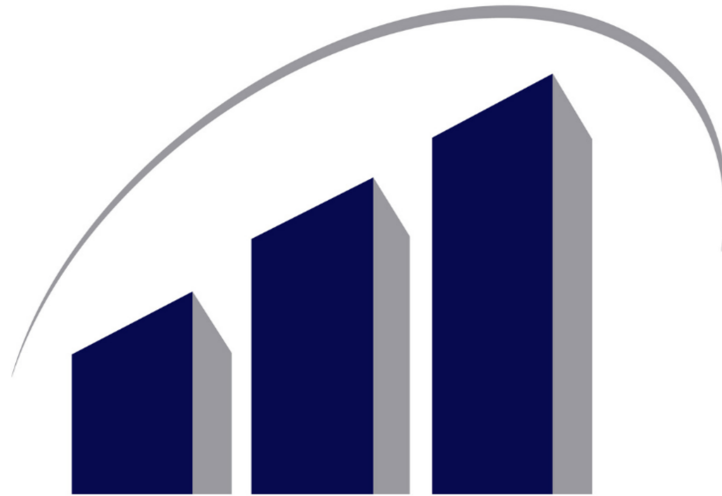

the osler fund

2021 Annual Report

Sept 2021 // Prepared by Lorne David Porayko, MD, FRCP(C), CIM

introduction

2021 ANNUS FRAGILIS

"Medicine is a science of uncertainty and an art of probability."

-Sir Wm Osler

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 Fragilis[1]

[2]

"Medicine[3] is a science of uncertainty and an art of probability."

-Sir Wm Osler

Dear Friends, Family and Fellow Unitholders,

In last year's letter, I wrote about the "Annus Incredibilis" (2020) being represented by the 4 horsemen of the apocalypse:

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[1] Credit for the unaltered image of the world on page 1 is to David Ginsberg. It is being used here under the [Creative Commons license 2.0]

[2] "Glass Planet" image by herval is licensed with CC BY 2.0. To view a copy of this license, visit https://creativecommons.org/licenses/by/2.0/

[3] We think it's just as appropriate to insert the word "investing" here as well.

> *"…flood, fire, famine and pestilence rode with wild abandon through 2020 in terms of extreme weather, extreme politics[4], distressed health care infrastructure and capital markets deeply dislocated from fundamentals. The social and economic implications are staggering and unfortunately, the worst seems likely still to come."*

At the time I wrote that I was wondering if it might age well, as I've been accused of having a bit of a flair for the dramatic. Unfortunately, these portentous trends did continue through to mid-2021: there are floods and fires that have led to loss of life, yet more bizarre political posturing and likely worst of all, SARS-CoV2 variants of concern spreading at exponential rates, while causing a excess death toll like nothing we have seen since World War II. This is the case despite the ultra-rapid development and distribution of effective vaccines most experts felt were not possible even at the time our first annual letter was published.

> *"The pandemic clearly accelerated and magnified secular trends that were well underway before the contagion's onset…Where it goes from here is anyone's guess…"*

Despite these 2020 existential woes, the developed world economies have snapped back rapidly since the spring of 2020 and are continuing to boom[5]--so much so that supply chains have been stretched and commodity and wage inflation is clearly evident. These consequences are likely the product of remarkable central bank interventions into a recession that was non-economic; that is, brought on by public health intervention rather than economic fundamentals. Economists have not seen anything like this, even circa the early 1920's!

The pandemic clearly accelerated and magnified secular trends that were well underway before the contagion's onset: streaming entertainment content and online shopping adoption are just two examples. On the other hand, disparities between rich and low income nations in terms of access to technology (including mRNA vaccines) have reversed the emerging markets 'catch-up' secular trend. Where it goes from here is anyone's guess, but I worry that pandemic downstream economic effects will be substantial and not necessarily brief.

The world markets put on even more of a showing with most posting double digit returns in the first 6 months of 2021. Aggressive fiscal and monetary policy has stretched sovereign balance sheets with a debt burden also not seen since WWII.[6]

Jim Chanos, the famed short seller and principal of Kynikos Associates, expressed the excesses we see today best on a recent interview on CNBC:

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[4] As mentioned previously, we have never found any profit in trying to analyze and forecast political/macroeconomic outcomes.

[5] The US and China were the fastest growing at 6.39 and 8.44% respectively!

