*This is an excerpt from our Annual Report which was mailed to all Partners in March*

# The McElvaine Investment Trust

## 2020 Annual Report

***The McElvaine Investment Trust ("the Trust")***

The McElvaine Investment Trust is a RRSP eligible fund. The Trust was formed on September 27, 1996 with the following philosophy:

1. Highly satisfactory longer-term performance can be achieved by focusing on companies selling below net asset value.
2. The purpose of an investment vehicle is to make money not to own stocks. This is an important distinction because it means the Trust will only invest when presented with an attractive situation.
3. As there are few good ideas, there are times when concentration may be helpful.

Further information is available at our website:

**www.avaluefund.com**

*Cover Photo by Micheile Henderson on Unsplash*

## The McElvaine Investment Trust
## Annual Performance Summary as of 31Dec20 (5)

| Full Calendar Year (5) | Net Return Series B Units (1)(2)(3) | BMO Canadian Small Cap Index | S&P/TSX Total Return Index | Average Cash Balance (4) |
|---|---|---|---|---|
| 1997 | **12.8%** | 6.3% | 15.0% | 59% |
| 1998 | **16.6%** | -18.6% | -1.6% | 27% |
| 1999 | **29.5%** | 19.1% | 31.6% | 26% |
| 2000 | **19.2%** | 6.3% | 7.4% | 9% |
| 2001 | **28.0%** | 2.5% | -12.6% | 2% |
| 2002 | **5.0%** | -1.6% | -12.4% | 5% |
| 2003 | **28.2%** | 41.6% | 26.7% | 14% |
| 2004 | **8.6%** | 13.2% | 14.5% | 23% |
| 2005 | **17.2%** | 18.8% | 24.1% | 13% |
| 2006 | **11.9%** | 13.6% | 17.3% | 11% |
| 2007 | **0.6%** | -1.2% | 9.8% | 9% |
| 2008 | **-48.8%** | -48.6% | -33.0% | 6% |
| 2009 | **18.1%** | 68.9% | 35.1% | 17% |
| 2010 | **1.8%** | 35.2% | 17.6% | 6% |
| 2011 | **-13.4%** | -16.2% | -8.7% | 10% |
| 2012 | **18.3%** | -0.5% | 7.2% | 18% |
| 2013 | **19.1%** | 4.3% | 13.0% | 31% |
| 2014 | **6.0%** | -2.8% | 10.6% | 26% |
| 2015 | **-9.8%** | -16.3% | -8.3% | 18% |
| 2016 | **4.1%** | 31.9% | 21.1% | 18% |
| 2017 | **25.0%** | 4.0% | 9.1% | 26% |
| 2018 | **-17.2%** | -20.3% | -8.9% | 20% |
| 2019 | **8.2%** | 16.1% | 22.9% | 17% |
| 2020 | **6.3%** | 5.6% | 12.9% | 17% |

*Notes:*

(1) *A discussion of the returns of the Trust can be found in the Management Report on Fund Performance.*

(2) *The performance shown above includes results prior to December 23, 2019 when the Trust was not a reporting issuer. Had the Trust been subject to the additional regulatory requirements applicable to a reporting issuer during such periods, the expenses of the Series B units of the Trust would likely have been higher. Moreover, prior to becoming a reporting issuer the Trust was not subject to and did not fully comply with the investment restrictions and practices set out in National Instrument 81-102 Investment Funds ("NI 81-102"). The Trust's non-compliance with NI 81-102 may have impacted the Trust's performance for the period prior to the Trust becoming a reporting issuer. The financial statements for the period when the Trust was not a reporting issuer, are available on the Manager's website at www.avaluefund.com or upon request.*

(3) *For Series B only as there were no Series A, D or F outstanding prior to December 31, 2019.*

(4) *"Average Cash Balance" is our estimate of the average of the month-end cash and short-term bond balances held by the Trust. We have included this to allow you to assess how the Trust was invested in order to generate the returns shown.*

(5) *The Trust's inception date was September 27, 1996. The performance summary only includes only full year returns and thus does not reflect the 3 month period in 1996. Please see the Management Report on Fund Performance.*

**Friendly disclaimer:**

*Simply put:*

- *Our Annual Report contains forward looking information. I will not update this report even if my view changes.*
- *While I believe my comments and facts to be accurate, you should not rely on them without doing your own work.*
- *While I would be delighted if this report encourages you to consider investing in or adding to your investment in The McElvaine Investment Trust, the Trust is only sold via Prospectus. Further information is available on our website: www.avaluefund.com*

*And less simply put (our required disclosure):*

*Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total return including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional changes or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.*

## The McElvaine Investment Trust

## To my Partners:

For a change of pace this year, I thought I would break my comments into 3 sections:

1. A “letter” I received from myself dated 2030. Of course, this is just a fictional view of how things may unfold but does reflect both my views and perhaps “hopes”.
2. A discussion of some of our larger holdings; and
3. Other items.

