IBV CAPITAL

Q2 2017 Partnership Letter
July 2017

Dear Partners,

"Don't fight the Fed" is an age-old investing mantra for investors considering a strategy that goes against the planned monetary policies of the United States Federal Reserve. We find this saying analogous to investing in Canadian residential real estate, though it should be adapted to "Don't fight, well, everyone!"

In July of last year, British Columbia announced a 15% foreign home buyers sales tax for properties in the Greater Vancouver area – a measure designed to make homes more affordable for the average individual. By October, the Canadian Federal Government joined the fight and administered changes to mortgage insurance eligibility thresholds, and began requiring the application of a mortgage rate stress test to all insured mortgages moving forward. This represented a broader approach to slow the ascension of home prices in Toronto and Vancouver. Despite these measures, home prices continued to rapidly escalate, especially in Toronto. In April, it became the Ontario Provincial Government's turn to respond, with the implementation of 16 new rules to address the mounting housing affordability crisis.

By happenstance, these deliberate policy measures coincided with Home Capital's near collapse in April, which offered an unexpected further cooling effect. While small relative to the overall Canadian financial system, they were an important institution in the alternative lending space. We've watch this institution and other Canadian alternative lenders closely, as they represent the proverbial canary in the coal mine for loose lending practices. These lenders are the most worrisome, because it's been easy and cheap access to debt, not income growth, that is responsible for Canadian home price appreciation. Home Capital may have been the first to have their troubled lending practices uncovered, but we suspect they won't be the last.

The way Home Capital's near-dissolution was handled by regulatory authorities was particularly concerning to us. While it wasn't deteriorating loans that created a run on the trust company (and it was most certainly a run), it was a loss in confidence in its management team. Not one government entity attempted to calm investors' or depositors' nerves. This was an error in judgement, and one that we hope will not be repeated. Without a calming voice, panic quickly spread to other alternative lenders, such as Equitable Group, which saw similar levels of stressed reactions throughout their capital structure. We're keenly aware that the banking system relies on trust (the Latin word credo, which evolved into the word credit, means "to trust"), and once that trust is gone it's extremely difficult to rebuild – and impossible to rebuild quickly.

If a regional policy response to rectify housing unaffordability represents a precision tool, a monetary policy response represents the blunt instrument. This is why the Bank of Canada's Senior Deputy Governor, Caroline Wilkens, market-surprising hawkish speech in June was so impactful. After Stephen Poloz supported her sentiments, it became clear the two were priming the market for a rate increase. On July 13th, they announced a 25-bps increase in the official overnight target rate to 75 bps, the first increase since 2010. To us, investing contrary to this seemingly coordinated effort to cool select housing markets and economic growth is tantamount to fighting the Fed.

Even before all these events unfolded, the Canadian housing market and banking system were a concern for us. Within the last few years, we've increased the intensity of our research into the space. The purpose of the analysis, which has taken us back to the 1990's, is to spot upcoming potholes and investment opportunities. As the saying goes, history may not repeat itself, but it sure does rhyme.

To aid our assessment, we asked the six major Canadian banks to send us their annual reports that weren't available on SEDAR. They all obliged – sending us decades of hand-scanned annual reports. It's been exciting (yes, exciting), studying these documents, to determine the loan book impact of the 41% home price decline that took place in Toronto between 1989 and 1996. That's right, home prices can and do fall in Canada. What we found were ravaged commercial loan books, but residential portfolios that were far less impacted than one might expect. A comforting finding, if we didn't feel the risks embedded in the system were much higher today than they were back then. To round out our analysis, we've assessed the validity of commonly held beliefs about why Toronto and Vancouver home prices are rising at such a rapid pace. We've also explored why Alberta home prices have hardly budged, despite large declines in GDP and a near collapse in residential rental rates.

The notion that Toronto is a world class city with immigration that's driving demand holds some weight, but we've seen a proportionate supply response, suggesting that the implied demand imbalance doesn't exist. Similarly, in Vancouver, since 1996, the population has increased by 24% while the number of dwellings increased by 31%, suggesting supply has also responded. However, prices have increased by 489% over that time – an 8.8% unlevered CAGR over 21 years. For most homeowners, they're likely generating more wealth from their house than they are at their jobs. The irony that their job financed the purchase of their home isn't lost on us.

Further inland, in Alberta, whose economy is more linked to the oil and gas industry than Texas, mortgage defaults have held up reasonably well, despite having its economy decimated by a sustained fall in oil prices. According to the Canadian Bankers Association, default rates have hardly increased from the 0.38% level registered in early 2014 to 0.46% today. However, delinquency rates on consumer debt is skyrocketing in the province. This suggests to us that individuals who have lost their jobs are relying on consumer debt – not savings – to stay afloat and keep their homes. Unless the economy turns, this is not sustainable. While the financial market seems to have put the turmoil of the last few months behind it, we can't help but remain increasingly paranoid about what may come.

