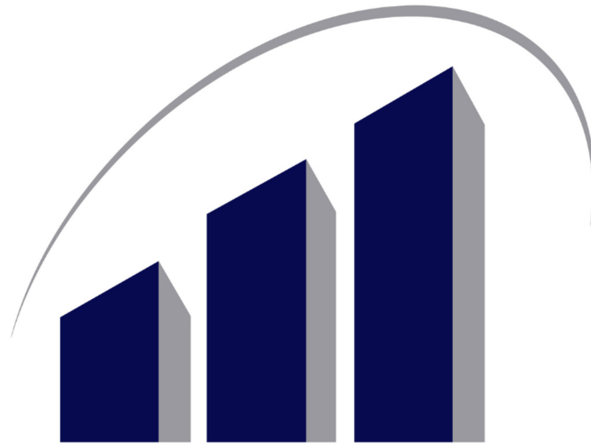

the osler fund

2022 Annual Report

Sept 2022// Prepared by Lorne David Porayko, MD, FRCP(C), CIM

The Osler Fund ("The Fund")

The Osler Fund is a RRSP/TFSA/RESP/Pension eligible fund. The Fund was formed on February 5, 2019 with the following principles in mind:

1. Satisfactory longer-term performance can be achieved by buying high quality businesses that are trading at substantially discounted prices and then allowing that value to compound over many years.

2. We view stock ownership as a partnership with the people who operate the company. As such, we want those people to be honest, talented and motivated (through substantial ownership of equity in their employer).

3. Downside protection is more important than trying to hit it out of the park. We like our companies to have strong balance sheets, thoughtful capital allocation and competitive advantages.

4. In order to create long-term value, one must be prepared to do the research to justify a contrarian opinion and then act accordingly. One must then have the patience to hold unpopular securities for long periods before other investors understand your variant perception of value.

Further information is available at our website: www.theoslerfunds.com

Our friendly lawyers remind us to always start off with some mandatory disclaimers:

- Our Annual Report contains forward looking information. We will not update this report even if our opinion changes.
- While we believe our comments and facts are accurate, you should not rely on them without verification.
- Commissions, trailing commissions, management fees and expenses all may be associated with investment fund investments. The indicated rates of return are the historical annual compounded total return including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional changes or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated.
- The Fund is governed by the terms of a trust agreement made as of February 5, 2019 between McElvaine Investment Management Ltd., in its capacity as manager of the Fund, and McElvaine Investment Management Ltd., in its capacity as trustee of the Fund.
- Further information is available on our website: www.theoslerfunds.com.

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Introduction: 2021 Annus Delirus[1]

[2]

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"

—— Lewis Carroll, Alice's Adventures in Wonderland / Through the Looking-Glass

"The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics."

—— Thomas Sowell, Is Reality Optional?

[1] The translation from latin is "A Crazy Year". It sure was.

[2] This somewhat disturbing picture is an AI generated image the author created on photosonic.ai; it is copy-write free (CC0)

Dear Friends, Family and Fellow Unitholders,

The capital markets' price and value remained utterly unhinged in the 6-month period between March and April of 2022. From ebullience to despair and back again. Macro-economic and geopolitical developments that were unthinkable only a few years ago came fast and furious: multi-decade-high inflation, an imperialistic and genocidal invasion in Ukraine, ongoing extreme weather, emerging market riots (concerning food and energy prices), an alarming liquidity crunch in China's absolutely massive real estate market[3] and an evolving global energy crisis with potentially existential downstream ramifications (particularly for Europe) are just amongst the more important ones! I would be remiss to fail to mention the ongoing and deteriorating distress in healthcare systems worldwide; in just under 30 years of medical practice, I have never heard the term "collapse" used so often inside the hospital. Signs of social chaos and economic entropy dominate the headlines.

Let's face it, there is much to worry about.

Insane Capital Markets Volatility

We do not claim to have any special forecasting skills. Despite this deficiency, our comment in the 2021 Annual Letter to Unitholders seems particularly apropos, in retrospect:

> *"It's as if Mr. Market is thinking not much could go wrong. Being fully invested in the broad market ie. via an S&P 500 index fund or ETF will not likely be for the faint of heart in 2022 and beyond..."*

[3] Worth at least $52 trillion USD according to this Wall St. Journal article in 2020: https://www.wsj.com/articles/china-property-real-estate-boom-covid-pandemic-bubble-11594908517

[4]

Owners of the SPY ETF were indeed in for a rocky ride. If history is any guide (and I'm not so sure—see my comments below), bear markets may also have saved their worst for last.