[6]https://www.wsj.com/articles/governments-world-wide-gorge-onrecord-debt-testing-new-limits-11626106592

"The problem with getting more people, retail, involved is that it always seems to happen toward the end of every cycle. Retail wasn't there at '09 at the bottom. They weren't there in '02 after the dot-com bubble collapsed. They were certainly there at '99," Chanos said Tuesday on CNBC's "Squawk Box." "So the problem in the last few cycles as I see it is that we get promoters and insiders and people who have done very well cashing out as retail is buying.

> *"I just think the last group of retail coming in are going to probably learn their hard lesson."*

"Wall Street also has a printing press in addition to the Fed. If you get prices high enough, you are going to see lots and lots of equity issuance not only from companies that can put it to good use, but from all kinds of questionable business plans and outright scam," Chanos said. "That's sort of where we are now. We are getting into money being raised for all kinds of things that probably aren't at the end of the day going to be productive but might line up pockets of the promoters doing it."

"When we start speculating in various different cryptos, questionable coins, the sixth SPAC[7] that some guy puts out, the 48th different electric vehicle charging company going public, that's when things start to get dicey in my opinion," Chanos said. "We are well into that part of the cycle. I just think the last group of retail coming in are going to probably learn their hard lesson."

To prove that truth is truly stranger than fiction, a recent article from Bloomberg described a scheme whereby avid consumers can spend their Bitcoin on Gamestop products while they are attending movies at AMC theatres...[8]

> *"The broad North American markets are expensive currently. 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..."*

It's true that markets are forward looking; however, the dislocation between perceived and real risk seems to never have been so pronounced (at least in our memory). We haven't the slightest idea how and when this will exactly play out, but we do know that we want to be prepared.

The broad North American markets are expensive currently. As of mid August 2021, the S&P 500 nominal earnings yield[9] (E/Y) was 2.87%. For perspective, the long-term average E/Y for

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[7] We are starting to suspect that busted SPACs (blank cheque companies) may be a source of opportunity for us in the future: a topic for another time...

[8] Honestly, I did not make this up! Read more here: https://www.bloomberg.com/opinion/articles/2021-08-10/spend-your-bitcoins-at-the-gamestop-in-the-amc

[9] 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).

the S&P is 7.3%, whereas the yield on a 10-year treasury bill[10] is currently 1.362%. What is particularly remarkable about this number is that when adjusted for the 5-year mean inflation index (CPI), the real yield is the lowest recorded since 1980! Furthermore, the equity risk premium spread[11] of 1.5% is approaching all-time lows. Shiller's cyclically-adjusted PE ratio (aka. "CAPE") is 38x for the S&P, the second highest in market history (after the 1999 tech bubble of 44x).[12] If one takes any stock in the wisdom of a 91-year old man (we do), the so-called "Buffett" indicator of total US market capitalization to GDP ratio has now exceeded 200%--another all-time high (but not a favourable one, unfortunately). To be fair, if one digs a little deeper, it becomes clear that there's a wide band of valuations within the index: anything remotely glamorous vs. almost anything else. Admittedly, there are pockets of value in there, albeit unequivocally diminishing in breadth and depth. 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..

"...the so-called "Buffett" indicator of total US market capitalization:GDP ratio has now exceeded 200%--another all-time high...It's as if Mr. Market is thinking not much could go wrong..."

I wrote last year that "...caution and preparedness now are justified" mostly because of uncertainty. In our opinion, today there is less uncertainty and much more risk. Once again, interest rates can go up without warning, stimulus will and must end, the timely end of the pandemic is not a given and the past isn't necessarily a reliable guide to the future. Caution and preparedness are particularly justified now, in our opinion.

"In our opinion, today there is less uncertainty and much more risk... Caution and preparedness are particularly justified now, in our opinion."

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[10] 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.
[11] The ERP is a measure of how much an investor gets compensated for by owning risky stocks versus 'risk-free' T-bills.
[12] You can find innumerable graphs and index value metrics at JPM's invaluable "Guide to the Markets"; it is open access and remarkably, completely free: https://tinyurl.com/3ccbku6f

Portfolio Performance & General Comments

As of August 31, 2021, TOF's 1-year rate of return was 23.5% vs. 2020's more disappointing return of -4.74%. This exceeds our 7.5% hurdle[13] by an acceptable margin.

