TONUS CAPITAL INC.

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# FOURTH QUARTER 2022 - NEWSLETTER

Dear Partner,

We are pleased to share with you our portfolio review and commentary for the fourth quarter of 2022.

## Performance

During Q4, the TONUS PARTNERS FUND registered a gross return of **11.3%**. For the year, the Fund's gross return is **3.5%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a gross annual compounded rate of return of **9.4%**, compared with **7.0%** for the benchmark.[2]

## A very strong finish

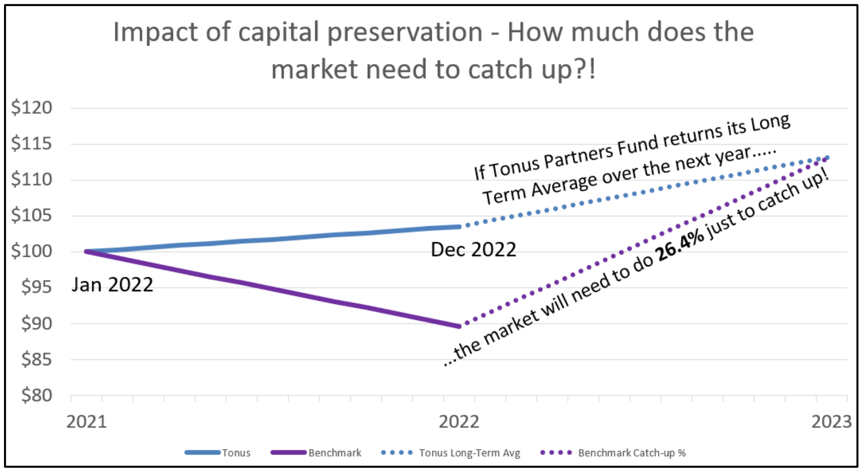
Under most circumstances, finishing up the year with a return of +3.5% would be considered disappointing for an investment fund. However, in a year like 2022 when asset prices all around collapsed by 10%, 20% and more, managing not only to protect your capital, but also to finish in the green, is more than just satisfactory – it is excellent. In fact, our fund finished in the top quartile of all North American equity strategies and finished second on the Emerging Managers' Board ranking of traditional managers in Canada. The fund had a stellar showing in the last quarter. Its unit value jumped 11%, bringing its appreciation in the second half of the year to 20%!

A year like the one just ended is a testament to our value investment style. Not only do we look to invest in sound businesses run by competent managers, we also seek to buy in when their stock is undervalued by the market. This provides us with a margin of safety in case internal or external factors take a sudden turn for the worse, in other words, the cheaper the stock when you buy it, the less money you can potentially lose. This is exactly what happened this past year: the economic environment deteriorated, inflation flared up and stayed high, and interest rates rose along with the cost of capital. The margin of safety came in handy and our portfolio navigated these challenging waters extremely well thanks largely to our investment approach, our structured process, and buy/sell discipline.

[1] Please see page 5 for a description of the Composite.
[2] Please see page 5 for a full description of the benchmark along with its historical returns.

### Value investing

It is in a year like 2022 that one can gain a genuine appreciation for value investing. Because it is rarely spectacular and it does not produce eye-popping results, the value approach never gets much credit in the media. Growth investing, because of its periodically extreme returns (positive or negative), gets all the attention. However, most investors have a long-term investment horizon.




And the majority also suffer loss aversion, which means losing money affects the investor stronger than making money does. Consequently, their investment strategy should centre on capital preservation and multiyear compound returns, the two elements necessary for wealth creation. Value investing has been proven time and again to be the way to go to come out on top in the long run. To put this into perspective, we are starting 2023 looking to grow your capital further. Most other funds, instead, will need double-digit returns this year just to make up their losses from last year! As shown on the graph, the benchmark (or the average fund) would need a sensational year of +26% to catch up to us (e.g. if our 2023 performance is similar to our 15-year average.) As the most famous value investor once said:

*"Rule #1: Never lose money. Rule #2: Never forget rule #1."* - Warren Buffett

Since the inception of our strategy in 2007, there have been five calendar years where the market posted a negative return. In these five years, our portfolio outdid the benchmark by 10.1% on average. In three of the five years, the difference meant that we ended up in positive territory. **The ability to compound wealth consistently over time with no major irrecoverable losses is a crucial part of our investing ethos**.

