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 or contact Lana Nicosia at 1-888-710-4242 ext.4539 or by email at 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.[1]

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."[2] 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".[3] 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).[4] 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.[5] 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.[6] 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.[7] 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."[8] 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

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. 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%.[9] 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

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).[10] 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."[11] 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,[12] Warren Buffett,[13] Phil Fisher,[14] John Maynard Keynes,[15] Charlie Munger,[16] Bill Ruane,[17] and of course Portland's own Michael Lee-Chin.[18] 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.[19]

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."[20] 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."[21] Munger has repeatedly (and characteristically forcefully) stressed the importance of opportunity cost in making investment decisions.[22] 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".[23]

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."[24] 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.[25] A further 36% of Canadians live in an owned dwelling without a mortgage.[26] 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.

Comparison in use of leverage to acquire:	Homes	Equities
Maximum loan to value ratio	95%[27]	70%[28]
Interest rates – Canada	2.5%[29]	2.0%[30]
Interest rates – U.S.	n/a	1.1%[31]
Is interest expense tax-deductible?	No	Yes
Does asset generate income?	No	Yes
Ownership expenses per annum	2%[32]	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.[33] 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.[34] 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

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".[35] Graham's use of the word "nonprofessional" is significant (he repeated it elsewhere)[36] 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 the 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.[37] 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)[38] 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."[39]

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".[40] 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."[41] Graham added, "I should greatly welcome an effort by security analysts to deal intelligently with speculative operations."[42] 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

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".[43]

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."[44] 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.[45]
- *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."[46] 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".[47] 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."[48] 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."[49] 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.[50] 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."[51] 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.

Short Selling

The section immediately above describes what the Fund seeks in long securities positions. The Fund, however, may also engage in short selling.[52] 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

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

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).[53] 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".[54] 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."[55] 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."*[56]

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."*[57]

MPT is based in part on the Efficient Market Hypothesis (EMH) to which it is closely allied.[58] Renowned investor Jeremy Grantham, co-founder of one of the world's leading investment management firms, recently described EMH as "laughable".[59] 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."[60]

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."[61] 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.[62] *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.[63] 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.[64] 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."[65]

Trading Costs

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.[66] 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.[67]

Equity transaction costs for a company of size:	Small cap.	Large cap.
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.[68] 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."[69]

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.[70] 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).[71]

Marginal tax rate on taxable income of $150,000 - 2013	Alberta	Ontario
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."[72]

Inflation

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%.[73] This is consistent with the Bank of Canada's "inflation-control target" (adopted in 1991) of 2%.[74] 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%.[75]

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.[76]

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).[77] 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

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.[78] 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).[79] This fee is half of that typically charged by other alternative strategies funds.[80] 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.[81] 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

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

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, 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.

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.
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.
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). 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
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
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
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.elkinsmcsherry.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.elkinsmcsherry.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. 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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