

# MCLEAN CAPITAL

Letter to Partners – March 2016

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## Our Performance

Here is an exposé of our performance for the period from January 1<sup>st</sup> 2012 to December 31<sup>st</sup> 2015.

This is a real portfolio. It represents all family accounts managed since 2012; the first year Ian McLean had full discretion over the investment decisions in these accounts. This portfolio serves as model for all private accounts managed by McLean Capital.

McLean Capital obtained its license with the AMF in March 2015.

Table 1:

Year	McLean Capital	S&P/TSX	S&P 500
2012	28.7%	7.2%	16.0%
2013	43.2%	13.0%	32.4%
2014	18.0%	10.6%	13.7%
2015	19.6%	(8.3%)	1.4%

Despite the fact that a five year period seems better to evaluate performance, I think three years is a strict minimum. I have therefore decided to present the results of the last four years versus the S&P/TSX. I think this table of past performance against a general index is the best way to evaluate a portfolio manager.

Here is the cumulative performance:

Table 2:

Year	McLean Capital	S&P/TSX	S&P 500
2012	28.7%	7.2%	16.0%
2013	84.3%	21.1%	53.6%
2014	117.5%	34.0%	74.6%
2015	160.1%	22.9%	77.1%

You may wonder if I have chosen an easy benchmark yet the S&P/TSX has generally proven to be a reasonably tough competitor. Over the last 65 years, it has returned a compound annual return of 10.2%. Its worst year was 2008 with minus 33.0% and its best year was +48.4% in 1950. In an article by The Globe and Mail dated November 13, 2014 titled *Actively managed funds vs. the index: once again no contest*, it was stated that from 2009 to 2014, 80% of Canadian funds did not beat the index after all fees and costs.

If we beat the S&P/TSX over a long period of time, the difference on cumulative performance should be substantial. Even when the market performance will be negative (sometimes greatly so) in the future, we will still be content if we are less negative. If the market is minus 30% and we are minus 15% in a given year, I will consider this performance to be superior to a year when we are +15% while the market is +15%. We will most surely not beat the market every year but if we can achieve this feat 2 out of 3 years or better, this will be a good start.

Here is our performance after McLean Capital fees:

Table 3:

Year	McLean Capital	S&P/TSX	Difference
2012	23.0%	7.2%	15.8%
2013	34.6%	13.0%	21.6%
2014	14.4%	10.6%	3.8%
2015	15.7%	(8.3%)	24.0%

## The Stock Market

If you believe there are more goods and services of superior quality that are accessible to you than were accessible to your parents or grandparents, then you probably believe in the economy. If you believe in the economy, you should believe in the stock market.

The stock market is a vehicle that facilitates your buying of a piece of the economy which is driven by businesses which are made up of people. The stock market is just an intermediary. It is not an end; it is a means to an end. Just like when you buy a house with the help of an intermediary (broker), you can also use an intermediary to buy your company shares, bonds and mutual funds.

The big difference is that the stock market is such an efficient intermediary and since a stock does not have the same use as a house, owners of stocks, bonds and mutual funds tend to buy and sell much more frequently than they should and get price information much more frequently than they need.

You do not get or need a quoted price for your house every minute, every day or every month. Somebody who bought a house in Canada in 1989 and still owns it today may not be aware that he had a paper loss for the first 2, 3 or 7 years. He never assessed the market value of his house and if he did, he probably wasn't worried since he refused to believe the assessment.

The average price of a house in Canada in 1989 was \$150,000. 2 years later the average price of a house was about 20% less. In Toronto, the average home price dropped almost 30% from 1989 to 1996.

What's interesting is that many people who bought homes in the late 80s did not suffer any losses. How could that be? They were patient, did not react to short term market fluctuations and therefore greatly benefited from the surge that occurred afterwards. Many could refinance or take home equity loans that made them feel their house was a money machine.

If only people were able to behave the same way when it came to their stake in the economy; through their ownership of stocks, bonds and mutual funds.

The average price of a Canadian home in January 2016 was \$470,000. That means on average the purchase of a house in 1989 has provided an annual return of 4% (excluding municipal and school taxes, maintenance and other necessary expenses). The average annual rental income, which is a type of dividend, could be added to this return but since

we exclude all other necessary expenses and interest payments, I think it is fair to exclude it. The S&P/TSX, the most popular Canadian stock index that anybody can easily purchase and keep long term, returned about 8% annually over this period including dividends.

