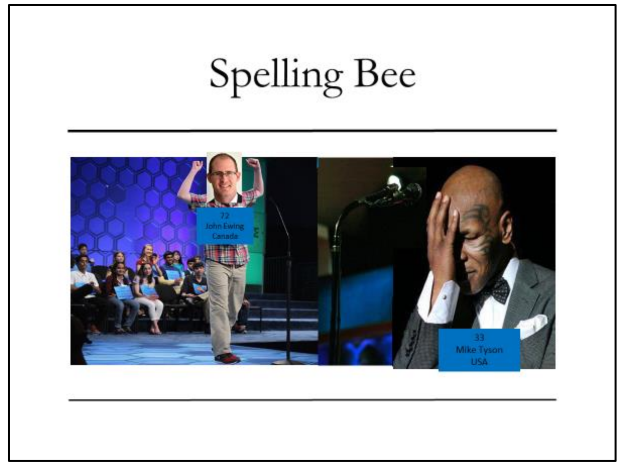


What do you do?

Here is what you do…you challenge him to a game of chess.

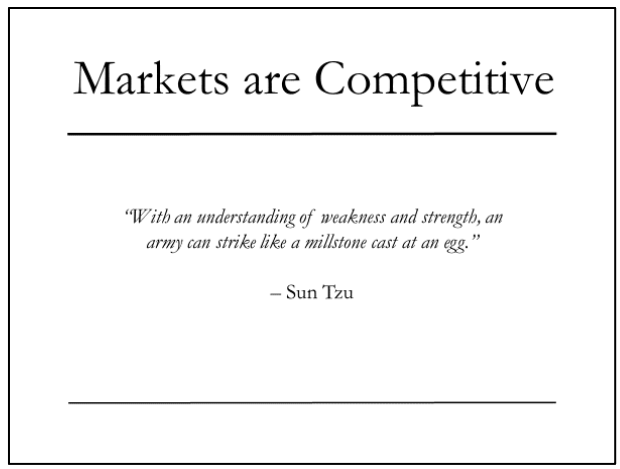


Or a spelling bee.



Pretty much anything except a boxing match.

Markets are as competitive as they have ever been. Which means it is more important than ever to remember your Sun Tzu and choose your playing field very carefully.



At its core, investing is all about pattern recognition and computers are very good at solving that kind of problem.

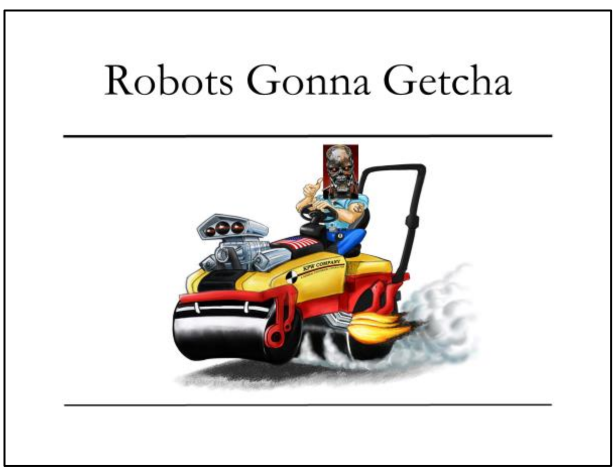
That means that "Big Data" is not just a buzzword; Big Data is a formidable opponent. To illustrate, let me share a few anecdotes with you:

1. A friend of mine works at a quant hedge fund. They write algorithms to scan press releases, looking for key words and then trade on what they find. The whole process takes less than one second…faster than a human can read the first sentence.

2. I recently interviewed a candidate for a research role at Ewing Morris. He currently works at a $20 billion hedge fund in New York. During our conversation, he described some of the research tools his firm commonly uses:

   a. Purchasing satellite images of retailers' parking lots and comparing them to prior dates in order to predict quarterly sales figures.
   b. Purchasing point-of-sale data from credit card companies to get real-time insight into consumer product sales.

I think these stories show you what we are up against. Big Data is a tough opponent. I worry that, if your investment manager is still screening large cap stocks, looking for companies trading at low price-earnings multiples, you could be in trouble. Because the robots, they're going to get you.



So how can Ewing Morris win?