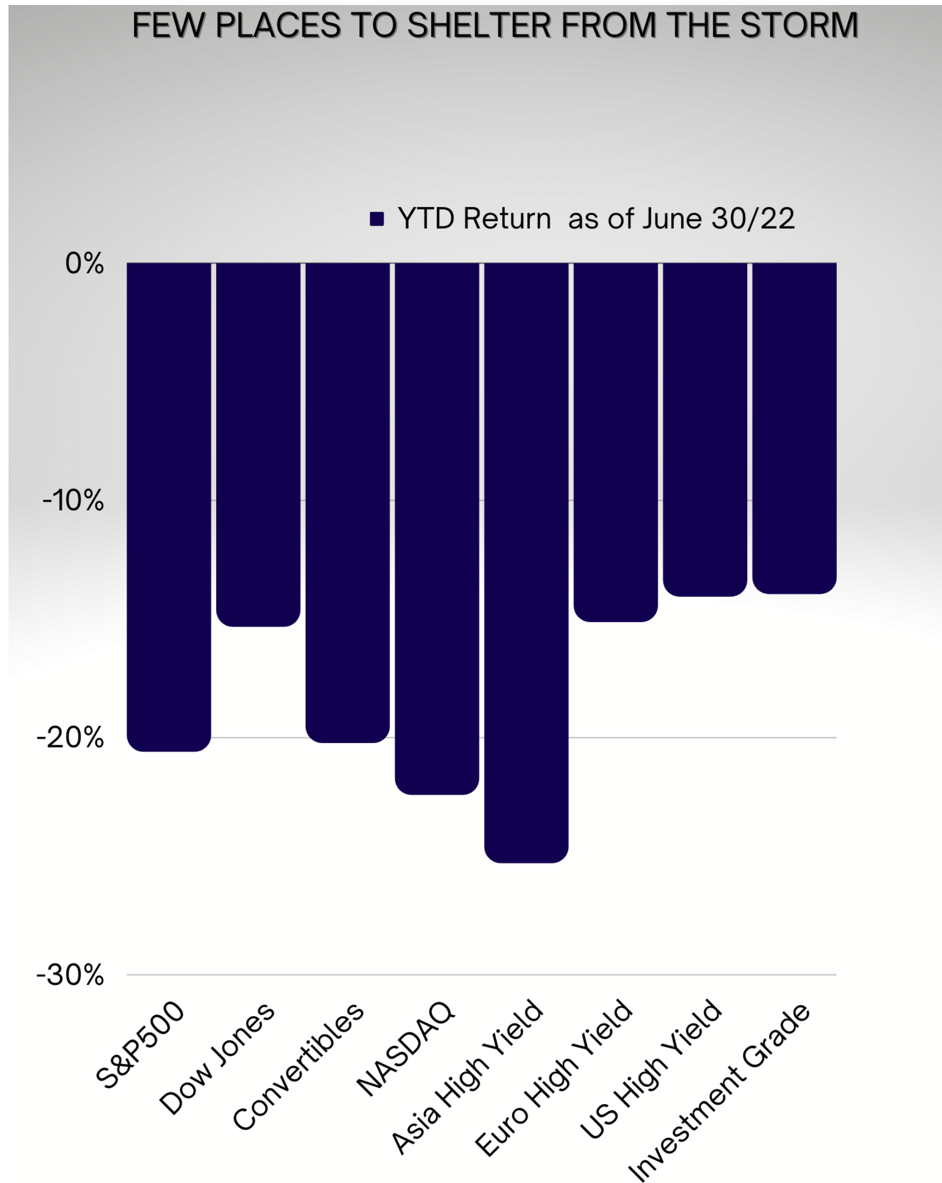
Bear Market	Duration: 1st Third	2nd Third	3rd Third
1929-33	-36%	-25%	-71%
1933-35	-6%	-21%	-11%
1937-38	-12%	-38%	-17%
1938-42	-8%	-22%	-24%
1946-47	-25%	4%	-8%
1948-49	-6%	-9%	-7%
1957-58	-6%	0%	-17%
1961-62	-3%	-3%	-23%
1966	-3%	-5%	-15%
1968-70	-5%	-9%	-25%
1973-75	-12%	-8%	-36%
1981-82	-6%	-12%	-13%
1987	-4%	-24%	-9%
2000-02	-11%	-16%	-34%
2007-09	-15%	-8%	-44%
2020	-13%	-2%	-22%
Mean	*-11%*	*-12%*	*-24%*
Median	*-7%*	*-9%*	*-20%*
Central Tendency	*-9%*	*-11%*	*-20%*

Source: Merk Investments, Bloomberg

Even in retrospect, there were few places to seek refuge outside of the energy sector and a handful of meme-driven stocks backed by unprofitable 'businesses' undergoing flagrant market

[4] Source: tikr.com

manipulation.[5] I worry that many widows, orphans and pension-holders have suffered gut-wrenching drawdowns despite being in 'safe' 60%:40% blue chip portfolios. According to BofA Global research,[6] retail equity outflows were virtually non-existent until near the end of the summer. Sadly, the most vulnerable and least sophisticated market participants are often the last to exit a burning theatre.



Source: KKR Credit Analysis

[5] By this I mean the antics of the Wallstreetbets Reddit crowd and the like who aim to intentionally collude to manipulate market prices. I won't give this any more attention than it deserves and may have done so already…

[6] https://www.bloomberg.com/news/articles/2022-09-02/bofa-says-brace-for-recession-shock-as-outflows-rock-equities#xj4y7vzkg

Year to date (ending August 31/22) both the broad-based equity and bond indices have double-digit negative returns. The cruel eventuality of losing out on both the fixed income and the equity portion of a properly balanced portfolio is historically unusual: the only years that have seen both stocks and bonds at a loss by end of August were 1973/4 and 1981.

Beware of a Hawkish Fed

"Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain..."

- Fed Chair Jerome Powell (29th Aug 2022)

After nearly doubling its assets over the past 2.5 years, the Fed started the process of shrinking its $9 trillion balance sheet at the beginning of August.

The central bank will allow the maturity of $95 billion in Treasuries and mortgage-backed securities this month, roughly double the peak rate of $50 billion during the previous period of quantitative tightening from 2017 to 2019.

The runoff will augment the limited supply of bills that have been pushing investors into the Fed's reverse repo programme, which has an unheard-of $2.4 trillion market cap right now. According to BofA strategists, the unwinding may ultimately reduce the S&P 500 by 7% in the next year.[7] Undoubtedly, we are rowing against the tide.

[7] https://www.bnnbloomberg.ca/bofa-says-quantitative-tightening-would-shave-7-off-s-p-500-1.1806055

The Evolving Energy (and Food) Crisis

unusual_whales
@unusual_whales

Michelin-starred chef Tom Kerridge says the energy bill at his UK pub has jumped from £60,000 to £420,000, per Bloomberg.

2022-09-02, 11:42

The supply-demand mismatch setup for energy (and food, soon to follow) has been in the making for several years, even before the onset of the pandemic. Shale depletion curves, ESG influences, labour market shortages and increasingly adverse regulation/legislation have strongly discouraged investment in new production worldwide (and in particular, the regions with the best stewardship practices such as Canada). The transfer to renewable sources has been unsurprisingly slow, unreliable and incomplete; barring any disruptive technological breakthroughs, renewable energy is not going to solve the crisis for a long time, and potentially for decades!

> Of the four substances (and despite my dislike of rankings!), it is ammonia that deserves the top position as our most important material. As explained in the previous chapter, without its use as the dominant nitrogen fertilizer (directly or as feedstock for the synthesis of other nitrogenous compounds), it would be impossible to feed at least 40 percent and up to 50 percent of today's nearly 8 billion people. Simply restated: in 2020, nearly 4 billion people would not have been alive without synthetic ammonia.
>
> **Vaclav Smil**
> *How the World Really Works: The Science Behind How We Got Here and Where We're Going*

