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THIRD QUARTER 2014 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the third quarter of 2014.

PERFOMANCE REVIEW

During the third quarter of 2014, the Tonus Composite decreased **0.58%**. Over the same period, the performance S&P/TSX Total Return was **-0.59**% and that of the S&P 500 Total Return in Canadian dollars was up **6.10**%.

Year to date, the Tonus Composite is up **8.34%**, against **12.20%** and **13.96%**, respectively, for the S&P/TSX TR and the S&P 500 TR $CAD.

Since the inception of the Tonus Composite in October 2007, it has achieved a compound rate of return of **12.53%**, compared with **3.33%** for the S&P/TSX TR and **8.37%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The portfolio's return was more or less flat in the third quarter, with our gross return steady at 8.34% year to date but nevertheless up 20.88% over the past 12 months. Our quarterly gains earlier in the period were wiped out in September when markets fell from historical highs. As pointed out in recent letters, there was a disconnect between stock valuations and underlying earnings growth, especially in small-cap stocks.

Unsurprisingly to us, this first wave of market decline struck nearly across the board, including value, growth and speculative stocks. Small caps were especially hard hit, the corresponding Canadian and U.S. indexes returning -9% and -6%, respectively, in September. Smaller caps represented half of our invested assets earlier in the year but, given valuations, three investments in that category were sold or significantly reduced during the quarter. Needless to say that, as the ones still owned declined, we took advantage of the weakness to increase certain positions. At time of writing, our portfolio was considerably outperforming the markets, which were down significantly in the first trading days of October. Our discipline kept us on the sidelines for most of the year. As a result, the cash position swelled and finished the quarter at 27% of assets, an enviable position to be in as opportunities begin to emerge early in the fourth quarter.

Let us, then, review the quarter's main transactions, starting with the stocks sold. First, all our shares in **CST Brands (CST - $35.95)** were liquidated. This investment dated back to when CST was spun off from refiner Valero in April 2013. As explained in our 2013Q2 letter, there were three reasons for buying CST shares: advantageous geographic location of stores, expected improvement in in-store merchandise margins, and large ownership of real estate. The pop in the stock came from the third catalyst. In August, CST announced the acquisition of the general partner of a publicly traded limited partnership (LP). Over time, CST intends to drop its real estate holdings into the LP. Most of the value creation resulting from this financial engineering was quickly realized on the announcement as the stock jumped more than $3. As future upside lies in operational improvement, an area where we found the company to be adequate at best so far, we sold our shares.

Similarly, our investment in chemical producer **Tronox Limited (TROX - $26.05)** benefited from the promises of a future transaction. As we uncovered during our research prior to buying the stock in early 2012, Tronox carries a large deferred tax position on the asset side of its balance sheet owing to reorganization earlier this decade. This position can be used to offset future tax payments on profits generated in the United States. Following a court ruling against Tronox's former parent Kerr-McGee/Anadarko in April, the size of this deferred tax asset was increased further, which means the company will be able to receive billions of dollars in U.S. federal income tax deductions. In order to boost their U.S. taxable income, the logical move would be a transaction and, with their largest competitor, DuPont, spinning off its performance chemical unit, the market grew excited in anticipation of a merger and drove the stock up more than 20%. We took advantage of this appreciation to decrease our stake in Tronox significantly with the stock at $30 per share, not wanting to speculate on the likelihood of a deal.

Finally, the third stock sold was **Weight Watchers International (WTW - $27.44)**. Following a meeting with senior management at their head quarters in September, we came to the conclusion that our original investment thesis did not hold up. On the marketing front, after a couple of disappointing years, 2014 results were unfortunately not much better. Regarding costs, we expected the company to sharpen its pencil further and continue cutting expenses. Their original guidance called for $60 million in cost cuts, later raised to $150 million. However, the company's chief financial officer confirmed during our meeting that added cuts would be reinvested in the business. Finally, we believed they could stabilize the level of online subscribers after accrued competition from free online applications. At this point, we have no assurance that product improvements will suffice to fend off competition in future. As we are now uncertain about the growth driver in the original thesis (growth in online subscriptions), we decided to sell our position, take the loss, and find investments offering a better risk/reward.

In terms of purchases, with markets continuing to flirt with historical peaks until very late in the quarter, we remained patient and were mostly active increasing the weight of some stocks already owned in the portfolio, including **Leucadia National Corporation (LUK - $23.84)** and **Hornbeck Offshore Services (HOS - $32.73)**. Uncertainty creates opportunities for the well prepared and, with certain sectors hit hard, we were able at very attractive prices to increase the weight of companies we know well.