Over the same time period, positive contributors to the return included (in order of impact): Tourmaline Oil, Jefferies Financial Group and Suncor Energy. Negative contributors were the Cambria Tail Risk ETF (unsurprisingly, our hedging instrument), Amazon, Canada Natural Resources (which we no longer hold in the portfolio) and cash. Although there is no perfect comparison index, the Vanguard Growth Portfolio ETF (ticker: VGRO) probably comes the closest: it returned about 20% in the past 12 months.[14]

We were fortunate to experience a swing in sentiment away from growth and towards value investments in early 2021. Our satisfactory return was mostly due to our fortuitous overweighting of the highest performing securities which was precisely the opposite situation as last year.

We view 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.

Portfolio Breakdown[15]

The portfolio was reasonably concentrated with the top 10 positions making 56% of total assets, including cash.

Total Positions	16
Portfolio Dividend Yield	1.2%

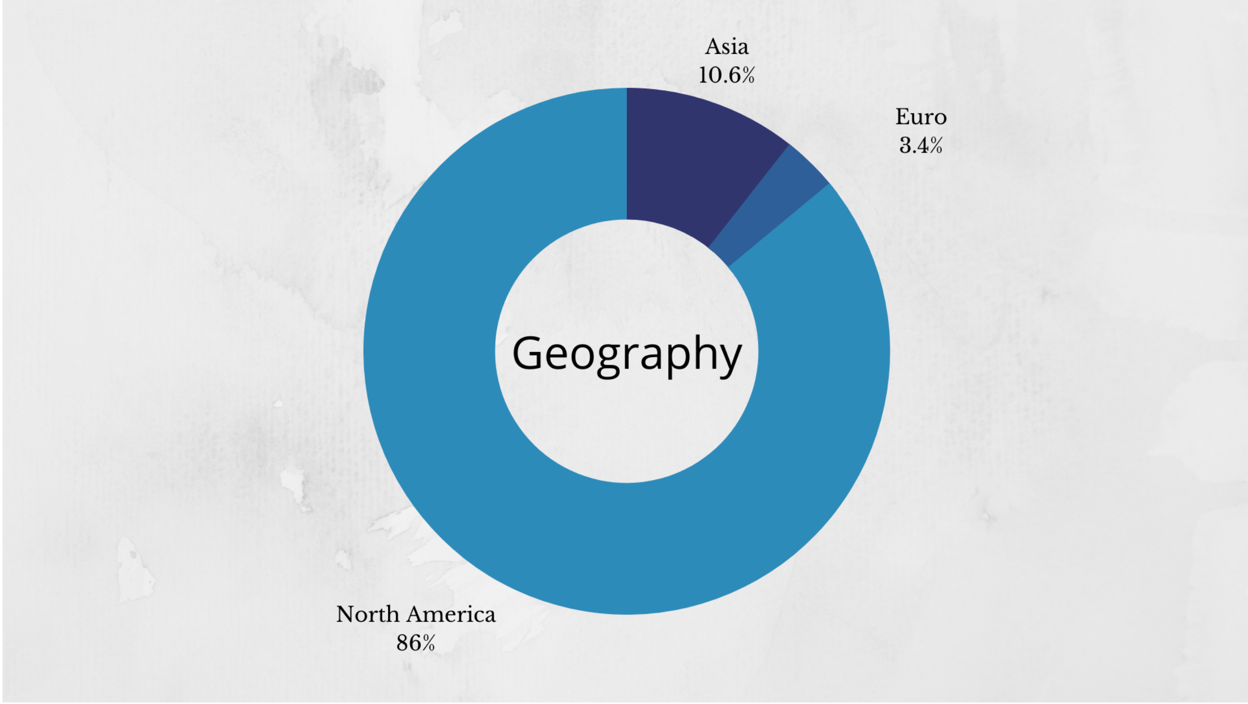
Total Portfolio Yield[16] (ex-cash)	14.8%

