



## Tim's "We are here" sheet

30Jun09

### To my Partners:

It has been a humbling two years, and I feel somewhat frustrated today as I believe we own a number of cheap stocks. Some of our holdings, for example, Sotheby's, have performed strongly. Unfortunately, our two largest positions have not. Below are our three largest positions and their performance since December 31, 2008:

Indigo	+2%	(14% of NAV at 31Jul09)
Glacier	-20%	(13% of NAV at 31Jul09)
EGI	+33%	(10% of NAV at 31Jul09)

In the past two months, I have met with senior management of each of the above. Indigo continues to upgrade their stores and invest in other formats. Their accounting is conservative and what some companies might capitalize as investments, they expense. Same store sales continue to increase. Glacier continues to generate significant free cashflow as well as look for opportunities among their fallen competitors. EGI faces an improving competitive environment as the standard insurers retreat from non-standard auto insurance. Like Glacier and Indigo, their accounting is conservative.

So why have these stocks not performed better? I suspect they suffer from a small cap discount. While this is disappointing, it does not concern me. It has been my experience that this changes. When it does our gains will be substantial and while we wait, I believe management owners are growing the underlying value, even in this environment.

I do not think I can be faulted for owning these securities. One may however fault me for perhaps owning too much of these securities. Certainly our performance was better in the early years when my position sizes were 5% to 10% of NAV rather than 10% to 15% of NAV. Our choice today is to either reduce these positions and diversify the portfolio a little more or wait. My approach, albeit a small change from our previous approach, is to limit new positions to under 10%, ideally 5% to 7% of NAV, but not reduce our large legacy positions. They are just too cheap.

I also refined our investment approach somewhat, and earlier in the year put together an investment "checklist" which I use for new investments. The purpose of this list was simply to remind myself what worked, and what did not, as I go into a new investment. Certainly my memory is not what it used to be so this crutch helps!

Simply put, my focus, known as my ABBA approach, is as follows:

- A Accident: As I try to focus on nightmares not dreams, I want to buy from sellers who just want out of a stock and are selling without caring about price. I also want to understand why they are selling.
- B Bird in hand: The question is what are we getting today that gives us a margin of safety. I also try to understand whether intrinsic value is growing (bird in bush) but we need a bird in hand today to invest.
- B Brick house: If you recall, I have talked in the past about the three little pigs and how the brick house survives the wolf. We are value investors so we deal in fix-me-uppers. The roof will be leaky, the shutters falling off, the paint peeling but that is what gives us a low entry price. If the foundation (or bones, so to speak) is good, that gives me the confidence to invest.

McElvaine Investment Management Ltd.  
Suite 463, Three Bentall Centre  
595 Burrard Street, P.O. Box 49308  
Vancouver, B.C. V7X 1L3  
[www.mcelvaine.com](http://www.mcelvaine.com)

Phone: (604) 601-8345  
Fax: (604) 601-8346  
E-mail: [tim@mcelvaine.com](mailto:tim@mcelvaine.com)  
[kim@mcelvaine.com](mailto:kim@mcelvaine.com)  
[diann@mcelvaine.com](mailto:diann@mcelvaine.com)

- A Avoid Lola: In the 70s, there was a great Kinks tune called “Lola” which was about a young man who meets a girl in a bar. They have a nice chat, he buys her a drink, they dance and one thing leads to another. Of course, our hero of the moment then discovers that Lola is not a woman but in fact a man. Not a good outcome for dating! How this applies to investing is that I want to understand where management is coming from up front. I don’t want to be surprised in, let’s say, the final act!

To put a little more meat on the bones, I applied this approach to our investment in Sotheby’s:

- A Accident: Sotheby’s fell from about \$55 to as low as \$6 or so (our average cost is \$7.60). Investors had been expecting earnings I suspect north of \$4 per share and they came in closer to 44 cents. This was the accident.
- B Bird in hand: Sotheby’s owns real estate in New York as well as on New Bond Street in London. I estimated the market value of this real estate and added in Sotheby’s current assets and investments then deducted all debt including mortgages. This gave me an “asset value” of approximately \$12 per share. As our cost of investment was about \$7.60, we were, in effect, paying negative for Sotheby’s business. The asset value plus the value of Sotheby’s business is the bird in hand. The large discount we paid from this is our margin of safety.
- B Brick house: Sotheby’s and Christie’s have about 98% of the auction market in fine art. Over time, Sotheby’s has earned significant returns on capital. It is a “toll both” on the art auction market. It is definitely a cyclical business but not necessarily a poor business. There are issues with Sotheby’s but its business has a pretty good foundation.
- A Avoid Lola: While the Sotheby’s management compensation scheme is not ideal, there was insider buying by directors when we were buying. Further, Sotheby’s is not controlled and I suspect it would be an attractive trophy for the wealthy art collector who wants respect.

We acquired a position in Sotheby’s of approximately 5% of the Trust’s NAV in the early part of 2009. We disposed of our last Sotheby’s shares in early August at approximately \$15. It was a reasonably good outcome for us and I hope this discussion has given you a better idea of how we approach our new investments.

I have received a number of calls asking where I think the economy is headed. I of course don’t have a clue. I suspect, however, that Winston Churchill’s quote from the 1940s might work in this environment:

*“Now is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.”*

Having said that, I have 100% of my investments in our stuff meaning our funds and shares of Rainmaker. Your returns are my returns.

### **The McElvaine Investment Trust:**

The 30Jun09 price for the Series B units of the Trust was \$14.23. This represents a gain for the first 6 months of 2009 net of all fees and expenses, of 3.6%. During this period, the TSX Total Return index rose by 17.6%.

### **Conclusion:**

As always, many thanks for all your support and confidence. I appreciate your trust.

All the best,



Tim McElvaine  
02Aug09