Regarding our performance, the Series B units rose by 6.3% in 2020. Things are progressing well so far in 2021 with the Trust rising some 11% to the end of February. On our website, you will find our Management Report on Fund Performance which discusses our 2020 performance in more detail.

Now onto my “letter from the future”:

> *February 2030*
>
> *Dear Tim:*
>
> *I thought I would reach out to let you know how things unfolded in 2021 and beyond. By the way, I am still working on losing those 20 lbs you put on during the lockdown. I don’t think apple fritters are a fruit substitute.*
>
> *Covid is still around although we get an annual covid/influenza booster shot. You will be happy to hear we have not had any further significant pandemics since 2020. On the other hand, we have had a lot of issues with cyberattacks on our grid and financial system. This has caused problems but I digress.*
>
> *Post covid, travel and the economy did come back but not as much as people expected. I guess people continued to be a bit cautious during 2021 and 2022. FYI, I am still waiting for our refund for that flight I booked in 2020. I understand the airline will issue this shortly.*
>
> *I know you are more interested in what happened with the stock market. Well, the amount of government spending and debt did eventually cause us some difficulty.*
>
> *Looking back at 2021, I am reminded of a scene in the movie “The Pink Panther Strikes Again”. You may recall Peter Sellers enters a hotel and sees a dog. He then asks the clerk if his dog bites. The clerk says no. Peter*

*Sellers goes to pet the dog and gets bitten. When Sellers complains, the clerk's response is very simple: "that is not my dog".*

*The dog or "false premise" in the 2021-2023 timeframe was interest rates. Investors saw rates were low and then assumed rates would remain low* <u>*indefinitely*</u>*.*

*Well, "indefinitely" is a very long time. It did not require a lot to change interest rate expectations. Was it inflation? A reappraisal of the risk premium? Or simply demand & supply in the bond market? I will let you find out the answer yourself but the impact on some portfolios was significant.*

*The hedging you were putting in place in early 2021 did help the Trust's performance but you were a bit early. I know it was hard being a wallflower when other investors were doing the "Tesla Tango", "Facebook Floss" and "Bitcoin Boogie". You will be happy to note the "McElvaine Macarena" did come back in style.*

*As you entered 2021, you were entering your 25th year of managing the Trust. I think you may find the years which followed 2020 similar in some ways to the period after the dotcom bust. You will recall this was a good period for the Trust.*

*In closing if I could give you one piece of advice it would be to spend more time communicating with your investors. They are a great group and I know you appreciate them.*

*Take care of yourself and please lay off those baked goods.*

*From: Tim in 2030*

<u>Portfolio Update:</u>

I hope you enjoyed my "fictional" letter. 2020 certainly was an unusual year. Below I discuss our largest holdings and have updated the portfolio information to the end of February 2021.

- Jefferies Financial – 11% of net assets (cost – US$16.18, market – US$29.04)

  I view JEF as having 4 parts: a broker/dealer in bonds and equities, an investment bank, an asset manager and a collection of "extra assets". The tangible book value of the first 3 parts ("core") is approx. $21 per share and the value of the "extra assets" I believe exceeds $10 per share.

About 3 years ago, JEF embarked on a process to dispose of its extra assets and refocus on its core business. Since then JEF has returned over $3.4Bn to shareholders through dividends and accreditive share repurchases. I expect this process to continue with a conclusion sometime in the next 24 months.

As you can imagine, the core business has had record earnings recently. There is no shortage of securities to be issued and companies to be restructured. If JEF can show it is able to consistently earn a double digit return on this core business, JEF is worth a significant premium to its tangible book value. This is not lost on the insiders. The Board effectively owns some 46 million shares currently worth about C$1.9Bn.

- Tourmaline Oil – 9.4% of net assets (cost - $13.26, market - $23.16)

  TOU is Canada's largest natural gas producer. I realize TOU operates in a commodity business. We have two things in our favour. One, our purchase price was attractive as we paid less than a reasonable estimate of the liquidation value. Secondly, TOU benefits from a virtuous circle. Its low operating and drilling costs produce significant free cashflow. This cashflow combined with a significant infrastructure base and a large undeveloped land bank allows TOU to be selective with its drilling which reinforces its low cost structure. An additional advantage as Mike Rose (Chairman and CEO of TOU) reminded me the other day is the distribution and sales business of TOU. This is a hidden asset which allows TOU to achieve selling prices above its peers.