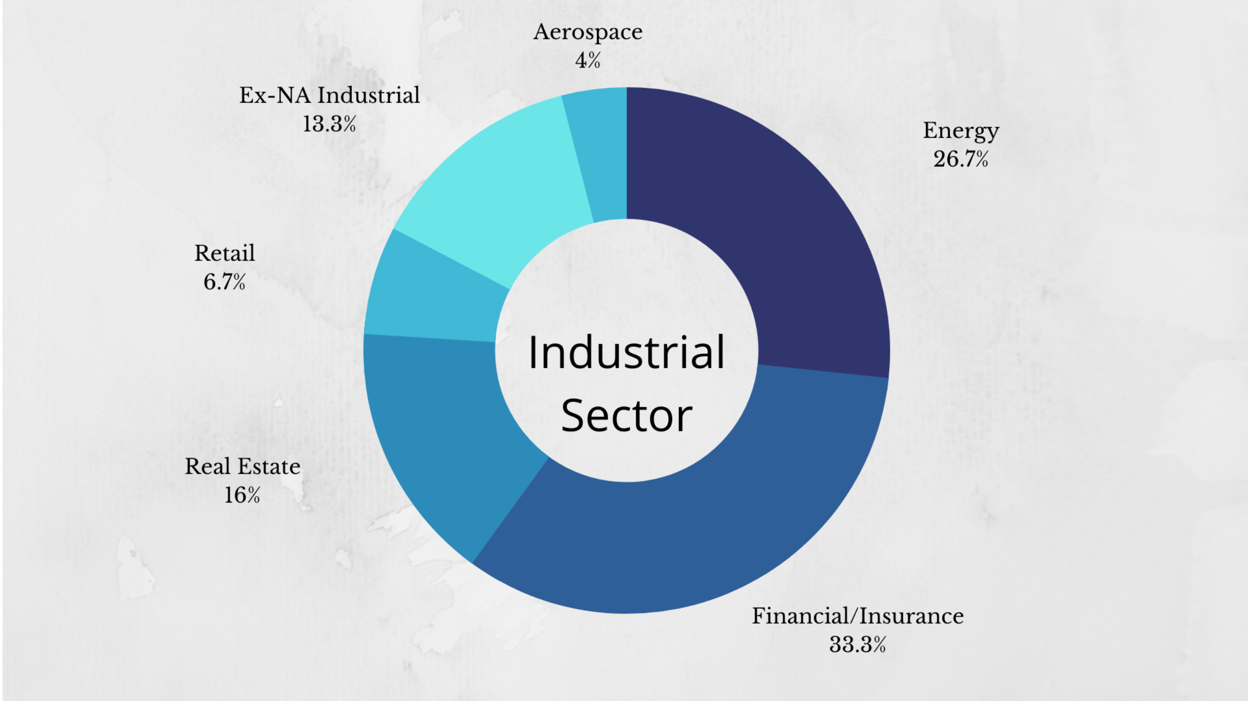
[13] 7.5% is chosen entirely due to the fact that CRA uses that figure for a target return in pension plans.

[14] Please keep in mind our portfolio is significantly different from these indices due to our limited number of holdings, our cash levels and the location of our investments.

[15] Estimated values as of August 21, 2021; the composition of the portfolio has changed slightly since August 21/2021.

[16] Inverted weighted harmonized P/E from those holdings where the author believes P/E reasonably represents a metric of value.





Source of AUM

Material Portfolio Changes

Our cash position remained roughly the same as a percentage of total assets under management (AUM) year over year. The TAIL ETF, our volatility hedging instrument, outlived its usefulness as 10-year treasury yields dropped to around 55 bps[17], creating some negative convexity (to our detriment). We sold the entire position and then bought a smaller (2%) holding when yields recovered (125 bps at the time of writing this report). We were able to pick up more shares of Fairfax Financial and one of its offspring at bargain prices. In the Fall of 2020, we sold about half of our position in SPG, entirely for tax planning reasons. This turned out to be somewhat regrettable: the stock price has doubled since then. We do have some concerns about delta's impact on SPG near to intermediate-term, so we have sold the remainder and may jump back in when and if the share price becomes more attractive. We initiated 2 new positions in early 2021 that look very promising and added to our oil/gas holdings (1 new position and increased exposure to 2 others).

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!

1. Cash: 31.9% of Assets[18] Mean Cash position: 30.9%[19]
1-year total return: ≈0%[20]

As of August 31, 2021, we had 31.9% of assets in cash and near cash equivalents. In terms of foreign exchange exposure, 35.4% of assets are denominated in US greenbacks and 32.7% are in loonies; adjusted for the mostly Canadian cash position, we are roughly equally exposed to each country's dollar. As

When markets crash, we don't despair like many investors do. We actually get excited about all the opportunities being thrown our way.