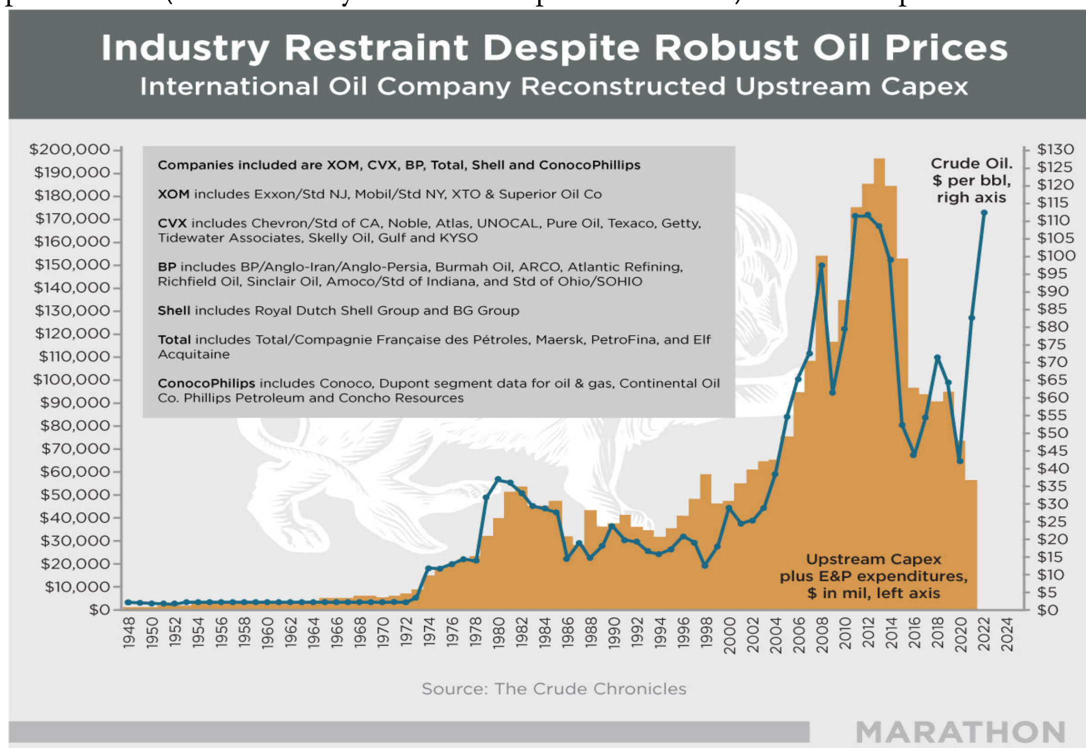
Many people I have spoken to about this issue were not aware that natural gas is a crucial input molecule for the production of fertilizer.[8]

The largest fertilizer producer in Europe recently announced that it was reducing production by almost two-thirds because of the escalating cost of natural gas, a key component of the ammonia synthesis (aka the Haber-Bosch process).[9]

[8] The Haber-Bosch process: for your interest a lay-person level article lives here: https://www.yara.com/crop-nutrition/why-fertilizer/production-of-fertillizer/

[9] https://www.bloomberg.com/news/articles/2022-08-25/yara-to-further-cut-european-ammonia-production-due-to-gas-spike

Research from Marathon Resource Advisors, a US-based natural resources specialist hedge fund shows the stark disconnect between the major E&P firms' willingness to invest in new production (manifested by the lack of capex investment) and the oil price:



Once again, history here has not repeated itself: instead of drilling like mad to rake in the short-term profits (and tank the oil spot price like what happened circa 2014), the majors are showing unprecedented discipline. They are deliberately selling down their inventories and carefully producing from their lowest cost geographies.

The impacts of escalating petrochemical costs are wide ranging. Cornwall Insight[10], a management consultancy, estimates that the average Briton household can expect to pay just under 7000 £ annually for energy in 2023; this compares with about 1000 £ per annum in recent years. The Germans are not much better off, with current natural gas pricing up 450% year over year and facing a bleak winter. The rest of Western Europe will likely fare no better, with Germany and Italy both particularly energy-impoverished. The charts are breathtaking. That this is utterly unsustainable is not a matter up for debate. What is less clear is how the EU will respond to avert a potential socio-economic disaster. Hoping for a mild winter may not cut it.

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[10] https://www.cornwall-insight.com/cornwall-insight-release-final-predictions-for-octobers-price-cap/

Nuclear Energy: A Potential Green Solution?

Although there is much debate on the subject, contemporary production of nuclear energy is probably safer, less expensive, more efficient and more sustainable than most people think. It also is unrivaled in terms of energy density. A U308[11] pellet, the approximate size of a gummy bear, contains as much energy as 3 barrels of oil and 17,000 cubic feet of natural gas, while producing no net greenhouse gas output during operations.[12] It delivers power regardless of wind or sunshine. There are evolving attractive solutions to nuclear waste disposal (one being that they can be recycled) and preventing the weaponization of the byproducts.[13]

Approximately 440 nuclear power reactors are now in operation throughout 33 nations, with a total capacity of 390 GWe[14]. These generated 2653 TWh[15] in 2021, or almost 10% of the world's electricity.

There are now 55 power reactors being built, mostly in China, India, Russia, and the United Arab Emirates, but also in 15 other nations.

Compared to just two in the US, China has an additional 46 nuclear reactors under construction. Over the following 15 years, China also plans to construct an additional 150 nuclear reactors.

In light of the fact that China is currently the world's largest consumer of coal, a switch to other, less noxious energy sources will be crucial for the advancement of greener efforts.

Upgrading existing plants is another option for growing nuclear capacity besides adding more reactors. This is a very economical method of adding more capacity.

Because the Chornobyl and Fukushima disasters remain in front of mind, many worry about the safety of nuclear energy. In the more than 18,500 total reactor years of commercial nuclear power operations in 36 nations, only two significant reactor accidents have happened, both in reactors with antiquated technology/fail safes. It is reasonable to expect contemporary and upgraded reactors to continue (and improve) their favourable safety profiles.

There is a lot of cynicism about the role of nuclear energy in alleviating the pain during the transition from fossil fuels and this is reflected in attractive valuations in many of the businesses involved in the long-suffering industry. This could be a fertile area for finding future bargains.

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[11] An isotope of uranium suitable for fission after refinement.
[12] https://nuclear.gepower.com/nuclear-power-basics and https://www.world-nuclear.org/information-library/energy-and-the-environment/carbon-dioxide-emissions-from-electricity.aspx
[13] http://nuclearsafety.gc.ca/eng/waste/index.cfm and https://www.energy.gov/sites/default/files/2017/11/f46/fy18npcr_final_november_2017%5B1%5D_0.pdf
[14] Gigawatt*hours equivalents: a metric of power production
[15] Terawatt*hours: also a metric of power production

The Ukrainian Invasion

This humanitarian catastrophe is also deeply personal for my family.[16] We are equally perplexed and appalled that a dictator's vast war machine has once more rolled toward the West after three-quarters of a century of relative calm in Europe. Obviously, I have strong feelings about this event, but since these thoughts do not contribute directly to the performance or welfare of The Osler Fund unit-holders, I will not comment further about them.

From a purely financial perspective, however, I would encourage you to watch the video in this tweet: https://twitter.com/i/status/1566111781117775872

"The economy of imaginary wealth is being inevitably replaced by the economy of real and hard assets."

—Vladimir Putin, September 2022

Although Putin appears to have ideological motivations for his decision to invade Ukraine, he quite explicitly lays out the economic argument for creating scarcity in hard assets/natural resources. In my opinion, this strategy may not work out very well for the Russian people although, somewhat ironically, the energy-rich nations Putin has identified as his enemy (particularly US and Canada) might end up reaping the benefits in the end.