First, is to choose the right playing field. The tools I am describing are expensive, so they require large pools of capital to justify their cost. If you manage large pools of capital, you are forced to focus on large cap stocks. What should we do? The <u>opposite</u> and focus on smaller cap companies.

Similarly, these tools require liquid stocks that trade lots of shares every day, like the companies you will find in large ETFs. What should we do? The <u>opposite</u> and focus on companies not typically found in large ETFs.

Choosing the right field is not enough. We still need a strategy to win. What we do at Ewing Morris is actively seek situations where wisdom and experience are going to be really important. Our answer to Big Data is "Big Judgment".

This page lists a variety of situations where Big Judgment should beat Big Data. We also list some examples from our track record.

Norbord was the single biggest contributor to returns in 2017 so I am going to speak for a moment about it. If you want to learn more about these, we would be happy to expand during Q&A.

Norbord is the largest North American producer of a product called "OSB" which stands for oriented strand board. It is a lumber product that comes in sheets and looks similar to plywood. It is primarily used to build new homes.

We made the investment in mid-2015. At the time, the situation was pretty ugly. Here is what the market saw:

1. An expensive stock trading at 30x EBITDA.

2. An extended balance sheet with 7x leverage

3. An underperforming stock price.

After a closer look, we made a few important observations:

1. The U.S. housing market was depressed. Single family housing starts were 35% below their long-term average of 1 million per year.

2. The commodity was trading 20% below its 10-year average.

3. Most importantly, the industry was recently transformed. The #3 and #5 players had just merged in 2015 and the #1 was gradually exiting the business. We expected that competition would be much more rational going forward.

Based on these observations, we reached the following conclusions:

1. We thought housing starts would likely rebound. The American population continued to grow and housing starts had to rebound eventually, likely sooner than later.

2. If housing starts were to rebound, we expected the commodity price would rebound too. More housing starts would increase demand while the recently consolidated industry was likely to add supply slowly. As we all know, when demand goes up and supply does not change, prices have to increase.

3. We thought that, if the commodity price rebounded, earnings would go up a lot because Norbord's costs are mostly fixed.

4. We thought that if earnings increased a lot, the stock price would follow.

What <u>we</u> saw was:

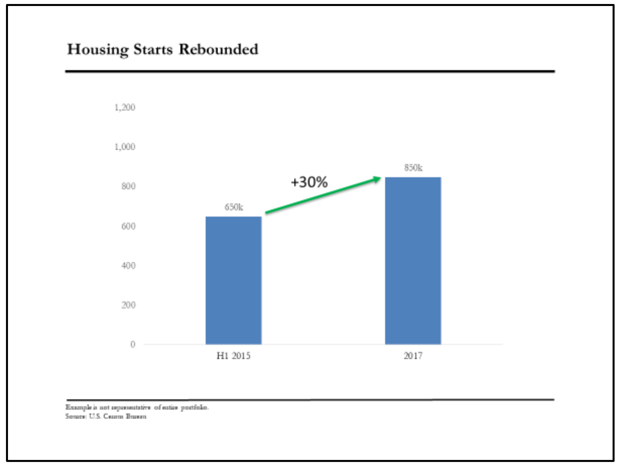
1. An undervalued stock, relative to its earning power.

2. A solid balance sheet as evidenced by a recent bond offering.

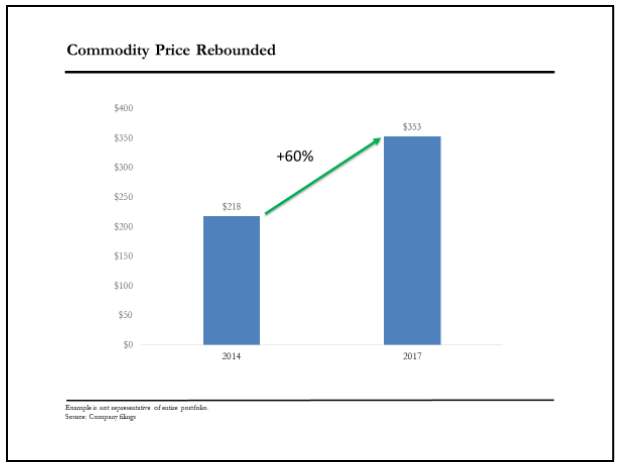
3. A compelling investment opportunity.