[17] The lowest yield in 234 years!
https://www.marketwatch.com/story/10-year-treasury-yield-plunged-to-its-lowest-in-234-years-says-deutsche-bank-11596214464
[18] As of August 31/21; you may assume the same date for TOU, JEF, FFH and BRK.
[19] Average cash position using month end data points from Aug 31/20 to Aug 31/21
[20] Calculated using the closing price August 31/21 divided by the closing price August 31/20 minus 1.

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 are very low currently (around 60 bps in the CSAV ETF we use) and the real rate of return[21] on cash is negative.

Why do we hold so much cash when the returns on that asset are so poor? The short answer is optionality. We don't have to sell already undervalued securities to 'raise cash' at the worst possible time and then desperately scramble to try to find something even more undervalued. One doesn't need to wait long to put that cash to work: Schwab did a study that showed that in 55% of market years, a double digit percentage correction occurred.[22]

One doesn't need to wait long to put that cash to work: Schwab did a study that showed that in 55% of market years, a double digit percentage correction occurred.

A common criticism of holding cash is that it is just a variety of market timing. We tend to view this differently. Rather than holding a certain targeted percentage of cash, we allow it to accumulate (from client contributions and from selling portfolio components that no longer meet our criteria). When the universe of investment opportunities shrinks, the cash position naturally rises. The opposite applies just as much: our cash levels will drop significantly when blood runs in the streets. Over the lifetime of the Osler Fund, we might expect cash levels to sometimes transiently drop below 10% at times and at other times go as high as 50% or higher.

2. Tourmaline Oil Corp (TSE:TOU): 7.6% of total assets 1-year total return: 107%

In spite of its name, Tourmaline is Canada's largest natural gas producer. As mentioned in the past, Tourmaline was of interest to us given it had the management talent and financial capacity to take advantage of what was a weak resource environment. Boy did they ever! Mike Rose and his team completed 4 large acquisitions over the last 6 months and several smaller ones. Given natural gas' current price, Tourmaline is expected to generate significant free cash flow. Tourmaline is now turning its attention to returning excess capital to shareholders. The supply:demand dynamic for natural gas looks favourable for the intermediate-term.

3. Jefferies Financial Group (JEF): 7.2% of total assets 1-year total return: 115%

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

[22] https://intelligent.schwab.com/article/stock-market-corrections-not-uncommon.

This NYC based investment bank continues to produce stellar operating results earning $3.43 per share in the first 6 months of 2021. Keep in mind, the stock price is about $37. As mentioned previously, Jefferies has a relatively strong (and improving) balance sheet and significant extra assets which are being slowly liquidated. Insiders own some 17% of Jefferies (worth about C$2.1 billion) and Jefferies has been repurchasing its shares.

4. Fairfax Financial Holdings Ltd: 6.3% of total assets 1-year total return: 42%

Prem Watsa and his team have been firing on all cylinders, thanks to a more favourable underwriting market ('hard' insurance market) and a general shift in sentiment towards their value-focused investment style.

Prem Watsa and his team have been firing on all cylinders, thanks to a more favourable underwriting market ('hard' insurance market) and a general shift in sentiment towards their value-focused investment style. Book value for Q2 rose to $693 CDN (15% over the previous quarter); the common stock is still cheap at only 0.82x book value. We were pleased to see that the combined ratio[23] was 92% which is a dramatic improvement trend in the bottom line; plus there was a stellar 27% premium growth quarter over quarter.

Non-insurance investments are performing very well and are benefiting from a number of positive catalysts (such as IPO's) that may play out over the next year or so. One of the holdings, Digit (an Indian insurance subsidiary), is particularly well poised to surprise to the upside.

In terms of the margin of safety, we were also reassured by de-leveraging/balance sheet improvements with the sale of some non-core insurance holdings expected to create over $1.1B in incremental liquidity (for a total of close to $19B total) for the parent.

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

5. Berkshire Hathaway Class B (BRK.B): 5.9% of total assets 1-year total return: 31 %

On the face of it, Berkshire seems like a complex quagmire of 20th century industrial businesses held together only by the strength of will and brilliance of two nonagenarians. If you dig a little deeper, you will find something quite different.

Berkshire can be summarized in four parts[24]:

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[23] The combined ratio is calculated by summing the incurred losses and expenses and dividing the sum by the total earned premiums; a CR of less than 100% means the insurance company is earning a profit on premiums written.