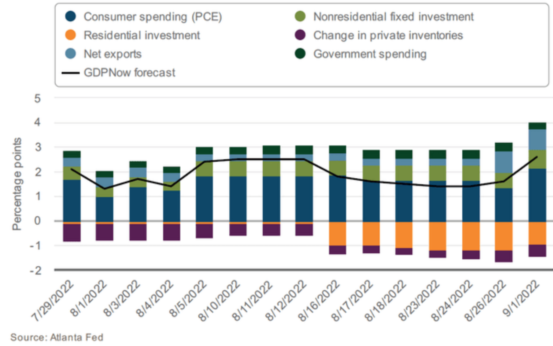
On the Brighter Side

2021/2022 wasn't all bad news. The North American consumer continues to spend (for now), unemployment is very low and corporate profitability remains strong; the Main Street CEOs of the firms that we follow are generally optimistic. Supply chain constraints and shipping costs have eased substantially and most employers appear to be struggling less to find reasonably skilled and reliable employees. The coronavirus pandemic continues to roll on with wave after wave and although it continues to exact a remarkable toll, we are adapting (somewhat). Some forecasters believe that North America, in particular, is heading for a 'soft landing' rather than a harsh recession. This is predicated on 3 findings (supported by the following charts):

1. the bond markets have 'baked in' a 2.6% inflation rate within 2 years;
2. Strong consumer spending trends right into September; and
3. Professional Fund Manager sentiment and equity exposure are very bearish (if you are contrarian like us, you might believe these likely mean markets are oversold).

[16] As one can surmise from my name, my family has Ukrainian roots.

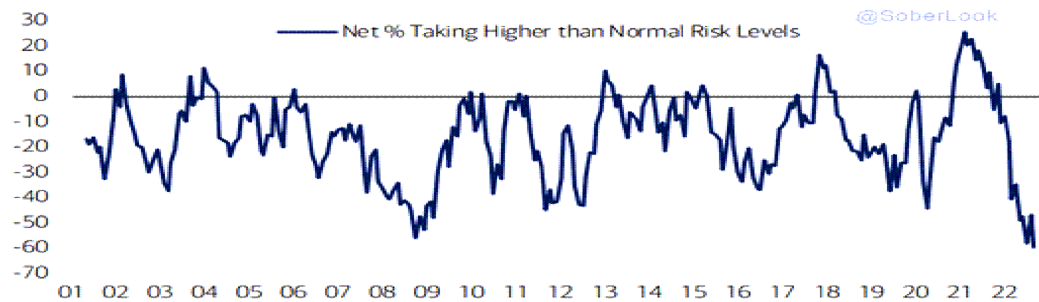
Subcomponent contributions to GDPNow real GDP growth forecasts



Investor Risk Appetite

Posted on
The Daily Shot
13-Sep-2022
@SoberLook

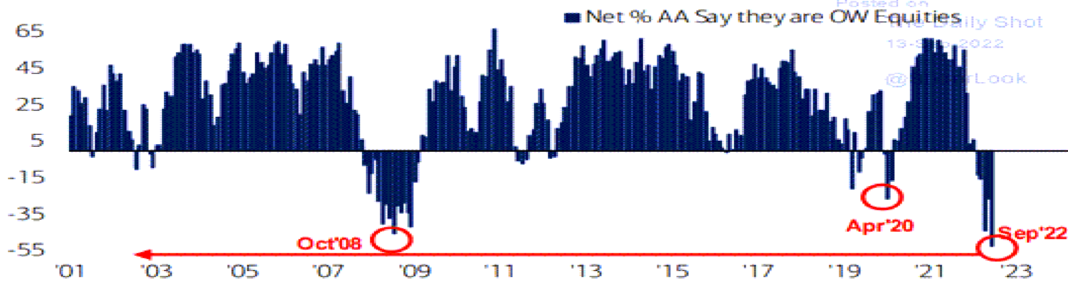
Chart 36: What level of risk do you think you're currently taking in your investment?
Net% of FMS investors taking higher than normal risk levels



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

Net % OW Equities



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

In September, FMS investors cut their net underweight in stocks further to -52% (from -26%)...

Lessons Learned

The last few years have taught us a few lessons:

1. History may not be a reliable guide.
2. Valuation does matter and much more so than (frequently) specious narratives.
    - Eventually, anyway.
3. Volatility can create opportunity, particularly when it is driven by market mechanics rather than economic fundamentals.
4. Patient, counter-cyclical investing pays off.
    - Eventually.

I believe points 3 and 4 are self-evident. 1 and 2 probably deserve further discussion.

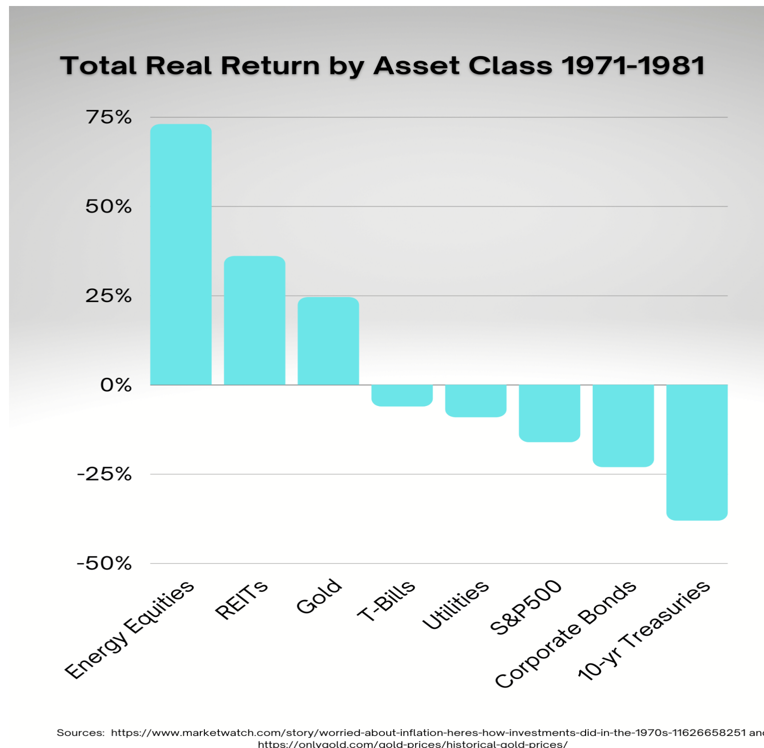
Capital Markets History May Not Be A Reliable Guide For The Future

In 2020, the word 'unprecedented' was used in approximately 75% of corporate conference calls and continues to be one of the most commonly used terms in word clouds.[17] From negative spot prices for oil contracts, teenagers buying thousands of derivatives securities at a go and (foiled) attempts to storm the White House to overthrow a democratically elected government in the USA are just a few examples of recent unprecedented events. Why would history be any kind of guide to the future when new and crazy stuff like this is happening regularly?