| Returns during Years of Negative Returns for the Benchmark since Inception | | | |
|---|---|---|---|
| | Tonus Return | Benchmark Return | Relative Outperformance |
| 2007* | 2.0% | -4.3% | 6.3% |
| 2008 | -4.0% | -29.6% | 25.6% |
| 2011 | 3.8% | -5.7% | 9.5% |
| 2018 | -11.7% | -6.7% | -5.0% |
| 2022 | 3.5% | -10.4% | 13.9% |
| * partial year | | | Average Outperformance 10.1% |

### A (very) busy and active year in review

In a normal year, our portfolio turnover, that is, the percentage of our holdings that change, averages 33%. Of the 20-25 stocks we hold, we will typically replace about seven. Last year was anything but normal. We were more active than usual in order to take advantage of the market's volatility. Of the 24 holdings we owned to start the year, only half were still in the portfolio at year's end. Three companies were taken private at nice premiums (IBI Group, Houghton Mifflin, Recipe Unlimited). Our active management led us to add 10 new names with a higher-quality business model and/or a lower stock price valuation. As long as uncertainty lingers, there will be volatility. When asset prices fluctuate wildly, it creates opportunities for stock pickers like us. In such a context, you can expect us to be quite active.

In our January 2022 letter, we highlighted that we were bullish on small caps because they had significantly underperformed the market in 2021. Consequently, we remained heavily invested in small caps, but they were not the reason for our strong performance last year. In fact, they underperformed again, albeit by a smaller margin. Nevertheless, we continue to believe that this category is poised for better relative returns in the years to come given their current lower valuations.

In April, we pointed out that inflation could be a problem and explained how we had positioned our portfolio to protect it accordingly. Pivoting towards companies with business models that allowed them to pass on cost hikes, with little or no debt, and which were trading at a decent stock valuation was clearly the way to go in a rising interest rate environment. These moves proved judicious.

In July, we set our focus on earnings and valuation. Stocks had come down considerably and pessimism was running high among investors. It was time to be rational and to weigh the lower stock prices against earnings power. In such an environment, picking the right individual stocks and disregarding the market as a whole is key. Highly volatile markets are the best playground for our approach.

Finally in October, we stressed the importance of staying in the game, that is, the need to remain invested. While the short-term economic outlook was not bright, in many cases, stock prices were already discounting bad news. Trying to time the market perfectly is impossible, and we did not try to be too cute, either; we stayed invested while remaining active by making changes to our portfolio. In the end, the fourth quarter with its double-digit return turned out to be the seventh-best quarter in our history.

### If the shoe fits

One of the changes we made in the fourth quarter was the addition of a new position: **Caleres (CAL - $22.28)**. Previously known as the Brown Shoe Company, Caleres runs a well-oiled, profitable chain of retail footwear stores (Famous Footwear) and owns and operates several iconic footwear brands (e.g., Allen Edmonds and Naturalizer).

What attracted us to the stock was primarily its valuation. Our $22 purchase price represents a lowly 5.5x multiple of our calculated normalized earnings. We believe the market is failing to recognize the improvements the company made to its cost structure during the pandemic, primarily by closing underperforming stores. This expanded operating margins by about 500 bps (5%) and we believe the company can maintain earnings per share above $4 for the foreseeable future.

We also believe that investors do not understand the company's market positioning and where it stands relative to brands such as Nike. Shoe retailers face the threat of brands selling directly to consumers. However, the risk is a real one primarily for retailers that carry higher-price-point items. Caleres does not carry this category of product. We believe brands will continue to use retail partners to sell entry-price-point products, which are the bread and butter of CAL's retail operations.

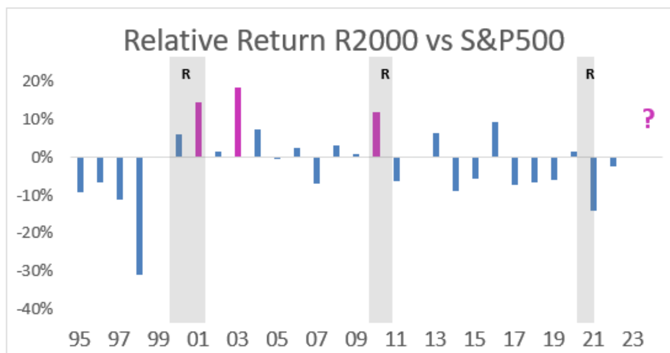
Finally, under a blue-sky scenario, we see significant earnings growth if Caleres finds a way to increase cross-selling between its stores and brands. The brands they own currently represent 6% of store sales. Were it to increase to 10% and subsequently 20%, it would bring in revenues with much better margins. In any event, our purchase price provides an ample margin of safety should these assumptions prove optimistic.