The purpose of this example is not to say real estate is not a good investment. On the contrary, real estate can be a great investment and very important personal/emotional reasons are involved as well. The purpose of this example is to show how the perception and behavior of many people with regards to the stock market is flawed. If people treated their stocks like they treat their homes, they would perform much better in the stock market. Do your homework. Be patient. Don't worry about short term fluctuations. Trust the wealth generating power of business and the economy.

### **Risk and the Stock Market**

There is an enormous quantity of philosophies and proposed programs on "how to invest your money". Some promote a (sometimes false) sense of security by investing in a portfolio made up mainly of bonds and certificates of deposit. Others swear only by real estate because it is supposedly more "tangible". Some will tell you it is possible to make good money in the market by using technical methods based on trends and frequent short term trades. Most are probably somewhere in between (with no commitment to any strategy in particular), often times in an overly diversified portfolio. So what is the best path to follow?

First of all, as you may have guessed, it is important to consider your personal objectives and constraints. The fact nonetheless remains that most people would not refuse a strategy offering superior returns with a diminished level of risk. The reality is that of all the different categories of asset classes, common stocks have outperformed on practically any long term period during the last 150 years. The problem most people face is that they firmly remember the short periods of time when the stock market crashed and were often not present when the stock market came back with strength in the following period. Yet after every crisis or market correction in the past, the stock market not only remade itself but also attained record highs afterwards. \$10,000 invested in the S&P 500 stock market index 50 years ago would have returned a compounded annual rate of 10% and would be worth over \$1,100,000 today. During this time, \$10,000 invested in gold or a basket of commodities, bonds or real estate would be worth less than \$200,000 today.

In school, they define stock market risk with what we call volatility or stock market fluctuations (frequency and size of ups and downs). We assume that the stock of a company whose price has fluctuated a lot in the past is more risky than the stock of a company that has not fluctuated as much.

Here is the problem: if you have stock A that went from \$5 to \$20 in three years but its path was bumpy and stock B that went from \$5 to \$3 but with a straight line path, stock A is considered more risky.

If the ups and downs of stock A were due to irrational short term reactions of the market and the fall of stock B was due to a deterioration of the performance of the company, it makes much more sense to consider stock B as more risky.

That is why the stock market is not necessarily riskier for someone who can be patient with his money and does his homework by analysing the intrinsic value of the businesses behind his common stocks.

We do not need to time the market to have success because in general it is much more evident and sufficient to focus on only determining if stock prices are depressed (as in 2009) or overvalued (as in 2000) in whatsoever period.

Certain company characteristics are also more evident than others to determine and can therefore play a role to diminish risk.

For example, successful innovation can seem more difficult to anticipate than the number of profitable stores Dollarama will have in 5 years. It can also give us a sense of security when a company can reinvest its profits to consolidate a fragmented industry or can increase its prices easily due to a “monopolistic” product that has a durable competitive advantage.

I hope this short exposé has helped change your perspective of risk in the stock market if you had any insecurities and that it gives you a better idea of the philosophy of McLean Capital.

Most people still do not fully grasp the power of compound interest and its effect on invested capital. Should we save or should we fully enjoy our material urges? Here are two reasons that support the former:

1. The power of compound interest

If you start with a total equity of one penny and double that equity every year for 27 years, what will be your pre-tax net equity at the end? I dare you to try and actually do the exercise. If you succeed, give me a call and I'll be glad to invest some of that money for you. \$1.3 million isn't so bad to start investing.

2. It can be better for your health

Let's look at an example of the impact on a smoker's health of consuming versus investing. This is from the very interesting book by Thomas J. Stanley and William D. Danko *The Millionaire Next Door*.

The authors mention a couple that started smoking three packs of cigarettes a day around 1950 and stopped in 1996. They give the readers a few calculations: 1,095 packs a year or 50,370 packs over 46 years; and in terms of money \$33,190 which is more than the price they paid for their home. Here's what they would have had if they invested those daily outflows of cash in the shares of Philip

Morris (the leading tobacco company) instead of Philip Morris cigarettes: they would have a *healthy* tobacco portfolio worth over \$2 million.