If the last 3 years have taught us anything, it's that history does not necessarily repeat itself and that using historical trends as a guide for investing could be dangerously misleading. For example, many pundits have used the era of the 1970's as a comparison to our current plight: hyper-inflation, oil shock, rising interest rates, Russian trouble (the Cold War was peaking about then) and marked social turmoil.

The graph below shows the returns of several asset classes from 1971 to 1981:

[17] https://www.bloomberg.com/news/articles/2020-04-22/-unprecedented-has-become-corporate-america-s-go-to-descriptor#xj4y7vzkg



One could just mindlessly buy the assets that did well and avoid or sell short the ones that didn't. That might work.

But think about it for a minute. Were the 70's really anything like today? Is it valid to extrapolate as such? I think not.

I'll provide just three examples of why it probably isn't. In the 1970s...

1. Interest rates were in the double digits and national debt was modest. Most developed nations had a light debt burden, whereas today the majority have debt:GDP ratios that exceed 100%![18]

2. The frictional costs of trading were very high, data flow was excruciatingly slow (even to the privileged few) and most retail investors were sophisticated and represented by a stockbroker; today teenagers directly trade call options commission-free on Robin Hood in their parent's basement.

3. Globalization, with all its windfalls and drawbacks, hadn't really started yet. It changed the economic landscape massively: cheap input costs, particularly.
    - China was impoverished and had very little global influence; most North American manufacturing was local (and labour-intensive, which was very expensive)

[18] https://data.oecd.org/gga/general-government-debt.htm

There is really no reason to expect similar results today as in the past because the context is so different.

On the other hand, noting broader themes could still be valuable: ie. real assets might be a better choice than financial assets in an inflationary environment. In many cases, history is the only source of information we have, unreliable or not. Finally, if one cares more about pricing than valuation, many influential price-discovery agents[19] use historical comparisons as core determinants of IPO print prices and most M&A activity. Social proof phenomenon in finance is inarguably powerful: price and value are often conflated, and not always intentionally.

We remain particularly cautious drawing any conclusion from financial history and certainly would not make an investment decision solely from empiric historical data.

Valuation, like Gravity, Eventually Matters

Despite double digit retracements across the board, the broad North American market indices remain expensive currently. In the interest of time and space, I will just pick on the best known index, the S&P 500. As of early September 2022, the S&P 500 nominal earnings yield[20] (E/Y) is about 3.5%[21], only 60 basis points higher than last year's 2.87%. For perspective, the long-term average E/Y for the S&P is 7.3%, whereas the yield on a 10-year treasury bill[22] is currently 3.351%. up 200 bps from last year's 1.362%!

The equity risk premium spread[23] of 1.49% is approaching all-time lows (and even lower than last year's 150 bps). If one takes any stock in the wisdom of a 92-year old man (we do), the so-called "Buffett" indicator of total US market capitalization to GDP ratio is 170%--down 30% from the all-time high of last year (200%). Less expensive, but still dear at a full standard deviation above the long-term average.

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[19] Often investment bankers, bless their hearts… ;-)

[20] The earnings yield (E/Y) is the reciprocal of the more commonly used Price:Earnings ratio. E/Y is useful for comparing investment opportunities in different asset classes ie. real estate vs. bonds vs. stocks etc. Earnings Yield = trailing 12 month earnings divided by index price (or inverse PE).

[21]https://www.currentmarketvaluation.com/models/price-earnings.php#:~:text=The%20current%20S%26P500%2010%2Dyear%20P%2FE%20Ratio%20is%2028.8.

[22] Because the interest and principle of a T-bill are backed by the full faith and credit of the US government, many people use this number as 'the risk-free' rate as a comparator to riskier assets such as stocks and bonds.

[23] The ERP is a measure of how much an investor gets compensated for by owning risky stocks versus 'risk-free' T-bills.

The problem with using averages in finance is that data is usually not normally distributed.[24] If one is curious and disaggregates the 500 holdings in the S&P, it becomes clear that it is, in fact, highly skewed. If one removes the 10 most expensive stocks, the remainder are, well, "on average" much more attractively priced! Beware of Simpson's Paradox.[25]

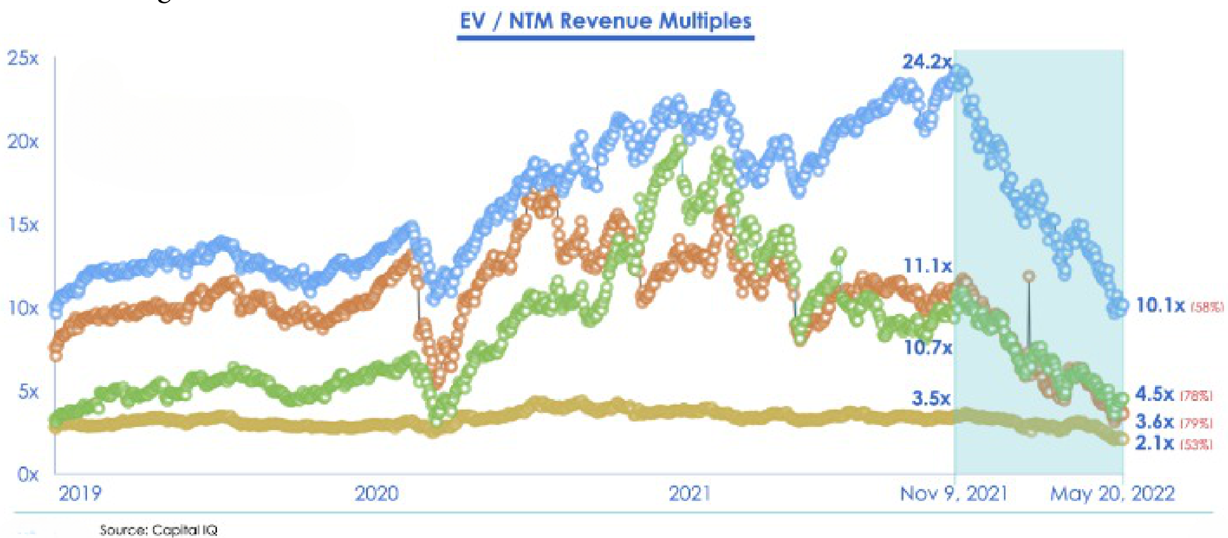
[26]

If one looks at the most expensive stocks (generally valued by revenue multiples, because they do not generate profits and free cash flow generation is negative!) that was the focus of both institutional and retail investor attention over the past year, the carnage was devastating. Suddenly and with little warning, investors wanted to see a return on their investments and with no evidence to allay their anxieties, head for the exits. The chart below shows several

[24] This is how a 6 foot man can drown in a river that is on average only 6 inches deep… (Attributed to W.I.E. Gates)
[25]https://money-zine.com/investing/simpsons-paradox-and-investing/

[26] Hat tip to Mike Zaccardi, CFA, CMT for the graph

different categories of software-as-a-service business valuations over time.[27]



In this case, the gravity analogy falls apart a bit: the bigger they were (in terms of multiples), the further and faster they fell.[28] Valuation matters.