[24] As of June 30, 2021.

1. Cash of $144B (≅ $124B of which is deployable)
2. A publicly traded stock portfolio worth $308B (≅50% being Apple common stock…hardly an old school industrial…)
3. 60+ privately owned businesses worth ≅ $344B broken up into 3 parts
    a. Insurance and re-insurance
    b. BNSF railroad
    c. BHE (Berkshire Hathaway Energy)
4. The insurance 'float'[25] worth ≅ $142B

If you subtract the float value from the assets, you come up with an enterprise value of about $344B. BRK's operating earnings for the past 12 months was $24B (a 21% improvement year-over-year). As such, the market is valuing BRK at 15x operating earnings vs. about 30x for the S&P 500 businesses in aggregate.[26] GAAP book value is about 1.37x, although this greatly underestimates intrinsic value, and even more so as the company cannibalizes itself (see below).

Investors were disappointed in 2020 that Mr. Buffett, the allocator-in-chief, was slow to buy back shares with the enormous cash pile it held in Q2 2020. He has made up for it: the company is on track to buy back $25B of its own shares in 2021 and perhaps $50B over 2 years at an average price of about $288/share of the 'B' class shares.

As written last year, as much as we admire the incumbent management, we really like the legacy team. Ted Weschler and Todd Combs are brilliant (and modern) investors in their own right, Mr. Jains will continue his exemplary role at the insurance subsidiaries and finally, Edmontonian Greg Able will be an excellent and equanimous chief executive. These four will not be able to replace the quintessential Buffett/Munger duo; they will be different, that much is for certain.

…we view the Berkshire position as a core defensive holding with attractive optionality/natural hedging characteristics during a frothy time in the capital markets.

Due to its attractive valuation, exemplary owner/operators at the wheel, current extreme overcapitalization with cash and collection of above average to excellent businesses, we view the Berkshire position as a core defensive holding with attractive optionality/natural hedging characteristics during a frothy time in the capital markets.

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[25] The source of the insurance float is from premiums paid by insurance clients in excess of expenses and paid claims against insurance: this provides Berkshire essentially free leverage!
[26] This is not an entirely fair comparison because the S&P500 earnings are GAAP and we are estimating BRK's operating earnings; however, the point is made that BRK is not expensive at these levels.

Q&A

We decided that an important role of the annual report should be to directly address some of the contemporaneous questions we get from existing and interested unitholders. Some examples are presented below.

What differentiates you from your competition?

Every professional investor struggles a bit to articulate what sets them apart from the crowd. Let's start off with some stark facts.

Other investment firms have resources that dwarf our own. They also have equal (or superior) access to publicly available information concerning the securities and underlying businesses we evaluate. As such, obtaining an informational or analytical edge is unlikely, at best.

I do think we are quite different from other investors in a number of important ways:

1. We love the practice of investing. Like medicine, some practitioners get into the field because they think they can make a lot of money really fast, while others deeply enjoy the intellectual exercise and would continue to participate whether or not they would be paid to do it. We are firmly in the latter camp: investing is in our DNA.

2. Career risk is not an issue for us. The average age of the Osler Fund founders is in the mid-50's and we already have other successful careers in medicine and finance. Not needing the job to put food on the table and keeping the lights on is highly liberating. Our less fortunate colleagues are often reluctant to take contrarian positions or exploit time arbitrage (see below) because in the short-term, they might get fired before that strategy pays off. There is convincing data published that correlates this career risk with negative performance.[27]

3. Our business plan fully exploits our biggest edge: time arbitrage. 3P Financial[28] assists physicians and other professionals in learning about and onboarding to personal pension plans. I (LP) was the first client. The unique structure of a pension plan strongly incentivizes a multi-decade investment horizon due to the tax advantages.[29] Semi-permanent (aka as "patient") capital allows us to take unpopular positions and hold them until they are back into favour. As short-termism in the investment

[27] https://www.jstor.org/stable/25835726

[28] 3P Financial is a division of McElvaine Investment Management.

[29] In particular, the ability to make large special payments during stock market drawdowns, while receiving generous tax refunds at the same time!).

management business is expected to continue[30], this will remain a strong competitive advantage for us.