### Looking ahead to uncertain times

As we start this New Year, we remain focused on finding value or, in simpler terms, sniffing out good deals. The worldwide economy is pressured on many fronts: inflation, cost of capital, on-shoring, leverage, and so on. These risks, however, are already known and reflected in the markets, which are down 20% or more from their peak. In such a context, what it comes down to is price and weighing uncertain short-term results against the opportunity for long-term value creation.

These days we are coming across many more names that meet our investment criteria. Consequently, we analyze our holdings and compare them against the prospects on our wish list. We can sell some of the investments that held up well in the past year in order to purchase names that have since become much more attractive. We are nevertheless keeping some cash on hand right now to be in a position to quickly take advantage of special situations and temporary market dislocations.

Mispricing is usually more prevalent among **small-cap stocks** (companies worth between $100 million and $5 billion), the category on which we like to focus. As shown in the graph to the right, this is the asset class to be in when exiting bear markets and recessions. The last two calendar years when small caps outperformed large caps by more than 10% were 2010, after the great recession of 2008-2009, and 2003, after the tech bubble meltdown of 2001-2002.




Since there is no way of knowing exactly when the market will bottom, we will stick to our tried-and-true approach that boils down to this: Analyze investments thoroughly. Be patient and buy only when downside risk is deemed limited. Be disciplined and sell assets that are fully valued. Remain active at all times to take advantage of temporary mispricing.

Even if the economy in 2023 does not look great, we must not forget that the market is always forward-looking. The next few months are likely to bring earnings revisions, further rate hikes, and an economic slowdown, but investor attention will sooner or later turn to 2024 and beyond. We believe that our fund, with our active management approach and concentration in smaller-cap stocks, will be very well positioned for the market recovery when the time comes.

Sincerely,

Philippe Hynes, CFA
Partner
January 6, 2023

Aaron Warnongbri
Partner

**For reference, find below the historical gross returns of our North American equity strategy:**

## Tonus Composite Performance – As of 12/31/2022

| | *Tonus Composite (Gross Returns)* | *Index* |
|---|---|---|
| *3 months* | 11.3% | 6.3% |
| *6 months* | 19.7% | 6.7% |
| *1 year* | 3.5% | -10.4% |
| *2 years* | 8.7% | 4.5% |
| *3 years* | 12.3% | 7.5% |
| *5 years* | 5.3% | 7.0% |
| *10 years* | 9.9% | 10.3% |
| *Since Inception* | **9.4%** | **7.0%** |

*Source: FactSet Research Systems, Inc.*
*Returns are gross of fees and are calculated using a time-weighted rate of return. Past performance is not indicative of future results. Returns greater than 1 year are annualized*
*Benchmark consists of 25% S&P/TSX TR Performance + 25% S&P/TSX SmallCap Index performance + 25% S&P500 TR Performance ($CAD) + 25% Russell 2000 TR Performance ($CAD).*
*S&P500 TR ($CAD) and Russell 2000 TR ($CAD) are adjusted for US dividend withholding taxes*

Please note that Tonus Capital serves as the investment manager for the Tonus Partners Fund. Historical returns shown are for the Tonus Partners Fund. Prior to January 2016, the returns are from the Tonus Select Fund from October 2007 to October 2011 and from the weighted average of all managed accounts (including those accounts no longer with the firm), using the same strategy implemented in the actual Tonus Partners Fund, from November 2011 to December 2015. Although the structure and the name of the investment product changed, it had for the entire period the same investment mandate, objectives, strategy, and benchmark. Past returns are not necessarily indicative of future performance. At any moment, the portfolio composition may vary widely from the benchmark. The benchmark was changed to the current format starting in 2021. Prior to 2021, the benchmark presented was calculated by taking 50% of the performance of the S&P/TSX and 50% of the performance of the S&P500 in Canadian dollars. Would you like to see the historical benchmark returns, please follow this link. Returns are gross of fees and in Canadian dollars. Any investment in the Fund is speculative and involves substantial risk, including the risk of losing all or substantially all of such investment. This document is not to be construed as a public offering of securities in any jurisdiction in Canada and is for informational purposes only. While the information and material in this document are believed to be accurate at the time they are prepared, Tonus Capital Inc. cannot give any assurance that they are accurate, complete or current at all times. The Tonus Composite was created October 31st, 2007 and the Tonus Partners' Funds was created January 4th 2016.