Interest Rates, Inflation & Central Banks

Mr. Powell, Chairman of the US Federal Reserve, has made it clear that its plan is to reduce their $9 trillion portfolio and quench inflation. The Jackson Hole meeting narrative left us with a clear message: The Federal Reserve must continue raising interest rates and hold them at a higher level until it is confident inflation is under control, even if unemployment rises.

This is a very complex topic that would likely bore the reader to death. I will leave you with 3 quotes from Mr. Buffett about the topic that I believe encapsulate what you need to know.

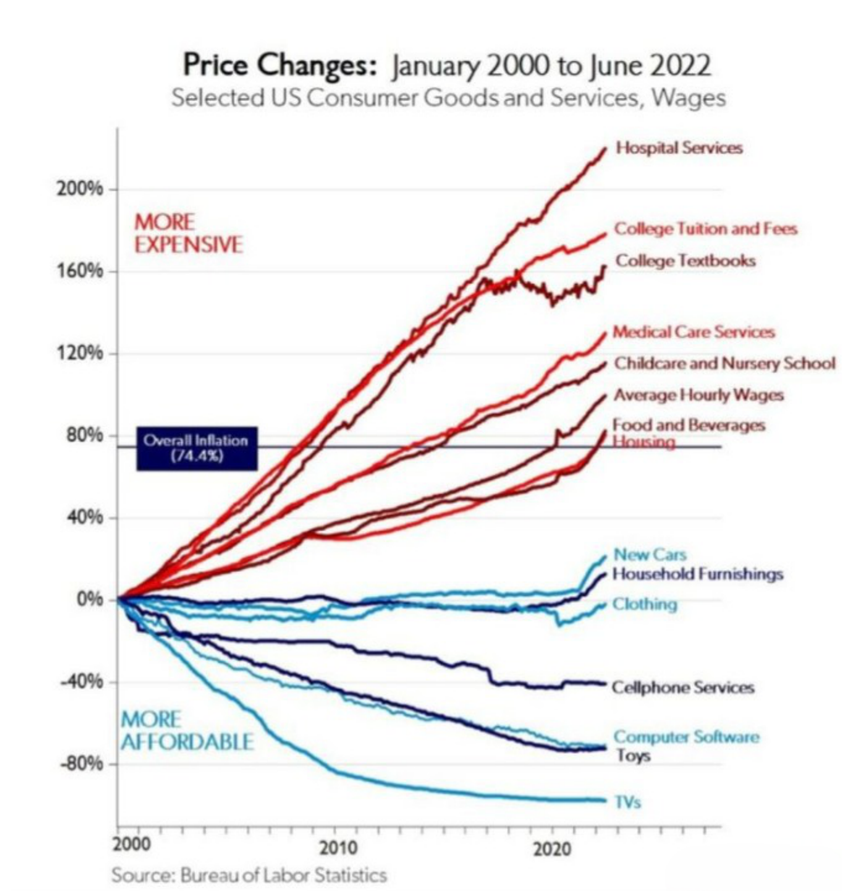
> *"Interest rates are like gravity in valuations. If interest rates are nothing, values can be almost infinite. If interest rates are extremely high, that's a huge gravitational pull on values."* *–2016 Annual Letter*

[27] EV/NTM revenue multiple means the enterprise value divided by the predicted next 12 months of revenue

[28] If you remember your high-school level physics, recall that objects with different masses fall at the same rate, specifically 9.81 m/s^2. For profitless high multiple stocks, this is clearly not the case...

"There's nobody whose predictions on interest rates I would pay attention to, even myself, even Charlie." *–2018 Annual Letter*

"It's the same thing as predicting what business is going to do, what the stock market is going to do. I can't do any of those things. But that doesn't mean I can't do well investing over time." (Buffett was explaining that he has no idea what interest rates will be in the future.) *–2020 Annual Letter*



Portfolio Performance & General Comments

As of August 31, 2022, TOF's 1-year rate of return was 10.14% vs. 2021's more satisfactory return of 23.5%.[29] This exceeds our 7.5% hurdle[30] by an acceptable margin, particularly considering the market conditions of those 12 months.

Over the same time period, it was unsurprising to note that the most important positive contributors to the return included the energy firms (in order of impact): Tourmaline Oil, Suncor Energy and Prairie Sky Royalty. Fairfax Financial was the sole strong positive non-energy contributor to return for the period. Our US dollar holdings were also helpful.

Holdings that were materially negative contributors were Fairfax India Holdings Corp and Onex Corporation. Although neither of those two are in our top 5 in terms of portfolio weight (yet), we have high hopes for them over the intermediate-term.

We were fortunate to benefit from a continuation of the general investor sentiment away from growth and towards value investments that began in early 2021. Our satisfactory return was mostly due to our fortuitous overweighting of our natural resource businesses, along with a generous cash balance. The latter is particularly interesting because of the remarkable appreciation of the US greenback in the last year. Evidently, cash is not always trash.

You might notice that I did not compare the Fund performance to the popular broad market indices (many of which suffered double digit drawdowns over the past year). This is intentional. Our job is to produce positive absolute compound annual growth over a multi-decade time horizon; we take only a passing interest in relative comparisons and will never use them as an excuse for a poor absolute return.

