IBV
CAPITAL

Dear Partners,

Over the past few years, we have had elections, interest rates, taxes, and now trade dominate the minds of investors all over the world. While these are important considerations when allocating capital, we would like to change gears and divert everyone's attention to a topic with equally far-reaching implications: corporate governance.

Surprisingly, corporate governance is not the riveting cocktail party conversation-starter one would think it should be. However, it is an important investment consideration, and one we take quite seriously. Since last quarter marked the height of proxy season, the time of year we spend deliberating on director and management performance, board composition, executive compensation, and the impacts of corporate by-laws and any proposed changes, we think there is no time like the present to share our thoughts.

Specifically, we have been internally discussing the proliferation of passive investment strategies, and the impact they're having on the formation of corporate governance policies and boardroom decisions. In 2008, ETF strategies had $700 billion in assets under management. Today, this has ballooned to over $4.6 trillion.[1] Amazingly, it's estimated ETFs will grow to over $7 trillion by 2020.[2] The apparent continued popularity of passive strategies has resulted in a dramatic increase in the breadth and magnitude of their investments in public companies. Herein lies the issue. Since most ETF providers do not transfer proxy voting authority to their ETF investors, this growth has placed ETF providers in the unprecedented position of being the 800-pound gorilla in boardrooms around the world.

The question we pose is whether the implications of consolidating proxy voting power into the hands of a select few ETF providers such as Vanguard, BlackRock and State Street has been thoroughly considered. Of course, this query should be expanded to include the corporate governance consulting industry, namely Glass Lewis and Institutional Shareholder Services, who influence many ETF providers' voting decisions. The deafening silence on this topic implies that the far-reaching impacts these few companies are having on corporate governance haven't been fully considered.

We have thought long and hard about this topic and suggest that such a consolidation of power isn't appropriate for a few reasons: (1) Separating the investment function from the proxy voting

[1] https://www.bmo.com/assets/pdfs/gam/uk/etf_outlook_2018.pdf
[2] https://www.ey.com/Publication/vwLUAssets/ey-global-etf-survey-2017/$FILE/ey-global-etf-survey-2017.pdf

function is a deeply flawed approach; what transpired at Darden Restaurants[3] is case in point. (2) The interests of ETF investors and ETF providers (and their consultants) may not be aligned. (3) We see limited external oversight of corporate governance practices at ETF providers.

While our concerns about this have been festering for years, they came abruptly into focus this year when Larry Fink, BlackRock's CEO, communicated to the investment world that BlackRock would use the full reach of their ETFs' voting power (all $1.75 trillion of it) to address social issues that impact company stakeholders.[4] For instance, in response to ongoing gun violence in America, BlackRock decided they would press firearms retailers and manufacturers on their sales and manufacturing processes.[5] Since these companies already work within the framework of fully formed gun legislation, placing our thoughts on the quality of that legislation aside, it's fair to presume BlackRock's engagement is to affect some form of change. Considering this social issue isn't the only controversial one in existence, their active involvement on the matter places them directly on top of a slippery slope. For instance, what if BlackRock's social conscience took aim at industries such as alcohol, tobacco, coal, oil sands, or gaming, to name a few. For us, BlackRock's announcement was a watershed moment in the passive investment space, and it occurred with almost no fanfare.

With this stance, BlackRock, a provider of supposedly passive investments, took a divisive social issue and turned it into a corporate boardroom issue. While the industry impact of what amounts to a few BlackRock employees' stance on gun control legislation is unknown, it raises some serious questions about the future of ETFs' role in the boardroom. To begin with the obvious, what if BlackRock's social views don't mimic the views of their investors? Equally important, is a passive strategy that's active in the boardroom a passive strategy? We'd suggest that it's not: being actively engaged in the boardroom to affect change is the pinnacle of active investment management.