Here is what happened next…

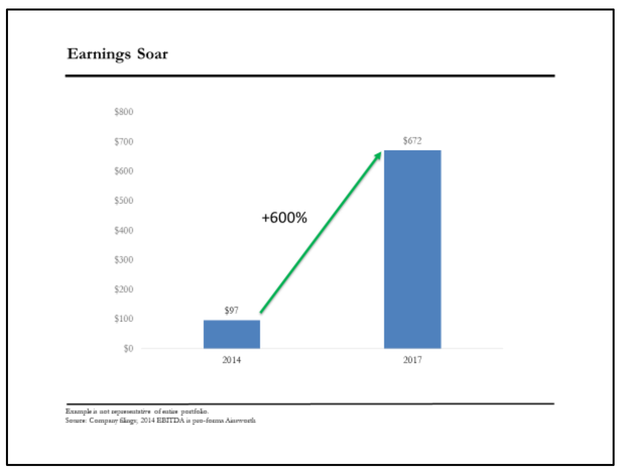
1. As we expected, housing starts did rebound…up 30%.



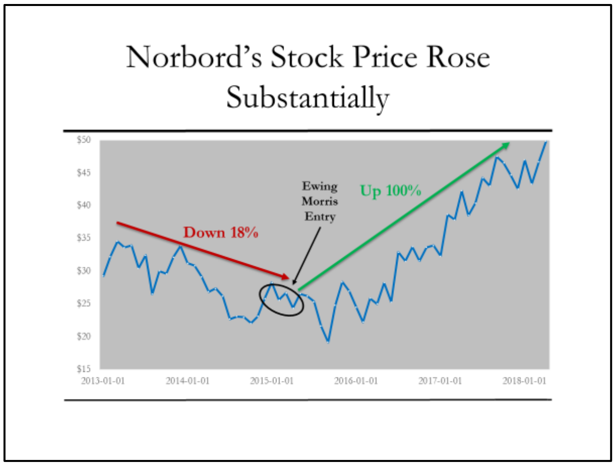
As we expected, the commodity price rebounded too…up 60%.



2. As we expected, earnings soared…up 600%.



3. As we expected, the stock price more than doubled.



That is the story of Norbord. It shows how a stock that trades at 30x EBITDA can, in fact, be undervalued if you apply Big Judgment instead of Big Data. A computer is not going to figure this out, it takes a human. With the rise of ETFs, there are fewer humans looking for this kind of situation.

That concludes our prepared remarks. I hope we have given you a clearer image of what it is we do at Ewing Morris; where we play and how we win.

I also want to thank you for your continued confidence and support.

And before we take your Questions, I would like to thank Jill Hamblin for all her efforts. Today's event would not have been possible without her.

Q&A

Question:
Could you discuss an idea that did not go according to plan?

Randy:
An important risk that we look for is industry change that can make a business go from fully operating to a zero.

We made an investment in a company called Clearwater Seafoods. The company relies on fishing quotas, primarily shellfish. In the last six months, the government has reduced Clearwater's quota and the stock has fallen about 50%.

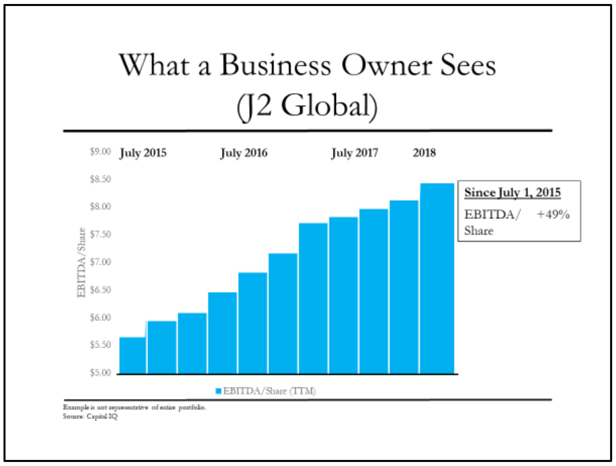
We bought the bonds at par ($100) on the new issue. We recognized the business challenges and, after the news of the reduced quota, we sold the bonds above par at $104.

This is a situation where we did not properly assess the actual risk, but we were lucky and were able to sell the bonds above where we bought them.