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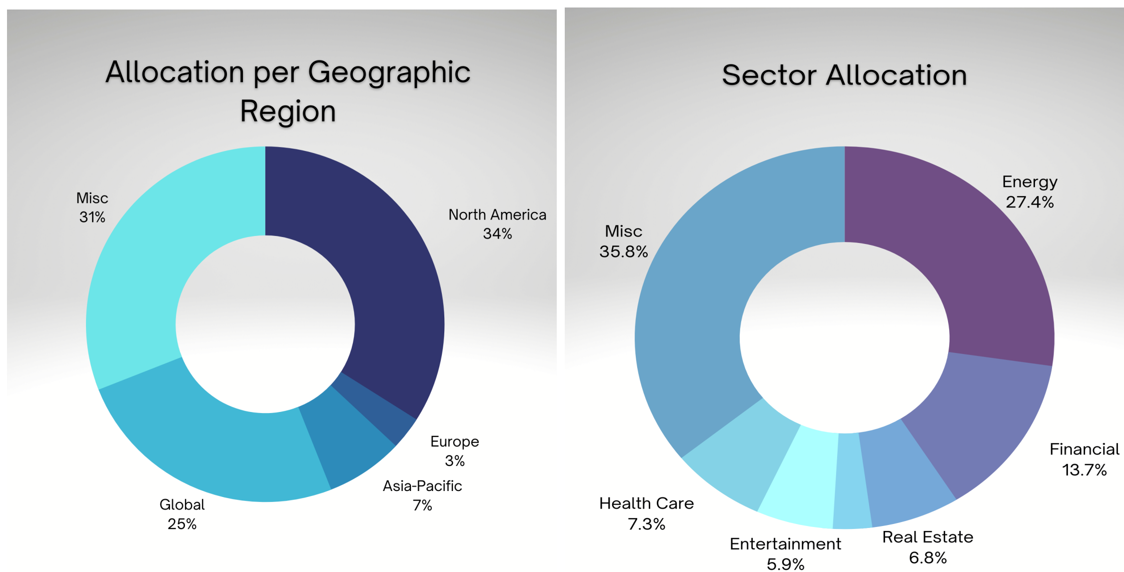
[29] This return is net of our fees but may not include other fees charged by others such as CI Direct or your advisor.
[30] 7.5% is chosen based on the CRA target return for pension plans.

Portfolio Breakdown[31]

The portfolio was concentrated with the top 5 positions making 49% of total assets, excluding cash.

Total Positions	15
Portfolio Dividend Yield	3.04%[32]

Holdings were reasonably well diversified across both industrial sectors and geographies, although we are overweight in energy and North America.



Material Portfolio Changes

This was a relatively active year. Sales/purchases were relatively balanced and as such, our cash position remained roughly the same as a percentage of total assets under management (AUM) year over year. The Tail Risk ETF was liquidated because at the time, T-bill yields were so low that we thought that the instrument would not function well (we were correct) and we thought cash might come in useful later in the year (definitely also correct). We sold AerCap

[31] Estimated values as of August 31, 2022
[32] Note that Tourmaline Oil issued very large special dividends in 2022. As such, this yield does not necessarily represent the dividend yield of the portfolio going forward.

Holdings for a tidy profit as it approached our estimate of fair market value. We sold our small position in Amazon to help fund another much more undervalued position. Although there is probably more upside in store for AMZN, we felt that the competitive landscape was less attractive for the firm, even for the crown jewel division (AWS). We also sold CK Hutchison Holdings for a modest loss and also despite how cheap it remained because it was difficult to handicap the geopolitical headwinds it was facing. We sold Howard Hughes Corporation because of several operational concerns. This turned out to be temporally fortuitous.

The proceeds were used to fund purchases of:

- A Swedish entertainment industry company
- A special situation concerning a high profile SPAC
- A Japanese biotechnology mega-cap
- A North American entertainment/media spin-off/merger
- A Global Eye Healthcare Franchise spin-off

Please note that our new investments are trending away from the North American and energy sector weighting of the previous year. We focus on where the value lies and not necessarily along with the current popular trends.

Discussion of Top 5 Positions

Note that since this report is a public document, we think that it is in the best interest of all unit-holders that we limit our discussion to our largest (and presumably full) positions. The undisclosed holdings all have substantial optionality and we would like to exploit any opportunity to acquire more shares when and if they become even cheaper. The more they lie in the darkness, the more likely for this pleasant eventuality to happen. We have thoroughly stress tested each holding in the portfolio. If any or all of them experienced a drop in their share price by 50% or more, we would be excited to buy more at such a bargain!

Note that we are highly cognizant of our relatively high energy weighting (around 27%). This is a consequence of being the sector that was most undervalued in 2019/2020 when TOF was established. We have no intention of becoming an energy fund. Natural resources businesses are tough: they are cyclical, price-taking[33], capital intensive (not always...see PSK below), subject to ongoing asset depletion and exposed to the vagaries of weather, political/regulatory/ESG ire. These are not 'forever stocks' and we will sell them as they approach intrinsic value. Energy is still a deeply hated industrial sector[34] and as such, we think this still has some time to play out.

[33] Price-takers for the most part cannot control or influence the prices they get for their product.
[34] https://finance.yahoo.com/news/investors-still-love-cathie-woods-hate-best-sector-2022-164419701.html

1. Cash: 29% of Assets[35]: 1-year total return: ≈0%[36]

As of August 31, 2022, we had 29% of assets in cash and near cash (US and CDN) equivalents. In terms of foreign exchange exposure, we are roughly equally exposed to each country's dollar. As we are agnostic concerning future forex price movements, we remain satisfied with the 50:50 situation.

It is entirely true that short-term cash yields remain low (although rising) and the real rate of return[37] on cash is negative. The point of keeping cash around is such that we can maximally exploit market dislocations when they come along.

2. Tourmaline Oil Corp (TSE:TOU): 8.3% of total assets 1-year total return: 148.7%

Tourmaline remains as Canada's largest low cost natural gas producer[38] and our top performing investment 2 years in a row. Mike Rose (CEO) and his team continue to show operational excellence in drilling reserves located in the Deep Basin, Northern BC Montney, and Duvernay zones of the WCSB.[39] They have managed increasing costs (wages/equipment etc.) by becoming even more efficient at land use and maintaining some of the closest drilling times in the industry. Reserve growth is extremely healthy: oil (PDP +26% YoY, 2P +35% YoY) and natural gas (PDP +29% YoY, 2P +26% YoY) booked reserves increasing meaningfully year over year. Total 2P reserves increased 28% YoY or ~C$12/share, partly due to accretive acquisitions of Black Swan and Saguaro. The company's balance sheet is pristine[40] and it is well positioned to scoop up sub-scale competition that remains attractively priced. The firm is well positioned to participate in LNG growth as both European and Asian markets clamor for more gas.

Despite the impressive triple digit percentage appreciation, the shares are still substantially undervalued at about mid-teens free cash flow yield.[41] Mr. Rose and his board have chosen to return 50-75% of FCF to shareholders in terms of an increased regular dividend, along with large special dividends: $6.28/share just in the last 12 months!

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[35] As of August 31/22

[36] This is a simplification; we do make some yield on our cash from our broker and in terms of foreign exchange benefits.

[37] The real rate of return incorporates inflation's negative effect on the purchasing power of said cash.

[38] 80% of production is natural gas.