  It pays to invest with good people. TOU was able to take advantage of the crisis and has exited 2020 as a much stronger company both strategically and financially. For example, with a resource company it is easy to confuse return <u>on</u> capital with return <u>of</u> capital. If we look at TOU on a <u>per share</u> basis, I estimate the following has taken place over the last 5 years:

    - Forecast Production per share has increased by almost 50%;
    - Reserves per share have more than doubled (2P Mboe);

- Operating expenses per boe have fallen by 28%; and
- Debt per share (net of value of Topaz) has fallen by about 1/3.

I realize there are ESG issues with owning a fossil fuel company. Among Canada's senior producers, TOU has the lowest CO2 emissions and emission intensity. Further TOU recently received a MSCI Global ESG Performance Ranking of "A" for sustainability and environmental initiatives. While I appreciate this is a work in process, I believe if we are going to use natural gas, we ought to source it from the best-in-class operators. TOU is firmly in this arena.

Investors are uncertain about the long-term demand for oil. In contrast, demand for natural gas continues to increase primarily due to power plant conversions and LNG export demand. There could also be a significant opportunity with hydrogen which I will discuss below. Finally, TOU insiders own shares worth over C$400mn and were buyers during 2020 and into 2021.

- Maxim Power – 9% of net assets (cost - $2.57, market - $2.18)

  Maxim Power operates a 204 MW simple cycle power plant located in Alberta. (A simple cycle plant operates on a standby basis and produces power only when rates are attractive). 2020 was significant for Maxim as prior to June, Maxim's facility had been coal powered. It is now natural gas powered. This significantly reduced both their cost structure and of course their CO2 emissions.

  Through a combination of free cashflow and the receipt of long outstanding reimbursements, I expect Maxim Power may be close to debt free by mid-year. This flexibility will allow Maxim to consider a number of alternatives. Outside of continuing its share repurchases, I expect Maxim to add a heat recovery unit which will allow them to convert their facility to combined cycle. (combined cycle produces a constant amount of power). In addition, Maxim has a number of other potential projects including a wind farm.

I believe the sum of the parts of Maxim Power is higher than its current price. It appears insiders agree with me; in 2020 insiders purchased over 4mn shares. I am quite comfortable being a junior partner to Bruce Chernoff, Brett Wilson and other insiders who own some 67% of Maxim's shares.

- Wintaai Holdings – 6.9% of net assets (cost- $18.45, market - $23)

  Wintaai owns a workers compensation insurer based in Louisiana. Francis Chou controls over 90% of Wintaai. Francis knocked the ball out of the park in 2020. An insurance company has two legs: the insurance operation with profitability measured by the combined ratio and the investment portfolio. Both performed strongly. This was achieved even though Wintaai is writing well below capacity.

  Wintaai is not listed on any stock exchange. A benefit of investing in the Trust is not only do we own listed value stocks but we also have a slice of our money in Francis' insurance company. Our listed portfolio is valued based on market prices. The valuation of Wintaai is a bit tricker. I believe the fairest approach is to value Wintaai at 1.1x its latest reported book value. I continue to believe Wintaai is a gem in our portfolio.

- Whitecap Resources 4.8% of net assets (cost - $2.12, market - $5.63)

  We invested in TORC Oil in early 2020. In February of 2021, Whitecap acquired TORC by issuing 0.57 shares of WCP for each share of TORC. For the purposes of today's discussion, I will focus on Whitecap.

  WCP is unique among O&G producers as it actually sequesters more carbon than it produces, a negative emitter so to speak. While the market does not really focus nor value this aspect of WCP, I think it is a hidden asset. I recently spoke with Grant Fagerheim, CEO of WCP. We spent time discussing WCP's sequestering operation. I believe there is a lot of opportunity in this business.

Perhaps it is fitting I discuss hydrogen at this point. I do not know if hydrogen may eventually displace some usage of fossil fuels. A significant amount of capital will need to be invested for this to occur. If the amount of hydrogen used does increase, we may benefit.

While hydrogen may be an attractive way to meet global emission targets, producing hydrogen can be messy. The two environmentally favoured approaches are green hydrogen and blue hydrogen. Green hydrogen uses energy to split water via electrolysis into hydrogen and oxygen. This requires a significant amount of water and power. Ideally to be “green” power would likely be sourced from hydro-electric dams. Blue hydrogen is produced from natural gas with carbon emissions being sequestered thus minimizing the environmental impact.

I do not think this is a winner take all scenario. I expect there to be both green and blue hydrogen used. Given the cost, water and energy requirements of green hydrogen, I suspect it will end up meeting say 1/3 of potential hydrogen demand. This leaves primarily blue hydrogen to make up the difference.