### **Underlying principles of McLean Capital**

Here are the underlying principles that you must know as a partner of McLean Capital:

1. Future returns are not guaranteed and past results are not a representation of future returns;
2. Returns are calculated based on the market value that includes realized gains and *unrealized gains*. The returns can therefore have little relation with the income taxes to pay in a given year since income tax is only applicable on realized gains. A long term approach therefore has a fiscal advantage over a short term approach with lots of turnover (and lots of commissions for the broker);
3. Our performance should not be judged by whether we are positive or negative in a given year but more by our relative performance compared to a pre-established index (it is easy to beat an index chosen after performance is known). Our index is and will be the S&P/TSX which represents the largest companies in Canada and should represent the average long term performance of the best Canadian companies;
4. My work does not consist of predicting stock market ups and downs or economic cycles;
5. I cannot guarantee future performance but I can guarantee the following:
  - a. Our investments will be chosen based on a thorough analysis;
  - b. I will consider our common stock participations as part ownership in a business (stocks are not lottery tickets);
  - c. I will be patient because we invest for the long term without trying to predict short term fluctuations;
  - d. I will try to profit from market fluctuations by obtaining better prices and not by trying to time the market;
  - e. I will follow the objective of always paying a price that makes sense and in this way we will obtain a margin of safety in our purchases;
  - f. I will invest in what I understand;
  - g. I will always learn and in particular learn from my mistakes;
  - h. I will research companies with managements that have integrity, that are competent and that are in the service of shareholders.

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## Market Corrections

It is not *at all* unusual for markets to go down substantially every so often. During bull markets, people tend to forget market prices will eventually go *down* (a lot) and during bear markets, people tend to forget markets will eventually go *up* (a lot). I like to tell my partners before they come on board with McLean Capital that stocks could come down 20% in the weeks after they join. I do this because I don't want my partners panicking due to the normal nature of the stock market.

US stocks had their worst opening week in history in 2016. From January 1st 2016 to February 12th 2016, the S&P/TSX was down 4.5%, the S&P 500 was down 8.5% and the NASDAQ was down 13.3%. Nobody can predict where stock prices will go from here. However we do know these market downturns are nothing new or surprising.

Historically, stocks have dropped on average 10% every 3 years, probably 20% every 7 years and 40% every 50 years (very rough rule of thumb). The important thing to keep in mind is that although you could not have predicted when these downturns occurred, stocks have always come back to surpass their previous highs. As long as you trust the wealth generating machine of free markets, you should trust that many companies will make more and more profits overtime and stock prices will follow.

That is why I am not at all worried about the last few weeks. I actually appreciate the opportunities that are showing up due to the contraction in price-to-earnings ratios. Stocks have been expensive for some time now and were long overdue for some adjustment in my view. Since markets tend to overshoot upwards and overshoot downwards, it was impossible to know when the reversal would occur but very easy to know it would occur sometime (they always do).

### *Causes*

I think you can dig into macroeconomic factors such as slowing worldwide growth, the high indebtedness of many consumers and countries around the world and of course China and oil. However, we don't focus on macroeconomic trends when making investment decisions.

I prefer to think of the last few weeks as a normal re-evaluation of assets after many years of upward evaluations. When buyers of securities start paying \$1.50 for assets worth \$1, they are basically speculating on \$0.50. In these circumstances, bad news will tend to have an oversize impact. That is one of the problems you can reduce by purchasing with a margin of safety (purchasing under the intrinsic value price).

Here is a measure of the evaluation of stocks by the market since the first full year of operation of McLean Capital:

Table 4:

<b>Date</b>	<b>S&amp;P 500 Price-to-earnings ratio</b>
January 1, 2012	14.87
January 1, 2013	17.03
January 1, 2014	18.15
January 1, 2015	20.02
January 1, 2016	22.18

We can see from this table that stocks have become more and more expensive over the last 4 years. Historically, the S&P 500 has traded at around 16 times its earnings of the previous 12 months. At 22 times earnings on January 1, 2016, stocks were getting somewhat expensive even though they have traded at much higher ratios in the past.

For the P/E ratio to drop, stock prices must come down and/or earnings must go up. For a P/E ratio at 20, a 10% increase in earnings will cause the P/E to drop to 18. The problem is that after many years of cost cutting and low top line growth, profit growth has started to dwindle. Without growth in revenue, it is getting harder for companies to achieve bottom line growth. Once again this is not a situation that is worrisome. It just supports the idea that stock prices are due for adjustment before they can start to rise again with rising profits in the future.