John:
The two primary detractors from returns in the Opportunities Fund in 2017 were j2 Global and Gear Energy. Both of these businesses grew their earnings in the year by more than 10%. The businesses began the year trading at modest multiples of earnings, but, in both cases, the stock prices were down, despite earnings growth as multiples compressed. We lost money in both of those cases, at least on a market-to-market basis, but it is hard to describe them as "mistakes".

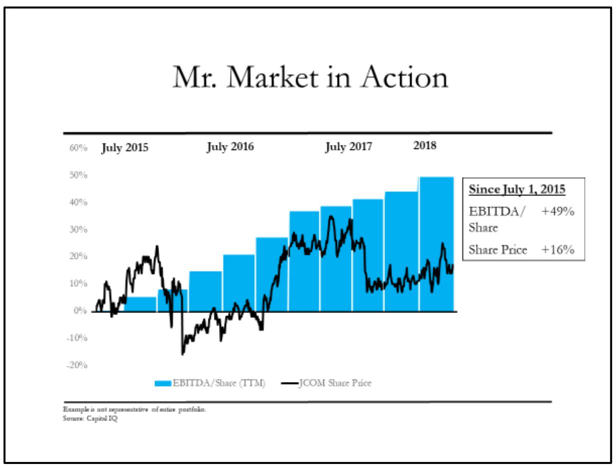
In previous meetings, we have discussed our biggest mistakes which were TeraGo, Washington Prime and Cloud Peak. At TeraGo and Washington Prime, we mis-assessed incentives of key shareholders. Cloud Peak, which was a short position, was a big drag in 2016. Cloud Peak, which is a coal mining company, was effectively an at-the-money option on coal prices. Following Trump's election, coal prices moved quickly and the stock price rebounded sharply, costing us a couple hundred basis points in return.

Darcy:
We spoke earlier about thinking like a business owner and, when you think like a business owner, you focus on the underlying fundamentals of the business. When the fundamentals do well, you expect the stock price to follow. But very rarely does it follow in lock-step. For example, the company j2, which is our largest investment, really illustrates how we think like business owners. If you are a business owner, this is what you see when you look at the business.

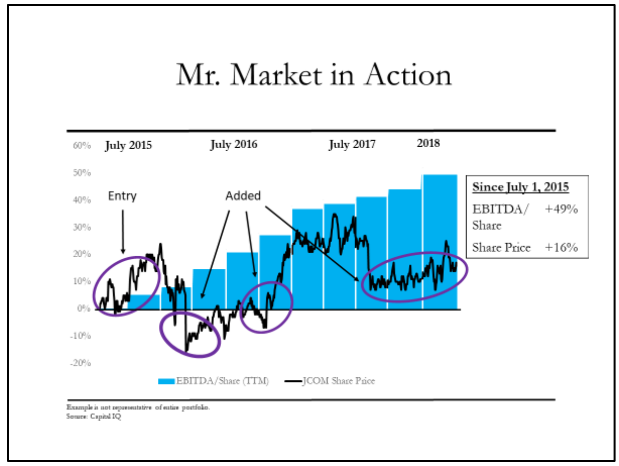


Since we made our investment in 2015, EBITDA per share has grown by 50%.

And here is what the stock price has done:



If you look at 2017, the stock has actually gone down while EBITDA per share has consistently gone up. Some people may want to classify this as a mistake, but for us, as we are focused on the business and we are taking a long-term perspective, and we are being enterprising, this meant that it was an opportunity for us to add to our position.



This slide shows our history on j2. As the business' profitability goes up, and the share price goes down, our discipline is to continue buying, as long as the thesis is intact, and we maintain confidence in the people running the business. So, that is where we are with this company, which we wrote about as potentially being a mistake in terms of its market-to-market stock price loss.

Question:
My understanding is that a lot of retail investors have been burned by preferred shares. Could you discuss the risks associated with this market?

Randy:
The Canadian experience with preferred shares has indeed been pretty bad. However, that was primarily with the rate-reset preferred shares that declined 30-40% in 2015. The Loblaw preferred shares that we own are different; they have a fixed rate and have not experienced the same volatility as rate-reset prefs.

The Loblaw pref was born in 2015 and was a refinancing of a private preferred share. If you think about the cost of capital of this business, its debt sits at around 4%. That is an interest rate deductible expense for the company as well, so it would actually make sense for Loblaw to call our preferred shares at a premium to refinance with lower cost debt. This creates some extra margin of safety.