What we find more discomforting is the potential conflict of interest that exists within BlackRock. Today, they have $1.7 trillion in actively managed products, and it's plausible they could use the voting influence of their $4.1 trillion in passively managed products ($1.75 trillion in ETF's and $2.39 trillion in Non-ETF indexes) to achieve self-serving objectives in their active portfolios. This concern isn't isolated to BlackRock. In 2017, it was reported that the top three ETF providers controlled over 70% of global ETF assets – each also offer actively managed portfolios to their clientele.

[3] In 2014, Darden Restaurants, the owner of family favorite restaurants such as Olive Garden and Red Lobster, was approached by activist investor Starboard Value LP to discuss unlocking shareholder value. Over the course of this shareholder engagement, it became apparent the Darden Restaurant board was highly ineffective and should be replaced. Almost immediately, the board was completely refreshed, but not before they were believed to have permanently impaired shareholder value with the controversial Red Lobster transaction. In the year prior to Starboard Value LP taking their position in the company, BlackRock and Vanguard were top shareholders, yet were apparently silent about the board's composition. They only chose to vote for the board's removal following Starboard's activism. If Starboard hadn't become involved, would Darden's board have changed in the manner that it did? We suspect not.

[4] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

[5] https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms

The degree to which corporate boardroom decisions can be influenced by passive investment products has become enormous. Admittedly, we're disappointed by the absence of a meaningful debate about the intended and unintended consequences this consolidation of voting power has had in the public markets. To us, this suggests it will be some time before the investment community and regulators respond to this growing imbalance of influence. However, we see the boardroom as a place where value can be created and destroyed. So, we will continue to be acutely aware of the impact passive investment products have on corporate governance matters and consider this factor in our investment process.

Overcoming Risk of Return Dilution

The market value of our IBV Capital Global Value Fund increased by 11.6% in the second quarter of 2018. Importantly, the intrinsic value[6] of our portfolio advanced 10.1% during the quarter. For comparative purposes, during the second quarter of 2018, the MSCI World Index advanced by 1.7%[7].

In our last letter, we extolled the virtues of assembling a portfolio of securities that had embedded catalysts. Our rationale for this approach is that embedded catalysts eventually come to fruition and unlock shareholder value. Therefore, a portfolio of securities sharing this characteristic would create idiosyncratic returns – an attractive feature to us in the current investment environment.

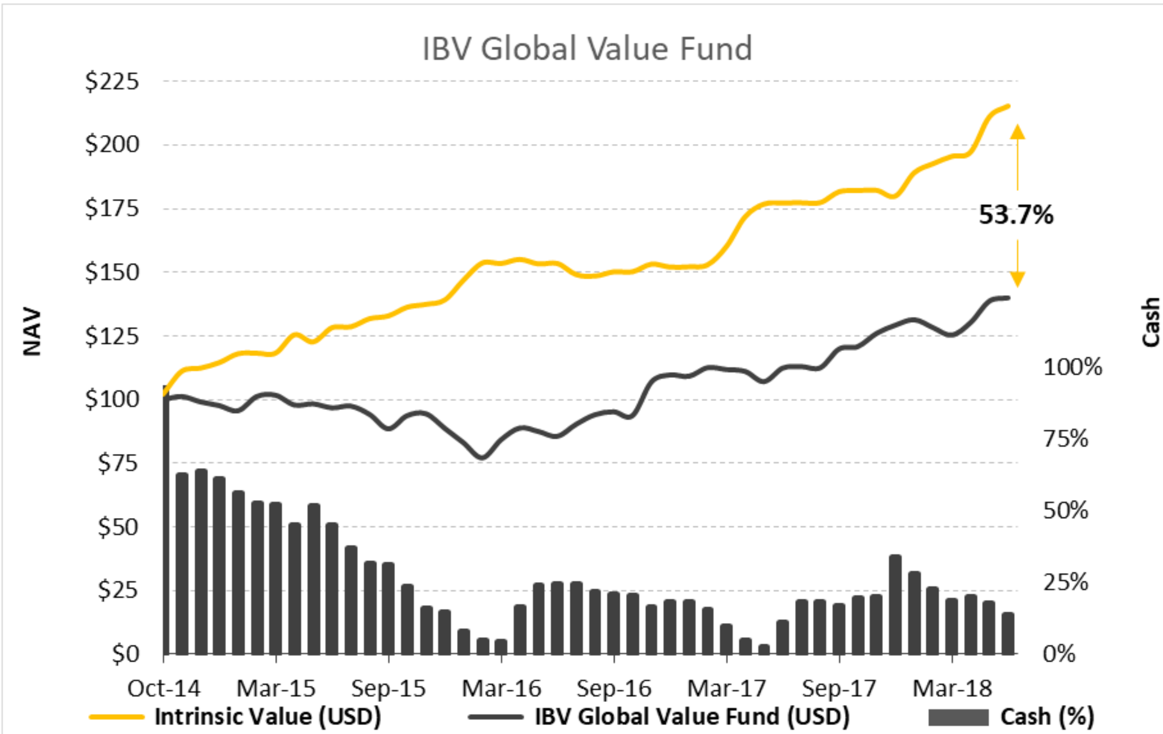
One of our investments this quarter, Ascendant Group, took the necessary steps to unlock shareholder value. We have long held the view that Ascendant Group represented a unique and compelling investment, but one that would take a while to unfold and be challenging to make due to its relative illiquidity. Nonetheless, this investment was so compelling that we allocated a meaningful portion of our portfolio to it – a decision that has proven highly beneficial.