[39] West Canadian Sedimentary Basin: https://en.wikipedia.org/wiki/Western_Canadian_Sedimentary_Basin

[40] We expect that TOU will be in a net cash position by q1 2023.

[41] Of course, this assumes that natural gas and oil strip prices do not collapse. This risk is somewhat offset by Tourmaline's hedging programme.

We have sold a few percent of the position over the last few quarters to fund other purchases, although we would not be surprised to see TOU in the top 5 position again in 2023.

3. Fairfax Financial Holdings Ltd: 7.9% of total assets 1-year total return: 19.5%

Prem Watsa and his team have benefited from a combination of fortuitous positioning and a hardening insurance/re-insurance market. FFH generates revenues from 3 broad areas:

1) underwriting income from insurance policies written;

2) interest and dividend income from the bond portfolio and dividends sent up from subsidiaries respectively; and

3) realized/unrealized investment gains from the equity investment portfolio.

Industry experts expect that the 'hard' insurance market may continue for another couple years which implies that combined ratios in the mid 90's are highly achievable. Over the last year there has been about a 20% growth in net written insurance premiums to boot.

FFH has a bond portfolio of about $36B that stands to benefit materially from increasing interest rates in US and Canada: it is extremely short duration.[42] If one projects a 3.5% interest rate for the fixed income assets in a year (with 21% of the portfolio turning over to higher rate securities every quarter), interest income could almost double from current levels (about $175B in q2 2022, for example). Interest income had doubled already from the prior year.

We like what we are seeing from the capital allocation standpoint: FFH's financial position is much stronger with the sale of the pet insurance business for $1.4B and Resolute for $600M.

Fairfax is a higher quality and better positioned company than it was when we first bought it in 2019. Despite this, the stock is cheap. If we assume in 2023 that the firm could earn about $1B in underwriting (assumes 95% combined ratio which isn't a stretch at all), $1.5B in interest/dividend income and subsidiary profits of about $0.5B, you can reasonably get to about $130 USD/share of operating pre-tax earnings. Today that values FFH at about 4x operating earnings. It also trades at 0.8x book value although this is probably a poor indicator of value due to the share count reduction over the past 4 years (see below).

[42] Simplistically, this means the holders of the investments will get their principle back in about 1.2 years so it can be re-invested at much higher rates.

Prem also views the common shares of FFH as deeply undervalued. The company has actively bought back stocks at desirable prices: the fully diluted share count has dropped by about 18% since 2018. On the most recent conference call, Mr. Watsa indicated that ongoing buybacks would be a priority (but not to the point of threatening balance sheet strength) if the share price did not improve substantially.

Considering the valuation and current tailwinds, FFH will likely remain as a core holding for TOF.

4. Suncor Energy: 6.7% of total assets 1-year total return: 87.9 %

Suncor is a bit of an unusual holding for us in that we had assessed management to be average or perhaps even a bit below average compared to competitors. In terms of execution (hitting production goals), a dismal safety record and an opaque investor relations strategy, Suncor was unequivocally 'under-managed', as the private equity folks tend to say. We were attracted, however, to SU's assets due to its low depletion and multi-decade duration characteristics, unlike other oil sources in North America.[43] We also like their best-in-class pipeline, refining facilities and a valuable non-core retail division.[44] In addition, an experienced and effective activist is nipping at the Board of Directors heels and has already achieved results: 3 new independent directors have been hired, the CEO is being replaced and the downstream assets are likely to be monetized, bolstering SU's balance sheet further. Additionally, the firm's wind and North Sea concerns are on the selling block.

We estimate that SU's free cash flow (assuming the oil price stays roughly where it is and costs stabilize) could be between $13 and 15B in both 2022 full year and 2023; on a roughly $56B market cap this provides about 27% FCF yield. The new CEO indicates that half of the FCF will be allocated to debt reduction and the remainder to increase the dividend (which is currently only taking 20% of FCF) until net debt drops to $12B, then 75% of FCF will be directed towards (hopefully accretive) buy-backs. The current dividend yield is 4.6% and this stands to rise substantially over the next few years and may well attract a larger natural shareholder base (income seekers). We think the shares are easily worth $60 or more if oil prices trend upward.

5. Prairie Sky Royalty: 6.7% of total assets 1-year total return: 31.5%

This company owns a large portfolio of Canadian fee simple mineral rights. It generates revenue from selling leases to third party producers, while generating royalty revenue from

[43] Source: https://tinyurl.com/h526tttb
[44] You will recognize these: PetroCan gas stations.

production on its lands. It is a lower risk, capital 'light' business model that we like. The firm has de-leveraged nicely to 0.4 x cash flow which has allowed for some accretive acquisitions. PSK's free cash flow/share is likely to come in around $2.67/share for the full year 2022; this gives us a FCF yield in the mid teens. The dividend yield is just under 3% and there is room to grow as the balance sheet improves. The shares are still cheap and are probably worth closer to $25-30/share (currently at around $18).

Conclusion

This annual report can be summarized by the following points:

1. The Fund performed reasonably well in its third year, likely due to a change in investor sentiment towards valuation vs. price and fortuitous positioning in both energy securities as well as more defensive companies.

2. We believe our portfolio securities have significant potential for substantial upside; yet they maintain a satisfactory margin of safety.

3. We intend to maintain our cash position in order to be able to maximally exploit future inevitable market dislocations.

    - Good ideas are uncommon, so we will prioritize our capital for higher quality, yet unappreciated businesses with strong balance sheets, run by management teams who are skillful and well incentivized owner-operators.

    - We expect market volatility to continue and likely even increase in the intermediate-term... We are well positioned to take advantage of opportunities.

4. All intelligent investing is value investing; high growth companies are more difficult to value precisely, but that fact doesn't preclude them from a value investor's portfolio. Growth is important but not enough alone to protect us from downside risk.

5. ESG[45] considerations are very important but nuanced.

[45] ESG = Environmental, Social and Governance issues.

6. Take note of the chart below. Investing is a marathon-type activity when done best!

We are pleased to have you invest alongside us and appreciate your trust and support.

If your friends, family or colleagues are interested in joining us, please feel free to have them email us at info@theoslerfunds.com.

Increasing our unitholder base will eventually benefit you directly: to date, we have waived a significant portion of our management fee and instead have been primarily rewarded by our incentive fee. We expect to continue this approach going forward.

If you or your friends/family/colleagues have any questions, please pass on our URL at

The Osler Funds. (The QR code is below).

Alternatively, you can set up all sorts of accounts (cash, corporate, TFSA, RRSP, RRIF, RESP, pension) from the comfort of their living room using the following link:

Join Us with CI Direct! (QR also below)

Note: the minimum contribution is only $1000.

Sincerely,

The Osler Fund Team