Question:
I wanted to ask about AlarmForce. How do you decide when it makes sense to become a director of a portfolio company?

Lee:
When I joined the Board, I was aware of the issues facing the company. The sale to BCE was obviously a great outcome, but we didn't need that to happen for the investment to be successful. We were big believers in the unit economics of the business and, following the sale of the U.S. business, we were well capitalized to pursue organic growth in Canada.

If you think about the way this business works, it is not dissimilar to the cellphone contract business. With AlarmForce, you have customers who will be clients likely for an extended period of time, giving you a certain number of years of recurring revenue. It is all about how much it costs to acquire that customer. With its direct sales model, AlarmForce is able to create new customer accounts for 27-28 times recurring monthly revenue, whereas ADT, with its dealer network, typically pays more like 35x for each account. Our view was there was nothing that prevented the company from getting back to that type of creation process. I think our core view was that this business could be run on a very attractive standalone basis for the foreseeable future, under better management.

Darcy:
Obviously, when we accept board representation, there is a cost in terms of reduced liquidity so we need to make sure we are being compensated. It's the same as if you make an investment in a private equity fund where your money is tied up for ten years. You are going to expect to earn a higher return on your private equity investment than compared to an ETF with daily liquidity.

We are not going to seek board representation unless we think the benefits, in the form of a higher IRR, are worth the cost. In our experience, we've been fairly compensated, earning in excess of 20% IRRs on this kind of investment.

We also consider the time-value of money. If you buy a dollar for 50 cents and it takes five years for the gap to close, you make a 15% IRR; but if we can act to close the gap faster, as we saw at AlarmForce, the IRR goes up pretty dramatically.

Question:
How is the Opportunities Fund currently invested across the Ewing Morris playbook?

John:
There are four plays in the playbook framework. First is Great Businesses –those are wonderful companies that can grow earnings per share at a high rate for a long time. Those are always rare and they are particularly rare when markets are buoyant like they've generally been over the last several years. That is a pretty small part of the portfolio today, about 10%.

The second play we call the "Great Capital Allocator". That's a company where, again, they can grow earnings per share at a high rate for a long time. Rather than the business being the driver of that – it's the people, and so the people are creating shareholder value through intelligent investment decisions – usually, acquisitions, but it could be other forms as well. Darcy showed j2 earlier which is an example of a Great Capital Allocator. The company has grown profit per share about 50% in the last couple of years and that's a pretty remarkable track record and it's consistent with the company's track record, which is growing profit per share close to 18% a year, for close to 20 years. It's a really remarkable track record. The people who built that track record are still at the helm. That single company is a big part of our portfolio. There's not a lot of other companies like that at appropriate prices that we see. Collectively, the Great Capital Allocator play is 25% of the portfolio.

The third main play, what we call "Cheap Assets", are not necessarily wonderful businesses, but situations where you can buy a good asset at a really attractive price and still make a 15% return over time, and AlarmForce is that type of company. They're not necessarily terrible businesses – they're just not businesses that you can be confident they'll grow 15% a year for a long time. Norbord is another one. Norbord is a really solid business with a defensible position. It's a cyclical industry, earnings aren't going to grow at 15% over time. If you can buy it at the right time in the cycle, you can make an excellent return, which we have. So, the Cheap Asset play is the biggest play today which, doesn't surprise me given where we are in the market cycle. We'd always prefer the first two, the compounders, but they're not always available.

The fourth play is what we call "Broken Businesses", and that's where we short. So, we profit from deterioration in the company's operations or the share price. I think the most exciting Broken Business idea we have right now is around the packaged food industry and I'll ask Randy to elaborate on that.

Randy:
The packaged food space right now is a very interesting place to be from a credit perspective. What we're currently doing is shorting the very long-term bonds of these large investment grade packaged food companies like Kraft/Heinz, Campbell Soup, General Mills. A lot of them have more debt than they have ever had. Campbell's Soup has five times leverage now. General Mills is at 4.5 times. These are the kind of businesses that have their products in the centre of the grocery store - the aisles that you don't shop as much as you used to.

We stand to profit from the balance sheets of these companies worsening, which can come either from the business declining or from executive decisions.

First, I think some industry history would be helpful. If you look at branded food a hundred years ago, people bought packaged food because it was safer than the alternative. Branded mayonnaise in a jar was safer than the unlabeled mayonnaise in a bucket. Today, safety isn't really a concern which has allowed private label products to take market share. You really see the changing industry dynamics evident in the financial performance of these companies.