While the sizing of our position was subject to extensive internal debate, we concluded that the asymmetrical return-to-risk profile was so great that allocating only a small portion of capital to it would have proven a lost opportunity – particularly given our deep research and understanding of the investment. The notion that a great investment idea would have only a modest impact on returns is a concept we refer to internally as risk of return dilution. We strongly believe that diluting returns with diversification, merely for diversification's sake, is a risk that carries an actual cost. Of course, the cost is intangible and therefore doesn't appear in actual returns. However, as far as we're concerned, it is there, and we try our absolute best to avoid it.

Throughout the quarter, we added one new investment and sold our investment in Tesco PLC, maintaining the number of positions within our portfolio at 15. While these activities impacted

[6] We would encourage all new readers to visit the "Our Liquid Conglomerate" section of our Q2-2016 investment letter to assist them in understanding the meaning and importance of our portfolio's intrinsic value.
[7] "IBV Global Value Fund" consists of USD$ IBV Capital Global Value Fund LP Class M unit returns, gross of fees. Inception date of this class is October 1, 2014. "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 can be found on Page 6.

our portfolio's intrinsic and market value, in absolute terms they were overwhelmed by the dramatic share price increase of Ascendant Group. That said, when we combine all our investment activities year to date, we've seen a significant increase in the portfolio's intrinsic value, but an even more meaningful increase in the market value of our portfolio. As a result, the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio narrowed to 53.7%.



While the number of our investments remained constant this quarter, our investment activities combined with the portfolio's market value movements, resulted in a reduction of our cash position to 14%. Considering the current environment, we're quite pleased with our cash position as well as the outlook for our portfolio companies.

Realities Appear in Time

Since we began our detailed study of Ascendant Group (AGL) in 2014, we've been captivated by the company's potential. While compelling, at the time, we appreciated that due to many moving parts it would take years of executing the right value-enhancing strategy for our investment thesis to unfold.

At the company's annual general meeting in May, management communicated to shareholders a strategy that we believe will unlock shareholder value. To summarize, operational performance improvements at AGL's electric utility, Bermuda Electric Light Company (BELCO), will commence immediately and ultimately provide flexibility to increase profitability under a newly designed regulatory framework. What's more, the balance sheet will be optimized, dividends will be increased, and the company will either re-list or dual-list their shares on a globally recognized exchange. The Toronto Stock Exchange represents a wonderful option, and we're highly supportive of management expediting this element of the value creation plan.

As previously reported, other elements of our thesis, including BELCO being granted the right to rebuild their aged generation facility and Bermuda transitioning to a sophisticated regulatory environment, have already come to fruition. An unexpected development was the formalization of an offer by Twenty First Century Utility to purchase AGL for $15 per share, a 50% premium to the share price at the time. If management continues executing their plan to unlock shareholder value (and quickly), we would support them in rejecting this offer. The combination of all these positive developments has prompted a 69% increase in the company's share price for the year – and has meaningfully increased AGL's weighting within our portfolio.