Speaking of which, we also reinitiated a position in **Jacobs Engineering Group (JEC - $48.82)**. As you might recall, we sold the stock back in 2013Q2 on the grounds of valuation. Fast forward to today: the stock is down more than 20% even though free cash flow per share will grow from $3.50 to a modeled $4.20 this coming year. The multiple contracted for two reasons that we believe to be one-time in nature: a) problem projects and b) accelerated restructuring. Where problem projects are concerned, Jacobs very seldom assumes project risk as the company

operates mainly on a cost-plus model. This year, however, Jacobs has had issues with two projects in Europe and the courts will ultimately decide which side is liable. The provisions taken by Jacobs should be enough and in no way stress its strong balance sheet. Regarding the accelerated restructuring, management took advantage of the slowdown in the mining industry to make two large acquisitions in order to significantly increase the company's presence in that critical sector. As the industry continues to be soft, Jacobs decided to accelerate integration of the firms and assumed some significant restructuring charges with the likely outcome of greatly improving profitability next year. The price-to-free cash flow multiple is now back to its historical low of 11x, the same multiple we paid when we acquired shares in 2009 and 2011. As the company fixes these temporary issues, grows the backlog, and continues to increase margins, the stock should once again perform very well for us.

COMMENTARY

The *Wall Street Journal* ran an article on September 15 titled: "Stock-Market Bears Turn Docile, Predict S&P 500 Gains". The last bearish strategists were throwing in the towel just as the market attained its all-time high (current peak reached September 18). As pessimists gazed at rosier outlooks, investors were, for the most part, on a buying spree. Markets were experiencing low volatility owing to the fact that participants were not factoring in sufficient uncertainty for the future. On the other hand, with valuations rising, companies worldwide were selling stock at record pace, satisfying investor hunger for riskier assets. According to data provider Dealogic, stock offerings in the first half of 2014 topped the previous record… achieved in 2007 just before the market collapsed. Another point of note: the majority of this year's deals have been driven by private-equity firms looking to cash in their investments. The crowning example of this might end up being Alibaba's IPO in September, which raised a record $25 billion.

With stocks rising, in order to keep feeding this investment frenzy, sell-side analysts have become more creative in their defence of ever higher price targets. Let us take the example of a research report titled: "Valuation: Y+G is the new P/E". Unable to justify further increases through the P/E multiple, the investor's favourite valuation metric, the author of the report concocted a new formula for determining target prices: free cash flow yield (Y) plus expected growth (G). This yardstick is somehow supposed to validate the relentless upward movement in price targets. In another case, switching his valuation metric allowed an analyst to go from a neutral to a buy recommendation after the price of a stock had tripled!

Date	Stock Price	Target Price	Recommendation	Valuation Metric
September 2012	$ 3.47	$ 4.17	NEUTRAL	7.2x forward EV/EBITDA
September 2013	$ 6.05	$ 7.33	NEUTRAL	7.5% free cash flow yield --> 9.7x EV/EBITDA
September 2014	$ 10.82	$ 14.00	BUY	4.9% free cash flow yield --> 12.8x EV/EBITDA

Though companies can, of course, create value over time and see their multiples expand, we have a hard time justifying valuation metrics almost doubling (from 7.2x to 12.8x) over a 24-month period for this stock. The same can be said about many other stocks we looked at. Consequently, we stuck to our disciplined approach, which meant passing on many stocks researched that were simply overpriced. Charlie Munger, vice-chairman of Berkshire Hathaway, commented in September that he had not bought any investment for his personal portfolio in the past two years. Although this is extreme, the fact that our cash position had grown to a three-

year high of 27% at the end of the quarter echoes this sentiment. Valuations are now returning to our comfort levels and cash has begun to be deployed in a prudent manner.

Sincerely,

Philippe Hynes, CFA
October 14, 2014

Tonus Composite Performance Report
As of September 30, 2014

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	-0.59%	-0.59%	6.10%
6 Month	2.09%	5.79%	7.75%
Year-to-Date	8.34%	12.20%	13.96%
1 Year	20.88%	20.38%	30.18%
2 Years	25.91%	13.52%	27.31%
3 Years	26.96%	12.06%	25.99%
5 Years	17.37%	8.66%	16.62%
Since Inception (Oct. 31, 2007)	12.53%	3.33%	8.37%

Source: FactSet Research Systems, Inc.

All returns are gross of fees.

Please note that all returns greater than one year are annualized.

The Tonus Composite was created October 31, 2007. The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of at least 25% of portfolio assets. Investors should carefully consider the firm's investment objectives, risks, and expenses before investing.

Portfolio composition is subject to change at any time and reference in this letter to specific securities, industries, and sectors should not be construed as a recommendation to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. The Composite return is not guaranteed; its value changes frequently and past performance may not be repeated.