If you look over the last two years, these stocks have lost money in a really strong bull market. Stocks are down and they've lagged S&P500 by 35% or more. When you have this type of situation you tend to attract activist investors that want to improve the share price by enacting different corporate actions. There are a lot of companies in the food space that are engaged with active investors, but the companies that we've shorted generally haven't attracted activists yet. When activists get involved, they usually want to do one or more of the following: 1) buy back stock; 2) raise the dividend; 3) buy another company; or 4) sell yourself. All of those things are actually really bad for balance sheets and lenders.

While the stock market has been noticing, the credit market doesn't care. If you look at long term bond spreads, the additional premium you get in long term bonds to compensate you for the company's specific risk, have prices that are actually at the most expensive end of their historical range.

The reason we're choosing the long-term bonds is that, because they're so long dated, a little change in the spread of these bonds can make a really big change in price. If a bond went from a 1½% spread to a 2½% spread, those bonds go down by 15%. Effectively, what we're doing is shorting the bond and buying the government bond underneath. If we're right and the spread goes up, we're paying only a percent and half away a year and we can earn 15% to maybe even 30%.

Also, what we're doing here is taking a contrarian view on a space that is very popular. The investment grade market is probably one of the most popular places in all capital markets at this point. You just look back over the last 10 years, S&P 500 total market value is up 100%, high yield market is up 100% and the investment grade market is up 200% in size. It's a very popular place and investors are overlooking these risks for branded consumer companies.

Darcy:
And this investment, which can be considered a hedge, has between 10%-15% weight in both our equity and our fixed income portfolios.

Question:
How do you think about when is the right time to sell an investment?

Alex:
There are two main reasons why we sell a security. Number one is obvious, which is that we made a mistake. Once we've realized that we've made a mistake, it's an easy decision and we exit the position. The second reason is returns expectations for this given position have declined.

When we underwrite our investments, our goal is to achieve 15% returns on our capital and our partners' capital. For example, in the case of compounders, the share price can continue to rise if the growth in the earning power matches it and we'll continue to own that business for a very long time. If the share price appreciation far exceeds the growth in the underlying earning power, then we start to consider reducing our position. In the case of Cheap Assets, we usually tend to sell more quickly.

Question:
How do you determine the size of an individual investment?

John:
If you think back to the playbook framework, that really informs a lot of our decisions. I'll describe how sell-discipline is different for Compounders versus Cheap Assets.

For Great Businesses and Great Capital Allocators that can grow earnings at 15% or more for a long time, they are rare and you want a meaningful amount of capital invested, usually 10%.

For Cheap Assets, 2-5% is usually more appropriate.

Darcy:
If we find a Great Business trading at a Cheap Asset valuation, you should expect a 15% weight. That's very rare but, it provides a framework.

Alex:
What differentiates us from some other investors is that we tend to have a dynamic view on position size. When we underwrite a certain investment, usually there is a probability distribution associated with the investment. As the company hits certain milestones, those probabilities can change. The likelihood of being right can go up and an investment can have a better than expected return even if the stock price is higher, so we might actually increase the weight. An example would be New Fly Industries which started as a 3% weight for us and then grew as high as 8% as the probability of the company achieving our earnings projections increased.

Question:
Can you talk about your view of Canadian oil and gas equities today?

John:
Generally speaking, stock market valuations are pretty expensive. Energy is one of the few places that is out of favor and within energy, Canadian energy is probably the most out-of-favor of all. It is an interesting place to look.

Canadian energy is out of favor for a reason; people are worried about things like pipelines, which is a real issue.

Over time, we are tending to prefer energy debt to energy stocks. A cheap stock can stay cheap forever if nobody else cares about it, but a bond has a maturity date which means you don't need to wait indefinitely. Randy, can you talk about an energy debt example?

Randy:
We tend to focus on shorter-dated bonds where the commodity risk is reduced. An example of this, is a company called Source Energy Services, which produces and transports sand for pressure pumpers. They issued at 10.5% a year and a half ago. Now, their cost of debt is probably more like 6% or maybe 7%. It is in their interest to refinance that really expensive debt, but the contract doesn't allow them to refinance until December 2018. The bonds now yield 6 to 7% between now and the end of the year. We think the outcome is independent of rate hikes or commodity prices.