#### *The profits of our businesses*

Corrections and bear markets show character. In a bull market, many may say they'll sit tight when the market falls yet when the bear market actually shows up and the fear of going down for many more months is present, they want to get out of stocks as soon as possible.

My simple advice: don't worry and focus on the performance of your businesses. Over long periods of time, the change in price of a stock tends to mimic the change in its earnings. Therefore looking at the change in earnings per share can give us an indication of a company's increase or decrease in its intrinsic value; which underlies long-term stock performance (refer to page 16 – Table 8).



Let's look at the results of our 5 largest positions in 2015:

Table 5:

Company	Increase in earnings per share (2015 vs 2014)	Change in Stock Price*
Position 1	37%	30%
Position 2	8%	18%
Position 3	1%	-1%
Position 4	15%	12%
Position 5	21%	-12%
<b>Average</b>	<b>16%</b>	<b>9%</b>

\* Excludes dividend return and the foreign currency impact

We can see from these results that our most important businesses (in terms of weight in the portfolio) have all performed satisfactorily. We can see that 4 out of 5 have had changes in price that were not a reflection of their earnings but mostly a reflection of the market's sentiment towards these companies (their P/E ratios decreased). Some years we can expect the market to over-reward us and some years the opposite.

#### *Summary thought*

It is very important to me to make sure my partners understand that the latest drop in stocks could have been much worse and that this will happen again in the future. That is the nature of the stock market. In the short term it is not always rational and sometimes even very irrational. In the long term prices tend to represent their intrinsic value.

No investor is immune to these swings and it is a reason why investing in stocks is not for everyone even though it is the best asset class in terms of performance historically in the long run.

Coca Cola went public in 1919. Someone who bought in and kept it until 2010 made a 20,000,000% return. Yet in 1973-1974 the stock went down 70%. This was not due to the Coca Cola Company having lost 70% of its true value; it was due to short term market irrationality.

Some may think that based on what I just explained the key is to stay cool when facing a market full of fear (have no emotion). I think it is more a question of being conscious of your emotions and how they may be affecting your judgement. In this sense it is more about managing your emotions. The key is independent thinking. You must make your decisions for yourself by separating your emotions, your rational thinking and what the market is telling you to do.

I want to finish with a funny story that relates to independent thinking that Benjamin Graham (excellent investor and teacher; author of *The Intelligent Investor* and co-author

of *Security Analysis*) shared roughly 70 years ago and that Warren Buffett recounted in 1986. Here is the excerpt from Warren Buffett's 1985 letter:

*You might think that institutions, with their large staffs of highly-paid and experienced investment professionals, would be a force for stability and reason in financial markets. They are not: stocks heavily owned and constantly monitored by institutions have often been among the most inappropriately valued.*

*Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do: An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. "You're qualified for residence", said St. Peter, "but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in." After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, "Oil discovered in hell." Immediately the gate to the compound opened and all of the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. "No," he said, "I think I'll go along with the rest of the boys. There might be some truth to that rumor after all."*

## **Bestar**

I want to use a few lines to reminisce about a very formative experience for me.

I spotted this company going through the list of companies on the Canadian National Stock Exchange (CNSX) about 4 years ago. Most of the companies on this exchange have very small and unprofitable operations yet some are interesting. Bestar was one of them. It took 2 years before I started buying the stock.

### *The Business*

Bestar is a self-assembly furniture manufacturer from Lac Mégantic, Quebec. It was founded in 1948, became a public company in 1986 and reached \$40 million in sales by 1996.

From 1996 to 1999 the company took advantage of the low Canadian dollar and underwent an important expansion financed with a good amount of debt. Revenues surpassed \$80 million in 1999.

Then in the early 2000s the company's conjecture started to change. With a recession in the US, the Canadian dollar gaining value and China increasing competition, the company started to lose ground with revenues almost cut in half from 1999 to 2004. Since interest payments obviously did not come down with revenues the company started to struggle, lost a good amount of money in 2002 and was forced to restructure in 2004 with the backing of an important shareholder of the company: the Fonds de solidarité FTQ.