Our portfolio's composition shifted further during the quarter when we sold our entire investment in Tesco PLC for a modest profit. Despite making money, this investment did not turn out as anticipated. However, the investment was not made in vein, as the team learned valuable lessons while comparing the outcome against our initial investment thesis. Before I move forward with a recounting of where things deviated from our expectations, it's important our investment partners appreciate that while I refer to the collective group using "we" in the explanation, it is "I" who is to blame for the Tesco misstep.

To begin, we made the investment in Tesco on the premise that they had a few valuable assets that weren't being appreciated by the market following a financial reporting scandal that had taken place. From our perspective, we felt that their South Korean business was quite attractive, as was their bank in the United Kingdom. Equally important, their leadership in market share in UK food retailing, both online and in well-located brick and mortar stores, suggested to us that their home market was secure and that their large real estate portfolio had value.

While new management was put in place to restore confidence and execute a turnaround strategy, a few exogenous factors would ultimately impact Tesco's underlying fundamentals, putting the value of their strengths in question. First, the South Korean government instituted a law that prevented big box stores from opening during specific days of the week to protect mom-and-pop retailers. This had a massive impact on Tesco's financial results in the country and changed our outlook of their business there.

At the same time, two private discount food retailers – Aldi and Lidl – were making remarkable strides in taking market share in Tesco's European markets. To compete with these exceptionally well-run companies, Tesco and other food retailers were going to have to compete on price, which would exacerbate the financial impact of their market share losses. Unfortunately, we did not see these once-small domestic German companies coming – a grave error on our part.

Finally, in April, when Walmart's Asda announced they would combine with J Sainsbury PLC, creating the UK's largest food retailer, we sold our entire stake in Tesco. By then, it had become crystal clear that competition would continue to increase in all of Tesco's markets. For the company to be successful, Tesco would now have to fend off a larger domestic competitor, two ruthless foreign entrants, and a plethora of emerging online-grocery start-ups whose success would be measured in terms of rapid sales growth in hopes of creating profits in the future. In an environment where the big get harder to compete against and the small don't need to show a profit for years, if ever, we believe it's appropriate to invest capital elsewhere – and so we will.

School's Out for Summer

As if the last few months weren't busy enough with our portfolio, the team has stepped up their continuing education pursuits. The CFA level III textbooks were a staple in the office as an unusually late June exam drew near. I can say with confidence, we're all glad that exam is behind us. Also impressive is how many exams Corey MacGregor has written in the past few months. While most would say a summer of rest is in order, the IBV team isn't comprised of most people, so we'll be putting our heads down and driving forward. In September, you'll have to let us know how the weather was!

Sincerely,

Talbot Babineau, CFA
President & Chief Executive Officer
T: 416.603.4282 | tbabineau@ibvcapital.com

Disclosures:
This material is not meant to be, nor shall it be construed as, an attempt to define all terms and conditions of any transaction or to contain all information that is, or may be, material to an investor. IBV Capital Ltd. is not soliciting any action based upon this material, and this material is not meant to, nor shall it be construed as, an offer or solicitation of an offer for the purchase or sale of any security or advisory service. This material is not meant to be, nor shall in be construed as, a representation as to past performance, and no assurance, promise, or representation can be made as to actual returns. Past performance is not indicative of future results. Certain assumptions, data and projections have been made in the analyses that resulted in return scenarios and forward-looking statements included herein. No representation is made that all such assumptions, data, or projections have been considered or stated or that any of them will materialize. Changes to the assumptions, data, or projections may have a material impact on the returns shown by way of example. Forward looking statements should not be read as a guarantee of future performance or results and will not necessarily be accurate indications of the times as, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or good faith belief as of that time with respect to future events and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. The Fund's actual results or activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors, some of which may be beyond the control of the fund.