John:
Another way to reduce risk in energy debt is with an equity hedge where you buy the bond and short some stock of the same company. Randy made an outstanding investment in a company called Precision Drilling. The debt was at 70 cents on the dollar, he shorted some stock when the stock was above $6. The bonds rallied above 90 while the stock price declined. We actually got paid to have insurance. In hindsight, we sold too soon. The bonds are now above $100 and the stock is below $4.50.

Question:
What's your process in evaluating the character of a management team?

Lee:
Obviously, we're not interested in working with people that are criminals, but nobody running a public company looks like a criminal the first time you meet them. It is not very difficult to sit there and say, "Well, I met the CEO three times. He seems like an outstanding person."

Something that I have learned through my work as a corporate director is how sensitive most CEOs are to their compensation. I think you can learn a lot about character by reading the proxy carefully.

Alex:
Every management team comes in with a PowerPoint presentation they want to walk through. If you just let them talk from their script, it will be very difficult to distinguish between those who actually know what they're doing and those who don't.

We always have prepared questions and never use the prepared slides and you'd be surprised how easy it is to distinguish between managers who actually know the business, know the numbers, and those who don't. There are instances where you would sit down, you would ask a very simple question to the CEO and he would say, "Well I'll have to have to ask my CFO and get back to you." Just by doing your work, I think you'll be surprised how big the difference is between really solid managers and average managers.

Question:
Can you explain the Broadview Dark Horse / Ewing Morris merger?

Darcy:
Our view is that investment talent is rare. When you find it, as an organization, you want to be in position to invite them to have a seat at the table. That, I think, summarizes what happened with Anthony and Lee. We have known both Anthony and Lee going back almost a decade now. We have shared philosophies, yet we have different approaches, and we had experience working together. We cooperated on a number of investment cases over the years. We knew we liked each other and we knew that we could work together and we knew that we shared a philosophy. I think one thing that was different was John and I have tried to build a real organization and develop a team whereas I think Lee and Anthony started off focused on just running a fund. As their business grew, they realized that some of the administration and operational requirements were a burden and, basically, were distracting them from their overall goal and that, if we combined our forces, then there would be synergies in that. Investment puzzles are tough and the more smart minds that you have working on them, I think the better the odds of success are. There's no question from my perspective that we're a stronger team now.

Lee:
I think that the point is that when Anthony and I founded Broadview, we very much ran it as we were running a fund, we weren't running a company. And, as you grow a business, there are complicating factors that distract you from what you really enjoy about it which, in our case, is the investment research and portfolio management stuff. We had to, in essence, make a decision on whether we wanted to internally hire more staff and build our infrastructure and add costs and likely further distract ourselves from the investment process, versus joining forces with Ewing Morris, which would allow us to once again go back to focusing almost solely on the investment management part, which is the part that we really enjoy. Given the great operations team under Matt Irwin, effectively, we were able to just hand over the twenty odd percent of our day which is usually tied up in administrative stuff. I don't want to downplay it, it's very important stuff, but not stuff that I wanted to do. Now, under the Ewing Morris umbrella, we're able to continue to run the fund as a fund and not necessarily think about the broader aspects of running a firm, which is ideal for us.

Question:
Where do you see the firm in three to five years and then into the future?

Darcy:
The goal continues to be the same - build a firm we would want to invest with. In terms of growth initiatives, I think the experiences with bringing Anthony and Lee, or Randy, on board are informative. In the case of the Flexible Fixed Income Fund, that was really a demand driven initiative from some of our investors who, frankly, didn't want any more equity exposure. They wanted fixed income exposure, but, at the same time, they were unconvinced that the traditional bond offerings would protect capital in a rising interest rate environment. It's in this context that we met Randy Steuart who articulated what we discussed today – a really new, novel approach to fixed income – and he expressed a desire to join us. Randy was a top player at his prior firm. It was a big sacrifice for him to join us, but he did and that's how we've expanded into that area. It's similar with Lee and Anthony. They have expertise that compliments the existing team.

In the future, if someone were to approach John and I, or if we were introduced to someone, who articulates an investment approach that is differentiated and occupies another niche in the market, and they had a willingness and desire to join our team, then that may be one way that we would grow into a new business line. We don't have any current plans to do that.