Although the company rebuilt its balance sheet and profitability over time, the stock (which went from being traded on the Toronto Stock Exchange to the CNSX) never recovered. Trades were being made at lower and lower prices over the years with the

stock coming down its high of \$8 (market cap over \$100 million) in the late 90s to \$0.05 (market cap less than \$800,000) in 2013.

Here are the company's results for the 5 years before I started buying in late 2013:

Table 6:

Year	Revenue	Profits	Free Cash Flow	Equity	Equity/Debt
2009	\$37.2M	(\$0.1M)	\$0.3M	\$12.1M	93%
2010	33.7	(0.8)	1.5	11.3	90
2011	33.6	(0.3)	1.1	11.1	95
2012	29.4	0.2	1.0	11.3	116
2013	29.2	0.2	2.2	11.4	144

Some people were therefore willing to sell me their shares on the market at less than ½ of free cash flow and 7% of book value. This was a deeply undervalued company. At these prices we weren't able to buy a lot and as 2014 advanced we were forced to buy at higher and higher prices until the stock reached \$0.15 in November 2014.

An offer to purchase all of Bestar was made in early November by a small group which included the president of the board of Bestar. They offered \$0.18 per share for a total of \$2.7M when including the stock options and preferred shares. The price was slightly more than 1X the free cash flow of the last 12 months. The company had \$1.1M of cash in the bank and less than \$1M in debt. It owned a 300,000 square feet building on a 600,000 square feet piece of land in downtown Lac Mégantic and had a \$6M untapped available credit line. The prominent accounting firm that was hired to evaluate the offer called it *unfair* to shareholders.

You may wonder how an offer like this could ever be accepted by shareholders. They used a mechanism that allowed them to get the company with only 2/3 of the votes. For a merger to work, you only needed 2/3 of the votes. For an acquisition to work, you needed 9/10 of the votes. The group set up a company called Newco and convinced the 2 largest shareholders who had a combined 62% of the shares. The Fonds de solidarité FTQ wanted to get out since this investment represented a minuscule percentage of their total assets of more than \$10 billion and they were most probably way past their investment horizon. We can assume that the other large shareholder sold his shares because he had gone through very tough times with the company and did not want to continue for personal reasons. Looking at his languishing stock and possibly thinking no other buyer would have an interest, he decided to sell at \$0.18.

We hired lawyers to complete due diligence and made an offer by mid-December at \$0.21 per share. In our case we did not oblige 1/3 of shareholders to sell to us at an unfair price. We made a *tender offer*, not a merger proposal as in the case of Newco. The other group countered at \$0.25 (with another merger proposal) and we dropped the bidding. Our lawyer had strongly pushed for us to make our initial offer higher than \$0.21 but I was quite stubborn and did not want to go higher than \$0.21. I felt our offer was fair since it gave more to those who accepted \$0.18 and did not force the other 1/3

to accept it. I now think we should have given our offer in person and allowed a very short timeframe to answer.

I have thought of Bestar and what could have happened many times but I will consider this short exposé closure for an experience that taught me a great deal. I may just keep reminding myself and my partner Gilbert Rousseau about the time we made a \$1.2 million gift to all the shareholders of Bestar who got 28% more for their shares (we had to foot the lawyer bill by ourselves).

### **Our Largest Position**

The largest position in the McLean Capital portfolio is a mid-size American bank with a market capitalization of less than \$5B at the end of 2015. It has been part of the McLean Capital model portfolio since the beginning and has been one of our best performers.

Here are the returns for this bank over the last 4 years:

2012: +16%

2013: +72%

2014: +37%

2015: +32%

Total over 4 years: +261%

The bank has been a public company for 18½ years. If you look at the track record, you get a 30% annual return on the stock excluding dividends. If you had invested \$100,000 in this company's stock in 1997 at the IPO, it would be worth almost 13 million dollars today and you would have received close to \$600,000 in dividends.