Andrew Grove, the former CEO of Intel, once said: "Only the paranoid survive". At IBV, we always operate with a healthy sense of paranoia. This approach has manifested itself into our belief that the probability of unexpected events is higher than most appreciate, but in most instances, the long-term impact is less dramatic. This is why we're such patient investors during periods of calm and transition into being very aggressive investors during times of turbulence.

In Canada, we're concerned about the level of investing complacency in the face of what we see as an elevated probability of negative macro-economic events. Exacerbating our concerns, is the fact that Canada's economy and stock market is concentrated in a select few highly cyclical sectors. For Canadian investors, who historically have had an intense home investment bias, these risks are especially problematic. We understand the appeal of investing in a familiar environment, but advise against assuming familiarity equates to safety. Our portfolio is deliberately void of any meaningful Canadian investments, because we believe the market has not appropriately accounted for the heightened level of risk. Until we see an appropriate investment opportunity that captures our sentiments or compensates us for the level of risk we see, we'll continue to avoid Canadian investments.

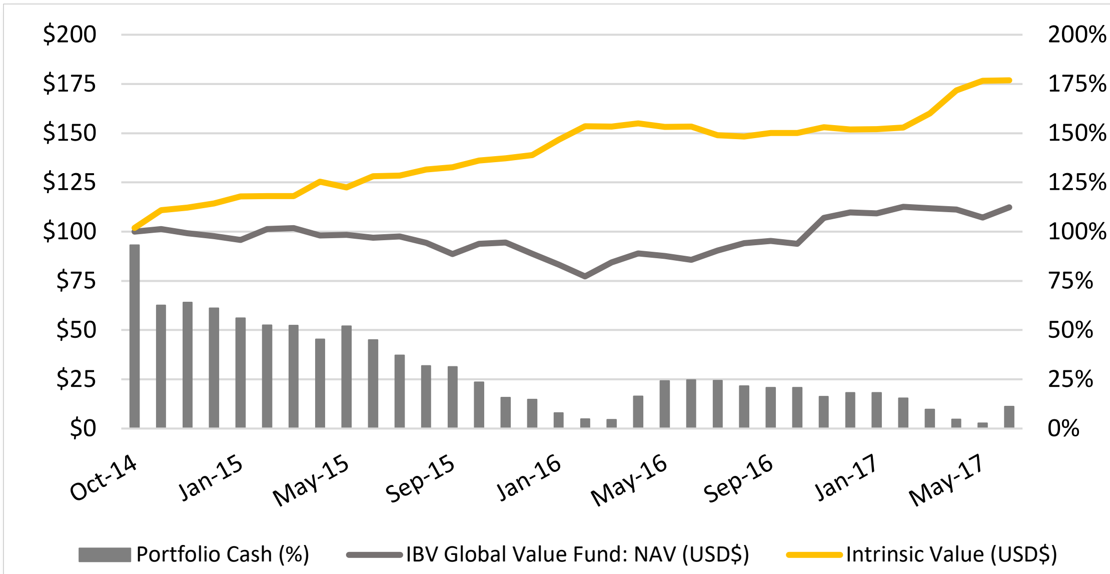
Investing Is Not a Popularity Contest

The market value of IBV Global Value Fund increased by 0.5% in the second quarter of 2017. Importantly, the intrinsic value of our portfolio advanced 10.5% during the quarter. For comparative purposes, during the second quarter of 2017, the MSCI World Index increased by 4.0%[1].

In the first six months of the year, the stock gains of five companies; Apple, Amazon, Facebook, Microsoft, and Alphabet (Google) – contributed 3.1% of the 11.0% return of the S&P 500 (the S&P 500 represents a large subset of the MSCI World Index). We're not invested in any of these technology companies, and unless their valuations change dramatically, we don't anticipate this stance to change anytime soon. To be clear, we like the products and business models of each, but struggle with their valuations. It's a dilemma we're often faced with, how much should we pay for growth? We know growth can be fickle, and we're cautious by nature, so we maintain a discipline of discounting the price we're willing to pay for future growth prospects. What history has shown us, is that at some point – the precise timing is always unknown – even the greatest of companies go on sale for one reason or another. These moments often represent attractive entry points into high-flying stocks of the past.

With indices' gains being concentrated in technology stocks, it becomes rather obvious that old world industries like banking and industrials haven't fared nearly as well on a relative basis. The November 2016 U.S. election provided a meaningful lift to our Bank of America and Citigroup shares, but so far in 2017 the increase has been less dramatic. This is despite underlying fundamentals improving considerably. Clearly, the flavor of the month is disruptive technology companies - of which we own none. We're okay with this, because we know tastes can change, and change quickly.

[1] **"IBV Global Value Fund"** consist of USD$ IBV Capital Global Value Fund LP Class M unit returns, gross of fees. Inception date of this class is October 1, 2014. "**Intrinsic Value of our Portfolio" / "Intrinsic Value"** represents IBV's internally calculated intrinsic value for the cumulative securities within the IBV Global Value Fund. "**MSCI World Index**" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures are found on Page 6.