4. We are small and will likely remain so for several years. This might seem an odd thing to try to portray as an advantage. However, in the portfolio management business, bigger is definitely NOT better when it comes to long-term returns. Despite having higher relative costs, small funds are more nimble and tend to outperform their giant brethren. [31]

5. We are accessible. If you have a question or concern, you can send us an email and you will get a response from us, not the marketing department.

6. We have skin in the game that strongly aligns our interests with other unitholders.

   "Show me the incentive and I will show you the outcome."

   — *Charlie Munger*

   You might be surprised to know that most portfolio managers have little to none of their own money invested in their own funds.[32] We do. In fact, the bulk of my family's retirement savings are invested in The Osler Fund. We pay all the same fees as you do. This strong alignment clearly incentivizes us to perform careful due diligence on new and existing investments, as well as keeping our costs reasonably low. Additionally, there is empiric evidence between positive fund performance and the amount of portfolio manager ownership.[33] Finally, and most importantly, downside risk has been demonstrated to be substantially lower in funds with high degrees of manager ownership.[34]

What's going on with inflation? Is this a permanent or transient thing?

The short answer is that we don't know.

As mentioned previously, we view most macroeconomic information as mostly uninterpretable noise that lends us no edge whatsoever. Inflation, deflation, disinflation and stagflation narratives all seem equally convincing and very smart people have been forecasting these for

[30] The average stock holding period over the last decade ranges between 6 months to a year! https://www.researchgate.net/figure/Average-holding-period-of-stocks-in-years-Source-World-Bank_fig3_338777348

[31] https://www.cfainstitute.org/en/research/cfa-digest/2005/08/does-fund-size-erode-mutual-fund-performance-the-role-of-liquidity-and-organization-digest-su

[32] https://www.ft.com/content/2c910bce-7105-11e6-9ac1-1055824ca907

[33] https://www.researchgate.net/publication/222572471_Portfolio_Manager_Ownership_and_Fund_Performance

[34] https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=5545&context=lkcsb_research

decades now. One day they may well be right (all of them, eventually) but to be pragmatic, we simply focus on creating a margin of safety in our portfolio in terms of the price we pay, the quality of the people we partner with and the innate protections of the businesses themselves (reasonably durable competitive advantages, strong balance sheets with robust free cash flows etc).

Fortunately, our portfolio has substantial weightings toward hard assets (ie. energy and real estate) that tend to thrive during inflationary periods.

Why don't you own any crypto?

This is a fascinating area that we enjoy reading about; however, we don't know how to value it yet (and may never). We are not even convinced that ICO's, NFTs and the like are true assets or even securities. The crypto markets are looking a bit like the Wild West: the spectrum of outcomes is so large that we believe crypto belongs deep in the 'too hard' pile of ideas we have on our desk. This may change one day. We have open minds. Until then, we will sit on the sidelines and watch with interest.

What's going on with all this SPAC stuff?

Special Purpose Acquisition Companies are shell corporations containing cash and a promise to try to invest in another (usually currently private) business. A brief review can be found here: https://tinyurl.com/2rdrd8ku

They are not new, but the retail investor interest in them certainly is. Until very recently, non-economic trading has created interesting valuation distortions (ie. the pre-deal SPAC trading far above cash value). Unfortunately, many of the SPACs have highly unfavourable terms for outside investors. I highly recommend watching this video created by a highly knowledgeable former investment banker before you evaluate any SPAC: https://www.youtube.com/watch?v=jaQ_73c7qMY&t=426s

Having written that, we suspect that the SPAC bubble is popping already. If the market over-reacts (as we suspect it will), there may be some opportunities in the ruins for us.

Are there opportunities in China?

Almost certainly. But to participate safely, we think that one needs 'boots on the ground'[35] there, as famous value investor Li Lui once said. We prefer to invest indirectly and will leave it at that for now.

Why do you own old school energy stocks when the future is in renewables? Are you ESG investors?

One of the more important tenets of investing is that one needs to find situations where the consensus narrative doesn't square with reality, even if that reality is quite unpleasant. Unintended consequences often create investment opportunities.

For example, the de-carbonization and electrification trends are clearly desirable. The ugly reality is that we will need to procure and consume hydrocarbons for several decades before that paradigm will be sustainable by renewable sources. Unfortunately, zealous efforts to accelerate that transition may catalyze a fossil fuel price spike. Right now, nearly all the money is chasing all things 'renewable' and the stratospheric valuations reflect that.