*What makes it such a great bank?*

First of all, it has high quality assets. The average return on assets of 2.0% over the last 5 years is much higher than average. The largest banks in the US (the Big Four) have had these average ROAs over the last 5 years:

JP Morgan: 0.9%

Bank of America: 0.4%

Citigroup: 0.6%

Wells Fargo: 1.3%

Its allowance for bad assets and bad loans has always been lower than the average standing at 1.0% at the end of 2015 (as a percentage of loans and leases outstanding). The largest banks in the US had these percentage allowances at the end of 2015:

JP Morgan: 1.6%

Bank of America: 1.4%

Citigroup: 2.0%

Wells Fargo: 1.3%

The balance sheet is strong. The assets-to-equity ratio (A/E), a measure of financial leverage, is below average and stood at 6.8 at the end of 2015. The largest banks in the US had these A/E ratios at the end of 2015:

JP Morgan: 9.5

Bank of America: 8.4

Citigroup: 7.8

Wells Fargo: 9.2

But most of all, what really sums up the reason behind these numbers is the great management and culture of the bank which starts with its CEO and founder who is a truly great banker.

### *Technology and the Banking Industry*

I find the Uber phenomenon fascinating. It demonstrates the enormous power of the internet on democracy and can inspire fear and hope at the same time.

For those who do not know Uber; it is an internet application that allows you to order a *vehicle for hire with a driver, used by a single passenger or small group of passengers, often for a non-shared ride*. Uber views itself as a ride sharing service but for most, it is like a taxi. That is why I transcribed the Wikipedia definition of the word taxi in the above sentence.

In Montreal, the licence to operate a taxi can cost up to \$200,000 and is administered by the Taxi Bureau. The fact that the self-employed workers of Uber don't pay for this licence helps them amongst other things to charge less than traditional taxis.

What fascinates me with Uber is that they were able to use the internet to get around the law and at the same time remove lots of revenue from the cities without getting too much pressure from public administrators since they want their votes from the population who, in general, adores Uber.

It brings us to think about what other industry could be completely deregulated by the internet and the power of the population's votes. Since the internet can give you enormous and very fast distribution across the world, the regulators don't have time to block these phenomena before they become so important that the general population does not accept measures to deter them.

Take the example of finance or banks. Many services that only banks used to offer are now offered by internet services that are not really regulated. PayPal allows you to keep an account balance and acts a little bit like a bank. The company also allows you to do peer-to-peer payments. Other internet services offer online loans and mortgages (Quicken Loans) without paying the large regulatory fees of the banks.

The trust of consumers seems to be the critical advantage banks still possess at the moment. If we contrast this with Uber, taxis don't have the trust of their customers and this has greatly helped Uber. Trust is harder to obtain when it comes to your banking needs than your transportation needs. Banks also have many services that unregulated technology companies can't offer yet. For those reasons I still think that the banks have

important competitive advantages and that it is more difficult for a digital service to uproot them.

Since brand names make people “stick” to their bank, the latter also have time to adjust and offer services similar to those that technology companies initially develop.

Take Bitcoin for example. At the moment, Bitcoin acts like a speculative security. It is difficult to imagine a world where Bitcoin becomes a stable currency for our economies without it getting support from a very large organization (like a government). People must trust that their currency will be stable in relation to the consumer goods that they buy; what Bitcoin does not offer at the moment.

Nonetheless, Bitcoin possibly contains an important innovation for the global banking industry: the block chain. The block chain is a large online ledger which is recorded on a worldwide network which, in theory, eliminates the possibility for retrospective changes. We can imagine this system being used to make securities trading, which could have a major impact on banks. This system could remove the necessity for an intermediary. Banks are currently considering the implementation of this innovation themselves and protect their profits through this process.

I continue to think the banking industry has a lot of value despite the heavy regulatory burdens, low interest rates and the treat of new technologies (from robo-advisers, new payment technologies and the block chain). I think it is nonetheless important to keep following the impact of technology on the profitability of the banks in the future.

### **Bob Iger and Walt Disney**

I want to take the time to write about one of my favourite CEOs: Robert Iger. He became CEO of The Walt Disney Company in 2005 and he has done a truly remarkable job that is definitely worth underlying here.

#### *Pixar*

Steve Jobs was pushed out of Apple in 1985. Many don't know this but he bought Pixar (called Graphics Group at the time) from Lucasfilm for \$5 million in 1986. He helped the studio become what it has become being the company's largest shareholder and CEO when it brought out its first huge success: Toy Story. Disney bought Pixar for \$7.4 billion in 2006.

Bob Iger was apparently the key to making this deal happen. It has been reported that Steve Jobs and the CEO of Disney before Bob Iger had some sort of disagreement. Bob Iger on the other hand had a very good relationship with Steve Jobs and even became a good friend. He saw the great value in Pixar and was able to convince Steve Jobs that Disney was the right home for the future of his company.