In the last six months, our portfolio experienced a material change in our cash position and decisive shift out of North America. We started the year with 18% in cash, and have since decreased it to 11%. This repositioning is a by-product of the sale of our Enbridge Preferred shares and purchase of Vertu Motors PLC, among other portfolio additions. As a result of these portfolio adjustments, the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio, now stands at 57%.

Harvesting Our Crops

As you may recall from one of our previous letters[2], towards the end of 2015 and into early 2016 the Canadian Rate Reset Preferred Share market was in turmoil – and indiscriminate selling had taken hold. At the time, a select few Enbridge Preferred Share Series that were tied to U.S. interest rates (not Canadian rates, as is typically the case), dropped considerably in price.

We inherently understood that despite the market turmoil, Enbridge's infrastructure was critical to the functioning of the North American oil and gas market – two resources we're by no means weaning ourselves off of. In our minds, this was reflected in the way they derived their revenues, which are through long-term contracts predominantly using methodologies that are not exposed to short term commodity price risks such as cost of service, take or pay and competitive toll settlements. We were also comforted by the company's diversification into gas distribution, which had already experienced a similar prolonged period of oversupply that wasn't impactful on their financials, and a sizable energy business.

Once our analysis showed the company's underlying economics would remain intact, we felt it was highly unlikely they would default on their financial obligations, specifically, their debt and preferred share commitments. Drawing on this conclusion, it seemed that the spreads between the yields on the preferred shares and their U.S. government benchmarks were unnecessarily elevated,

[2] 2015 Annual Partnership Letter

and would eventually narrow. So, we purchased some Enbridge Preferred Series L's and 5's. Actually, a lot of them – bringing our combined initial position to 7.5% of the fund's investible assets.

Not long after we made our purchase, the market "re-evaluated" the probability of default for higher-quality oil and gas infrastructure companies downward. The spreads narrowed and downward pressure on five-year U.S. Treasury rates eased. The combination of these events lifted the value of our preferred shares from our average purchase price of $17.34 to $22.97, at which point we exited our positions. While our investment did add to the volatility of our returns in early 2016, it ultimately resulted in a total return of 43%, inclusive of dividends, in a very short period of time.

Since 2011, the systematically important financial institutions who do business in the U.S. have undergone a Dodd-Frank Act Stress Test and Comprehensive Capital Analysis Review (CCAR). During these qualitative and quantitative examinations performed by the Federal Reserve, the Common Equity Tier 1 Capital and Supplementary Leverage ratios, among others, are measured under severely adverse economic scenarios. On June 28th, the Federal Reserve announced that our banks, Citigroup and Bank of America, performed particularly well during these tests. This announcement was promptly followed with a press release from both banks signaling they would return a considerable amount of capital to shareholders during the next 12 months.

Bank of America will increase their dividend 60% and repurchase $12.0 billion of stock during the coming year. This repurchase plan represents 5.0% of shares outstanding at the present share price. The ability to distribute approximately $15.8 billion, an increase from $7.6 billion, following a 2016 year where they made $16.2 billion is encouraging and rewarding. This capital return is a by-product of the earnings power we recognized they had a few years ago, as well as their greatly improved capital structure and risk management practices – three critical pillars in our investment thesis. A continuation of these dynamics lends itself well to our assertion that return on equity will be bolstered moving forward.

Citigroup's performance was particularly impressive considering three years ago they failed to meet the Federal Reserve's qualitative test standards, impacting the amount of capital they could return to shareholders. We felt this was a temporary stumble, and management, led by Michael Corbat, would right the ship. They did in subsequent years, culminating in this year's 100% increase in dividends and announcement that they will repurchase up to $15.6 billion in stock, which represents 8.5% of shares outstanding at today's stock price. Coupled with an improved operating environment, we're pleased with the direction Citigroup is headed in.

Road Trip to London

While in London, we continued our dialogue with Vertu Motors' management team, captured BREXIT sentiment, and assessed a few investment opportunities. Our meeting with Vertu provided additional confirmation that we're invested in one of the best auto retailers in the U.K. We got a first-hand look at their internally developed information systems, and enjoyed a detailed discussion about their thoughts on compounding wealth for shareholders.

We accompanied this in-person meeting with a market shop of a few Vertu dealerships just outside London. Much was learned from going through the process of "buying" a Mercedes at one of their recently acquired dealerships. We coupled this exercise with some informative meetings, including those with prominent sell-side analysts covering the auto retailing sector. Some of our more interesting appointments were with CBRE and Knight Frank, two globally recognized real estate brokerages, who play an important role in most major dealership transactions in the U.K.

During these meetings and others, we were also able to capture the general BREXIT sentiment and we were surprised by how optimistic everyone appeared to be. It was evident that the desire of Londoners, who you may recall voted overwhelmingly to stay, was for the government to adopt existing EU rules and, once capable, begin altering them to reflect the spirit of an independent U.K. Essentially, the presumption from the group who lost the vote was that nothing material would change – a surprising consensus, but an informative one nonetheless. It was a productive trip that highlighted the fact that there's simply no replacement for putting dress shoes on the ground.

Sincerely,

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Disclosures: