IBV
CAPITAL

Dear Partners,

In today's investment environment, we're comforted by our ability to invest in companies around the world and across their capital structure (equity, preferred shares, and debt). The benefits of this versatility are amplified by our historical tendency of maintaining a comfortably concentrated portfolio. From our perspective, combining these attributes makes fundamental sense in our effort to reduce risk and optimize returns.

While these are important considerations for assembling IBV Capital's portfolio, we've reflected on how our investment activities may impact a broader asset allocation strategy, where we represent only one piece of the proverbial pie. To gain a better understanding of this, we have explored how today's asset allocation strategies are formed and put into effect.

A good asset allocation strategy usually begins with identifying a specific objective. Only then is a strategy to achieve this objective decided upon. Almost always, this strategy incorporates building a portfolio of investments that are well diversified between asset classes, investment styles and geographies – we think of these as investment silos. While the exact weightings applied to these silos will differ, based on the desired objective and market conditions, a typical strategy will involve many different actively and passively managed funds.

When a diversified asset allocation strategy is put into effect, we have found that investors prefer to allocate only a small portion of their portfolio to any one fund; an allocation figure we frequently hear of is 2.5%.[1] To understand what this approach would mean to an investor, so let's use this weighting and apply it consistently across a broad asset allocation strategy. In doing so, it quickly becomes apparent that this will translate into having a portfolio of 40 different fund exposures.

What we wanted to further explore was how a seemingly innocuous decision to diversify among funds can lead to an explosion in the number of individual positions one holds. This proliferation is caused by fund managers executing their own diversification strategies when assembling their portfolio's. At the fund level, we often see managers allocating 2.5% to individual securities, increasing it to 5% for their high-convection investment ideas.[2]

[1] While only anecdotal, we have found a 2.5% allocation represents a commonly referenced investment allocation to a fund.
[2] Since these figures are generalizations, based on our familiarity with other funds, we would encourage investors to undertake the exercise of exploring how many individual positions are in each fund that they invest in to determine their total exposure.

If we take a step back and combine everyone's diversification efforts – 40 funds with 20-40 positions each – it equates to a broad asset allocation strategy having between 800 and 1,600 investments. That's a portfolio weighting of 0.06% to 0.13% for each security, assuming no duplications.

We contend that this hypothetical portfolio suffers from return dilution – a terminology we use to describe the notion that applying a modest weighting to great investment ideas will suppress their impact on overall performance. When this exists, we believe a portfolio has entered the realm of 'diworsification,' and adding a comfortably concentrated fund is warranted.

Living Between the Silos

The market value of our IBV Capital Global Value Fund increased by 2.7% in the third quarter of 2018, contributing to our year to date performance of 11.2%. Importantly, the intrinsic value[3] of our portfolio advanced 13.4% and 35.7% during the quarter and year to date periods, respectively. For comparative purposes, during the third quarter of 2018, the MSCI World Index advanced by 5%, bringing its year to date performance to 5.4%.[4]

As we pointed out earlier, at its core, the purpose of the asset allocation process is to assemble a portfolio that will achieve an objective. Today, this process has prompted many capital allocators to segment their portfolio's into investment silos – with each silo playing a specific role in achieving the overarching objective. In response, the investment management industry has seized the opportunity to create an endless array of investment products with mandates that fulfill the specific needs of each capital allocator's individual silos.

We have noted that both investment silos and their associated investment products have become more rigid in their design over time. This has created a market dynamic that makes allocating capital to unconventional investments very difficult – primarily because unconventional investments, by definition, don't naturally fit into investment silos, and therefore investment products. This means they're usually starved of capital and can often become mispriced. Conversely, conventional investments that fit neatly into a silo are flush with capital and more prone to being efficiently priced.[5]

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[3] 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.

[4] "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 7

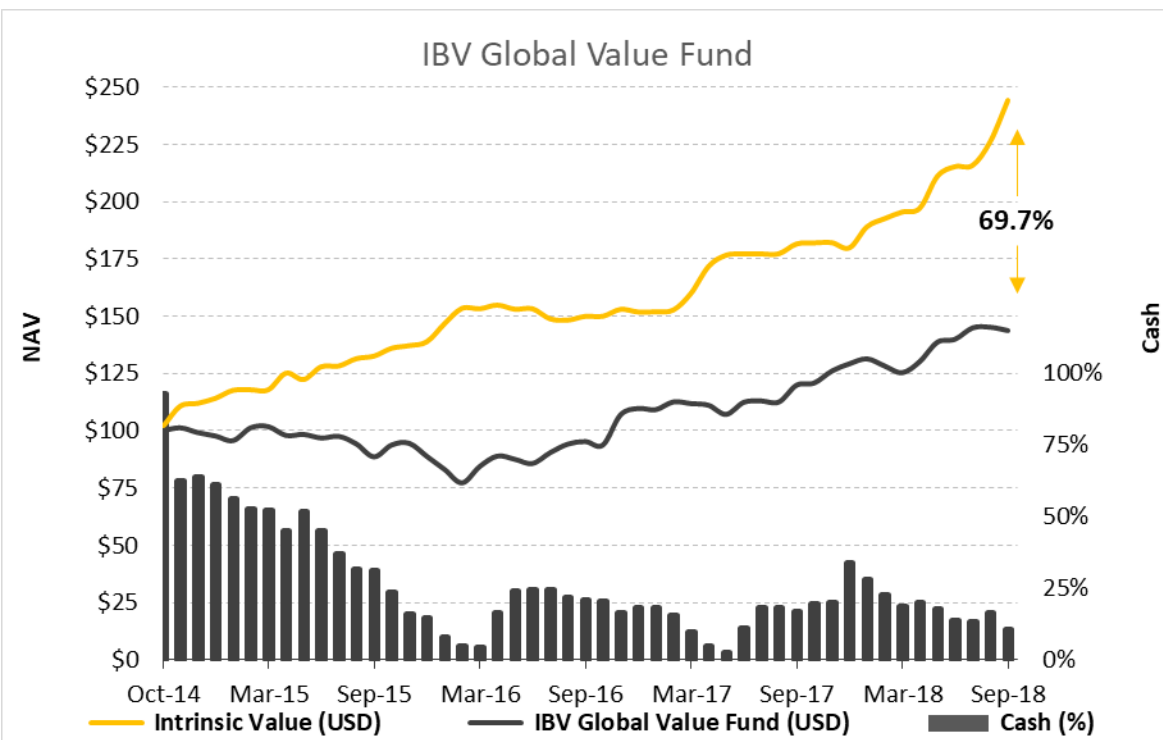
[5] There is a caveat to our observation. During periods of intense market stress, conventional and unconventional investments will both become mis-priced due to a general void of available capital.

This market dynamic begins to explain why we've been more frequently seeing efficiently priced conventional investment opportunities. This environment has in turn prompted us to increasingly shift our portfolio into unconventional investments that are dramatically mispriced.

For instance, our ownership stake in Ascendant Group, a security listed on the Bermuda Stock Exchange, falls well outside the geographical regions that garner investor attention. Another unconventional investment, which we are revealing for the first time, is our position in preferred shares of Brookfield DTLA, a downtown Los Angeles office REIT. This preferred share issue doesn't currently pay a dividend and therefore won't fit nicely into an equity or fixed income investment silo. These two investments, and others like them, are more than welcome in our portfolio.

From our perspective, the market structure we've identified will persist and continue presenting wonderful investment opportunities for us. However, we anticipate the frequency of sourcing these opportunities to be lumpy. This is as opposed to being awash with attractive investment opportunities, of all types, during periods of market stress.

Since our portfolio has shifted meaningfully towards unconventional and dramatically underpriced securities, we've seen a significant increase in its intrinsic value. While the market value of our portfolio has also risen, it hasn't kept pace with the intrinsic value. 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 has increased to 69.7%. One of the widest gaps in our fund's history.



Over the course of the quarter, we sold three investments (technically, we sold two and didn't fully exit the third until after the quarter ended), reducing the number of exposures in our portfolio to

12. Despite this decrease in investments, our cash position fell from 14.4% to 10.4% because we increased our investments in Ascendant Group, Brookfield DTLA preferred shares, and a select few other positions.

It's important to note that our portfolio is increasingly shifting towards securities with embedded catalysts.[6] Therefore, we should begin to exhibit less pricing correlation with the market. As well, the underlying economic fundamentals we've been adding to the portfolio are unrelated to our other positions and the market in general. For us, this meets the true definition of being uncorrelated. In today's investment environment, we are pleased to enjoy this stability and upside optionality.

Spring Loaded

We had more activity in our investment portfolio than usual over the course of the last quarter. This was a result of selling Footlocker, PG&E, and Exco Technologies, and purchasing more shares of Ascendant Group and Brookfield DTLA Preferred Shares.

Our investment in Foot Locker (FL) began in 2016. At the time, the market was extrapolating the growth of Amazon and decline of brick-and-mortar stores into perpetuity – concluding that the latter would die a slow and painful death. We determined that Amazon would be challenged to compete against FL's stores and online presence due to the company's close relationship with its main supplier, Nike. We also felt that FL's store sales were being negatively impacted by a dearth of new shoe styles, not Amazon's retailing prowess, but this would eventually improve with the anticipation of new platforms from Nike and renewed focus on strengthening their relationships with other trendy suppliers like Under Armour and Adidas.

What we failed to consider wasn't Amazon's strength, they're still a minor player in the premium sneaker space, but the effectiveness of Nike's direct-to-customer strategy. Specifically, Nike has done a remarkable job with their website and is aggressively driving sales through this channel. As Nike's success has continued, we began to sense it was going to be at the expense of FL. Considering the challenges FL was facing, we felt it was best to sell our position. It's important to note that we carefully considered the risks associated with an investment in FL and felt it was prudent to maintain it as a modest weighting in our portfolio. So, the loss we incurred has not been meaningful to our overall performance.

We also sold our small position in Exco Technologies, a Canadian based manufacturer of parts, castings and extrusions for the automobile manufacturing industry. Despite coming to an agreement on NAFTA, or shall we say USMCA, the changes to the automotive sector are pronounced. With Exco's manufacturing footprint heavily weighted towards Mexico and Canada, we envision this new dynamic will be a structural headwind. We also anticipate a dramatic change to the executive team, as Brian Robbins, a CEO whom we greatly respect, steps aside. All things

[6] Please refer to our Q1 2018 investment partner letter for our discussion on embedded catalysts

considered, we felt our capital could be allocated to opportunities with a more attractive risk-reward profile.

In the fall of 2017, a wildfire ripped through northern California's wine country. It soon became apparent that Pacific Gas and Electric Company's (PCG) transmission lines, which had arched due to high winds and hit nearby trees, were responsible for sparking the blaze. California's drought riddled landscape provided fuel to the fire and estimates of damages quickly reached $10 billion.

This devastating situation worsened further for PCG and its shareholders when California lawmakers showed a willingness to invoke the concept of "inverse condemnation." Inverse condemnation is a rare law, specific to California, that allows the State's government to take private property without paying compensation, as required by the United States Constitution. In the case of PCG and other California utilities, lawmakers could apply this law to make companies pay for damages caused by uncontrollable natural events – even if the companies weren't negligent in causing the damage.

Since our firm enjoys a core competency in regulated utilities investing, we followed all developments associated with the wildfire and revisited the storied history of California's energy market.[7] Following our assessment, we felt the application of inverse condemnation, to its fullest extent, was unlikely. This would not only limit the financial impact of the fire but create a positive regulatory precedent. We also understood that PCG's rate base, it's engine for earnings, wouldn't be impacted. Finally, the stock price had fallen far too much considering the underlying business was intact. Combining these factors, we chose to make an investment.

Almost immediately following our investment, lawmakers and regulators began reviewing whether applying inverse condemnation was a responsible approach to protecting customers from higher electricity rates. PCG also began taking steps to strengthen their balance sheet, such as cutting their dividend, in preparation for potential legal liabilities. These activities began to stabilize the outlook for PCG, and its share price increased correspondingly. At this point, we had made a reasonable return in a short timeframe. Since risks remained, and future return potential had diminished, we decided to exit the position.

Staying with utilities, our investment in Ascendant Group (its main subsidiary is Bermuda Electric Light Company) continues to go well.[8] Management has begun executing efficiency initiatives in earnest, which should greatly improve operational performance. Construction on the North Power Station is also underway, and importantly it is being financed with debt to help optimize the company's balance sheet.

We also combed through the Regulatory Authorities tariff methodologies which was released in October. This regulation determines how BELCO will earn income moving forward. As expected,

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[7] As you may recall, in 2001 Enron's improprieties played a role in thrusting PCG into bankruptcy, costing the utility's customers billions in higher rates over the subsequent years. This bankruptcy event has deeply scarred the electricity industry in California.

[8] If you'd like to refresh your memory on our Ascendant Group investment thesis, we would recommend you listen to our Money Talk interview through the following link: https://soundcloud.com/johnbudden/talbot-babineau-money-talk-on-october-28-2018

it will be a return on rate base methodology, which is consistent with a sophisticated western utility regulatory framework. Since this will effectively lock in a reasonable level of profitability for the company moving forward, we are pleased with the direction Bermuda's regulator has taken.

We also increased our position in Brookfield DTLA Preferred Shares. A little history is required to understand how this unique situation has come to pass. Prior to 2008, renowned L.A. developer Robert Maguire, through his company, Maguire Properties, was a dominant player in the downtown Los Angeles prime office space market. Unfortunately, Maguire Properties made a common critical error in real estate: using too much leverage to pay top dollar to expand their office building portfolio. The combination of these activities left the company financial unstable when the Great Recession hit.

Now in considerable financial distress, Maguire Properties, which was re-named MPG Office Trust, needed to generate cash to pay back creditors. They would be forced to take drastic measures: selling multiple office buildings and eliminating the dividends they were paying to both common and preferred shareholders. Unfortunately, this wouldn't be enough, and they would eventually sell the last of their buildings to Brookfield Asset Management – one of the world's preeminent real estate investors – for inclusion in a new fund called Brookfield DTLA Fund Office Trust Investor.

The acquisition by Brookfield re-capitalized the company's troubled balance sheet. This new financial flexibility has allowed Brookfield to execute on an extensive rejuvenation of these downtown Los Angeles office buildings. This has included refreshing lobbies, adding high-quality shopping concourses, and improving tenant amenities. This, along with Brookfield's 70% market share in downtown LA office space, helped them stabilize the assets and improve net operating income.

While all these value enhancements have occurred, the dividends on DTLA's preferred shares have not been reinstated. In fact, because these preferred shares are cumulative, they have been accumulating dividends at 7.6% per annum since the fourth quarter of 2008, when the dividends were originally eliminated. This means that at the end of the current quarter, on a par value of $25, a total of $16.66 in accumulated dividends are owed to the holders of these preferred shares. We are among them.

So, why hasn't Brookfield paid these dividends out yet? Well, according to the prospectus, Brookfield is not required to pay any dividends (to common or preferred shareholders). However, the prospectus also states that if a common shareholder – that's Brookfield itself as well as their fellow fund investors – would like to extract a profit from the fund by selling the buildings or through a payment of a common share dividend, they are required to pay preferred shareholders their annual dividend and any accumulated dividends first.

Since Brookfield is turning these buildings around, and we assume they'd like to profit from their efforts, we anticipate that Brookfield will pay preferred shareholders their accumulated dividends. We expect this to occur towards the end of the fund term in 2023 – though we're prepared if this term is extended. If we're to collect our $25 par value and all accumulated dividends in 2023, or shortly thereafter, we'd expect to earn between an 11.6% and 16.6% annualized return. To us, this investment exhibits a reasonably low-risk profile considering the strong return potential, which should be generated regardless of broad market movements.

Onward and Upward

This quarter was filled with successes and additions. First, I'd like to congratulate Thomas Wnuk and Brandon Thimer for successfully completing their CFA level III exams. It's an impressive achievement, and we're proud of the tremendous studying efforts they put forth. As well, we'd like to introduce everyone to Kazi Hassan who joined us from Citco and will be supporting Corey with all aspects of our operations. We're delighted by the contributions he's already made to the firm.

Sincerely,

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