Here are the 9 titles that Pixar has released since the 2006 acquisition:

Table 7:

Release Date	Movie	Budget (millions)	Global Box Office (millions)
June 9, 2006	<i>Cars</i>	\$70	\$461
June 29, 2007	<i>Ratatouille</i>	\$150	\$626
June 27, 2008	<i>WALL-E</i>	\$180	\$532
May 29, 2009	<i>Up</i>	\$175	\$731
June 18, 2010	<i>Toy Story 3</i>	\$200	\$1,060
June 24, 2011	<i>Cars 2</i>	\$200	\$560
June 22, 2012	<i>Brave</i>	\$185	\$554
June 21, 2013	<i>Monsters University</i>	\$200	\$743
June 19, 2015	<i>Inside Out</i>	\$200*	\$602*
<b>TOTAL</b>		<b>\$1,560</b>	<b>\$5,869</b>

\* Estimates

Movie studios can be very profitable. Although Bob Iger paid a handsome price for Pixar, this long-term “annuity” type business that Disney can tap into to generate lots of cash way down the line with its strong franchises contributes a lot to Disney’s value and competitive position.

#### *Marvel*

Disney paid \$4 billion to buy Marvel Entertainment in 2009. At the time, many thought Disney overpaid and were worried they would diminish the artistic value of the brand. Today the Marvel brand seems stronger than ever and the strategic value of the acquisition seems almost obvious (after the fact). The market now understands the tremendous distribution power of Disney and how it can be applied to brands like Pixar, Marvel and Lucasfilm to substantially increase their brand power and profitability.

#### *Lucasfilm*

*“It was like Lucasfilm was sitting on top of the world’s richest oil deposit, but didn’t want to drill.”*

- Wired (in relation to Lucasfilm before the 2012 acquisition by Disney)

Disney also paid \$4 billion to buy Lucasfilm in 2012. This time the market understood they were aiming for the same strategy they used for Marvel.

*Star Wars: The Force Awakens* has already amassed about \$2 billion US in revenue at the box office and you can add all the consumer products and licensing deals to the fold. This was an unbelievable deal and shows the tremendous earning power of The Walt Disney Company; especially when steered by a first class commander like Bob Iger.

*In summary*

Here are the Walt Disney results of the last 10 years:

Table 8:

<b>Year</b>	<b>Growth in earnings per share</b>	<b>Change in stock price*</b>
2006	+34.4%	+38.2%
2007	+37.2	(13.0)
2008	+1.3	(29.0)
2009	(22.8)	+49.3
2010	+15.3	+26.8
2011	+24.1	(0.5)
2012	+24.2	+33.8
2013	+9.3	+46.6
2014	+24.6	+31.6
2015	+15.0	+4.7
<b>CUMULATIVE</b>	<b>+301.6</b>	<b>+334.6</b>
<b>ANNUAL</b>	<b>+14.9</b>	<b>+15.8</b>

\* Does not include the dividend yield which brings the 10-year annual return to 17.1%

I hope Bob Iger stays at the helm of Disney for many years to come. He is only 65 years old and the board already extended his mandate above what was initially planned. I hope they keep doing this and that Bob Iger never retires!

### **Currency Fluctuations**

Since the first full year of operation, we have had a large portion of our stock ownerships in companies from the United States that are traded in US dollars. My partners often ask me what impact the currency exchange has had on the portfolio and what we can expect for the future.

In the last 2 years, the increase in the market value of the US dollar against the Canadian dollar has increased our return by about 12% in 2015 (return without currency effect is about 8%) and by 8% in 2014 (return without currency effect is about 10%).

Although I do not believe I can predict the relative value movements of currencies, I can have a general appreciation for the intrinsic value of a currency relative to another. Let's look at some valuation methods for currencies.

Purchasing power parity (PPP) states that one exchange rate in relation to another should be at a level where the purchasing power of either currency is the same in either country. For example (using the Big Mac Index), a Big Mac cost about \$4.90 US in the US in January 2016 and it cost \$5.80 CDN in Canada on average. That would translate to a currency value for the Canadian dollar in relation to the US dollar of \$0.84 US



(4.90/5.80). On a broader scale, using the OECD purchasing power calculation, the Canadian dollar should be worth \$0.82 US.

Another way to calculate the relative value of a country's currency is to look at the productivity of its workforce. The idea behind this theory starts by viewing money as claim checks on people since it can be used to hire employees. Since the economy is made up of people, when you put your money at work by investing, you are basically buying people's time. Now if one group of people is more effective with its time than another group of people, you would expect to pay more for use of that group's time. According to The Conference Board of Canada, the Canadian workforce was 19% less productive than the US workforce in 2012. By this measure, the Canadian dollar was worth \$0.81 US. In January 2012, the Canadian dollar was trading for \$0.98 US.

On this basis, it was clear to me and I think to most that the Canadian dollar was overvalued at the beginning of our first year of operation (2012). Although I bought US stocks because I preferred the price levels, I also thought the undervalued US currency could have a positive impact eventually; without knowing when this would happen.

I therefore still believe using the S&P/TSX (or the S&P 500) as a benchmark without adjusting for the currency fluctuation makes sense since the intrinsic value of a currency was and is taken into consideration when making foreign investments. Since the objective is to beat the market over the long term, it makes sense to compare our performance with the market directly; without adjusting it for currency fluctuations.

Over the long term, currency fluctuations should not have a large impact on the portfolio. They may increase the return in some years and decrease it in others but overall I don't think they will have a significant impact.

## **Outlook**

I cannot predict the future but I can propose different scenarios that can give possibilities for future performance. It is possible to obtain an annual return by using a model which involves 3 assumptions. The first assumption is the annual earnings growth. The second is the market sentiment (price-to-earnings ratio) and the third assumption is the level of the Canadian dollar which affects our foreign investments (probably all purchased in US dollars). Each scenario is a combination of those 3 assumptions.

It is true that the price-to-earnings ratio is often dependent on interest rate levels and the Canadian currency fluctuation is usually linked to the price of natural resources but trying to predict those factors is extremely difficult if not impossible and is not the purpose of this exercise. The growth in the earnings of our companies is the most crucial parameter in the long term and the one on which I concentrate my research and analysis.

The following table presents 7 possible scenarios from a more pessimistic to a more optimistic considering we currently have 64% of our portfolio in US dollars and our current portfolio price-to-earnings ratio is 15 (7 points below the market P/E):

Table 9:

Scenario	Annual growth in earnings	Price-to-earnings ratio in 5 years (change from today)	Canadian dollar/US dollar in 5 years (change from today)	Annual compounded return
1	+4%	15 (no change)	\$1.00	+0%
2	+7%	16	\$0.90	+5%
3	+9%	18	\$0.82	+11%
4	+12%	18	\$0.80	+14%
5	+12%	20	\$0.70 (no change)	+19%
6	+14%	21	\$0.70 (no change)	+22%
7	+16%	21	\$0.60	+26%

If we assume that annual growth in profits for the companies in the S&P/TSX will be 4% for the next 5 years and that our companies will do 5% more; that we suppose interest rates increase but still don't reach historically normal levels; and that finally the Canadian dollar to US dollar exchange rate stabilises around \$0.82; then scenario 3 is realistic and we could expect an annual return of 11% (total return of 69%) for the next 5 years. Obviously I would prefer to do better and I think it is very possible. Earnings growth could be stronger and our companies could get loftier market evaluations.

### Conclusion

I want to thank all my partners for the trust they bestowed upon me by becoming the first McLean Capital partners.

Investing is a passion for me and McLean Capital is the beginning of something that can allow me to share and develop this passion even more in the future. I am very grateful towards those who have allowed me to gain the necessary experience to obtain my license with the Autorité des marchés financiers.

Honesty and integrity are fundamental values for me and McLean Capital. These values are not only good in a moral sense; they are also excellent in an economic sense!

As I think “partner” is a more appropriate term, I have decided to use this term instead of “customer”. As I am invested in the same companies as you are, we are all in the same boat and “partner” makes more sense.

I hope this letter was interesting and helped you understand McLean Capital’s philosophy and underlying principles. If you have any questions, feel free to call me.

A handwritten signature in black ink that reads "Ian McLean". The signature is fluid and cursive, with a long horizontal line extending to the right.

Ian McLean



**MCLEAN CAPITAL**