By the way, I do not expect hydrogen cars. In Canada, I envision hydrogen being used in industry (such as the oil sands, chemicals, cement, and fertilizer), in replacing diesel in some commercial transportation and perhaps being blended (at 10% or 15%) with natural gas for heating. The biggest opportunity for Canadian hydrogen will be the export market.

In the Trust, we own two key “bookends” to the production of blue hydrogen. Tourmaline’s low-cost natural gas will be an important input. Whitecap with its experience in the sequestering of carbon and the use of enhanced oil recovery may play a role in dealing with the “carbon waste” from hydrogen production. As mentioned, I do not know if hydrogen will be an important fuel in the future. If it is, we are paying nothing for this option in our holdings of Tourmaline and Whitecap.

- CK Hutchinson – 4.3% of net assets (cost - $46.87, market - $58.60)

  CK Hutchinson is a holding company controlled by Li Ka-shing. It is now run by his son, Victor Li. CKH owns several businesses:

  1. Telecom – A global telecom group serving roughly 100mn customers via operations in 6 European countries, Hong Kong, Macau, Indonesia, Vietnam, and Sri Lanka. I estimate the Telecom operations in aggregate represent over 40% of the value of CKH;
  2. Retail – Their retail operations sell health, beauty and personal care products in 23 countries via some 16,000 stores. I estimate retail represents about 20% of CKH's value;
  3. Ports - CKH is one of the two leading port operators in the world handling some 7% of global container shipments. I estimate the port operations represent about 20% of CKH's value;
  4. Other businesses – Included in this segment are their holdings in a number of other businesses including a listed infrastructure company and Cenovus Energy. You may recall CKH was a large owner of Husky Energy. In 2020 Husky was merged with Cenovus. Cenovus represents less than 3% of my estimated CKH value.

  Clearly the retail and port operations were hurt by the pandemic. Outside of this, CKH did not stand still and cleverly disposed of their European cellular towers for about EUR10Bn. At the time of its sale, this represented about ¼ of the enterprise value of CKH. A hidden asset indeed.

  CKH exited 2020 with its balance sheet in good shape and an improved earnings outlook. In sum, CKH is thoughtfully run, owns unique assets, pays a good dividend, and sells at a single digit PE. It is cheap.

Wrapping up this note:

The best way to keep in the loop with us is via email.  If you do not receive emails from us, please let us know and we will add you to our list.

As you read through this report and think about your investment with us, I hope you conclude our approach is straight forward, disciplined, and understandable. While we are not an ESG fund, I am careful where we invest and call us “a value fund with values”. Finally, our interests are aligned as our fee structure rewards performance and not simply asset growth.

We are now issued via prospectus. A key reason for doing this was to allow investors to purchase and hold their investment in the Trust wherever they like. If you would like to transfer your units to an account where you have other investments, please let us know. If you are interested in making or adding to an investment, you are now able to do it directly via your financial advisor or with DIY brokers such as Qtrade, Questrade, Scotia iTrade, National Bank Direct, RBC Direct and TD Direct. The Trust is RRSP, RRIF, RESP and TFSA eligible. Please contact us if you have any questions or problems.

Most importantly, thank you for your trust and friendship. I appreciate it.

Warm regards,

Tim McElvaine

March 12, 2021

# *<u>How we Invest</u>*

*Our investment approach is centered on four items (affectionally called "ABBA"). We prefer to invest when we have:*

*(a) a competitive advantage when making the investment (such as a seller who does not care about the price they are getting). We call this the accident or "A";*

*(b) observable investment value which exceeds the share price at the time of purchase (no financial spreadsheet gymnastics involved). We call this a bird in hand or "B";*

*(c) a financial position ideally combined with strategic position which provides staying power. We call this the brick house or "B"; and*

*(d) a board of directors and management team which is owner-focused with "skin in the game". We call this alignment of interests or "A".*

*Our process does not rely on macro forecasting or economic predictions.*

## *Why Invest with Us*

*Our approach is focused, and our interests are aligned. Many firms and ETFs invest automatically with little regard for value. Other firms have multiple funds and their fund managers look after several funds. Are these firms interested in asset growth or your investment returns? Do the portfolio managers have their money in the same place as you? When they manage several funds, how do you know you are in the right one?*

*With The McElvaine Investment Trust:*

- *We are experienced value investors;*
- *We get paid when we perform;*
- *We invest our money alongside yours;*
- *We care how our investees make their money;*
- *We do one thing and only one thing: value investing.*

*If you have any questions or would be interested in an Investor Package, please call or email us at info@avaluefund.com*

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