According to Rystad Energy, total global recoverable oil resources are running down to 1,725 billion barrels, down 8% from last year's estimate of 1,903 billion barrels.[36] US oil production, rig counts and fracking stacks stayed relatively flat, throughout the spring and summer of 2021, despite increasingly attractive oil spot pricing. The 4 global super-majors have deteriorating production:total reserve ratios.[37] There are many reasons for this trend (a trend that we believe is secular), the most important being reluctance for upstream firms to invest in new production due to hostile legislation/regulation/activism. More and more oil is shut in, in some cases permanently. The cost of capital for new drilling projects is now prohibitive and much of the new funding is being earmarked for greener endeavours.

On the other hand, oil demand remains surprisingly healthy through the pandemic[38] (particularly from emerging markets) and supply is constrained, particularly from ex-OPEC producers. Even Norway, the IEA's model 'carbon zero' nation, has not reduced its own oil consumption despite increasing electric vehicle sales to over 2/3rds the total in 2021.[39]

> *...we believe it's important for businesses to have <u>sustainable</u> business plans executed by honest, talented and fair managers who thoughtfully weigh all of the counterparty interests.*

[35] By 'boots on the ground', I mean more than just the fact that you've visited the country as a tourist. One needs to essentially be a local to understand the complex social, cultural and historical nuances underpinning the crucial-to-understand incentives. I believe this applies equally to India.
[36] shorturl.at/giHPV
[37] https://www.statista.com/statistics/1248742/big-oil-reserves-to-production-ratio/
[38] https://www.statista.com/statistics/271823/daily-global-crude-oil-demand-since-2006/
[39] Listen to this great podcast on this topic by Morgan Stanley here: https://speevr.com/podcast/special-episode-the-curious-case-of-norway-evs-and-oil/

This dynamic has been largely ignored by the investment community: energy exploration/production concerns remain at rock bottom valuations (in August mean producer free cash flow yields remained in the double digits).[40]

Natural gas, the most resilient and cleanest of fossil fuels, is currently at its highest price since 2018. This is likely due to the unprecedented level of the U.S. LNG exports, low domestic inventories, and recent extreme temperatures. Despite this, natural gas production in the United States has stayed relatively flat through the spring and summer.

Because of the tough operating/funding conditions, many producers will disappear. We believe the surviving firms with the best balance sheets, geographic positioning and smartest capital allocators at the wheel will be able to generate attractive profits for about a decade or so before we are finally able to wean ourselves almost entirely off fossil fuels.

There is a running joke on FinTwit, the finance list on the Twitter social media platform, that goes something like this:

I have decided to fully embrace ESG investing.

As part of the push, I bought Altria, Philip Morris International and British American Tobacco.

This is because tobacco is vegan, renewable, low-carb and gluten-free.

(attributed to the "Dividend Growth Investor")

Like most satire, there is a kernel of truth to it. We won't criticize specifically here, but suffice to say that there appears to be a lot of 'green-washing'[41] going on these days, unfortunately. Yet it is very important not to allow ourselves to become cynical about such an important issue.

As pragmatists, we believe it's important for businesses to have sustainable business plans executed by honest, talented and fair managers who thoughtfully weigh all of the counterparty interests. So, yes, we are ESG investors. We think that all good long-term investors should be.

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[40] Author's calculations.
[41] This is an activity whereby a company's management actively portrays its ESG qualities, yet on deeper inspection, they either don't exist at all or are ephemeral. For some particularly egregious examples see: https://www.etf.com/sections/blog/esg-etfs-looking-polluted

Conclusion

This annual report can be summarized by the following points:

1. The Fund performed reasonably well in its second year (September 2020 to 2021) likely due to a change in investor sentiment towards valuation vs. price.

2. We believe our portfolio securities have 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.

        - With both the cash and TAIL positions available as a source of funds, we are well positioned to take advantage of opportunities.
        - Berkshire is so over-capitalized and well positioned to take advantage of a distressed market that it likely serves as a natural (and costless) market hedge.

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 considerations are very important. We consider ourselves to be ESG investors; however, one must dig deep below the surface in order to avoid 'greenwashing' and

unintended downstream consequences. Owning shares of fossil fuel exploration/production companies doesn't necessarily mean you are 'not ESG'.

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 if they have any questions and pass on our URL at The Osler Funds. Alternatively, they 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!

Note: the minimum contribution is only $1000.

Sincerely,

The Osler Fund Team