● TONUS CAPITAL INC.

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FIRST QUARTER 2013 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the first quarter of 2013.

PERFOMANCE REVIEW

During the first quarter of 2013, the Tonus Composite increased **14.52%**. Over the same period, the S&P/TSX Total Return grew **3.34%** and the S&P 500 Total Return in Canadian dollars rose **12.86%**.

Over the past 12 months, the Tonus Composite is up **26.40%**, against **6.11%** and **15.84%**, 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 **10.41%**, compared with **0.41%** for the S&P/TSX TR and **3.78%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The stock markets continued their upward journey during the first quarter and so did the Tonus Composite. Indeed, the portfolio posted its best quarterly performance ever with a 14.5% gain. Needless to say that this did not come from short-term trading or portfolio turnover but rather from a broad based increase in the price of our existing holdings. **Jacobs Engineering Group (JEC - $56.24)** and **Devry Inc (DV - $31.75)** were our best performers, as each rose more than 30% in the quarter. You might remember that the weight of both these stocks had been increased in the second half of 2012, making them two of the portfolio’s top five holdings. Trading was light in Q1, with some stocks in the portfolio rebalanced to reflect their current upside potential and downside risk in light of share price appreciation. Let’s review the period’s main transactions.

Only one new stock was bought in the first quarter. **Weight Watchers International (WTW - $42.11)** had been on my watch list for three years since my wife joined the program after her first pregnancy. Consequently, I was able to personally witness the competitive advantages the company enjoys. First and most importantly, the program really works. Second, most clients enrol in the program multiple times. Third, the company benefits from a huge amount of absolutely free and effective publicity in the form of testimonials from its best possible spokespeople, its members past and present. Proof of fact: my wife achieved her weight loss objectives both times she enrolled in the program and she motivated at least a dozen people to join WW! Over the past 40 years, the program has evolved to embrace new technology. While the traditional WW plan of in-person weigh-ins and meetings is still offered, the company now operates one of the most profitable subscription-based websites in the world. The site boasts close to two million paying subscribers and alone generates some $260 million in profits for the company.

The opportunity to purchase the stock arose recently when the company lowered its enrolment expectations for this year owing to: a) the task of explaining the benefits of its revamped points program, which has proved more challenging than anticipated; and b) the marketing campaign centred on new spokesperson Jessica Simpson, which fell flat. In addition, following an ill-timed $1.5-billion stock buyback in early 2012, WW now carries debt on its balance sheet. These factors converged to prompt investors into dumping their shares. After the stock dropped 30% over January and February, I was able to buy in at 10x my estimated earnings for 2013.

The company still generates plenty of free cash flow, which it is using to pay down its debt. In this regard, the company reimbursed $100 million of its debt in the second half of 2012. Moreover, after years of mounting expenses, I expect management to rationalize the company's cost structure. Finally, marketing dollars sometimes produce a hit, sometimes a miss. That is the nature of the beast. Last year's campaign unfortunately landed in the second category. However, WW has demonstrated a great deal of creativity over the years and their next effort could prove a smash and have a positive impact on enrolment, profitability and, ultimately, stock price.

During the quarter, I also seized a golden opportunity to buy more shares in helicopter operator **PHI Inc. (PHIIK - $34.21)**. As I expected, intensified drilling activity in the deepwater region of the Gulf of Mexico is driving demand for their services (for a full description of the investment thesis, see the 2012Q2 letter). PHI took delivery of four new large helicopters in 2012 and has six more on the way this year. The company has already secured contracts for all of them. Moreover, on the medical side of the business, the company signed a multiyear contract to operate, support and maintain an air ambulance service and train crews in Saudi Arabia. The contract went into effect in 2012Q4 and the company expects to earn quarterly revenue of approximately $10 million from this activity. Over time, the company could quadruple the size of this contract as more medical helicopters are needed in the kingdom. What's more, CEO Al Gonsoulan bought an additional 500,000 company shares in December at $31.78, bringing his total to over two million worth more than $60 million. Our shares were purchased at a price below his; and I believe we will both make a great profit on our investment.

One stock was liquidated during the quarter: **Liberty Ventures (LVNTA - $75.58)**. These shares were initially inherited from a spinoff last year from Liberty Interactive (which we still own). I subsequently bought more shares for the portfolio, some at $35.99 when I exercised rights. Liberty Ventures is a financial entity with three principal assets: 1) 23 million shares of publicly traded Expedia; 2) 32 million shares of publicly traded TripAdvisors; and 3) $2 billion in cash in the hands of one of the best capital allocators in the media industry, John Malone. These are offset by approximately $1 billion in future capital gains taxes and a deferred tax liability of more than $5 billion. In a bold move to create value, Malone years ago swapped shares of publicly traded companies with a third party against low-coupon debentures to which Malone attached call options to convert the debt securities back into the publicly traded shares initially received. The beauty of the deal is that, for tax purposes, Liberty is able to defer current taxes by claiming a cost associated with the value of these call options while, at the same time, being protected on the downside by owning the shares.

The company will need to honour this $5-billion liability towards the IRS only when the call options are exercised or when they reach maturity in 2030. (N.B. The IRS has since closed this loophole in the tax code.) In January, the Company announced the redemption of one of the exchangeable debentures. This will trigger a deferred tax payment. I approximate the present value of the remaining liability to be $500 million. With both Expedia and TripAdvisors having appreciated, I estimated the value of Liberty Ventures to be in the mid-60s. With the stock trading $10 above my fair value during the quarter, I sold the position realizing a gain of more than 70% on our cost.

Two large positions were reduced by half during the quarter as the stocks' strong performances reduced their respective upside potential. Both **Primerica Inc (PRI - $32.78)** and **Comcast Corporation (CMCSK - $39.42)** still hold good risk-adjusted return potential, just not quite as much as a year ago when they were 25% cheaper. Given that very large weights in the portfolio should always offer a large discount to their intrinsic value, I felt it prudent to downsize our position in these two over-achievers.

COMMENTARY

Investors often ask why I keep so much cash and why I am not always fully invested like most other portfolio managers. The reason many of these managers keep no cash and overly diversify their portfolios into myriad small positions is to reduce their volatility relative to an index. If your main objective is to beat a benchmark by 1% or 2% annually, it makes sense to reduce the tracking error. However, the main objective of the Tonus Composite is not to reduce volatility versus an index, but rather to achieve solid long-term absolute returns. To this end, it is at times more appropriate to hold considerable liquidities. The portfolio ended the quarter with 11% in cash and this figure could rise in future. Why? Because when holdings in the portfolio reach full value, I sell. When this occurs, there might not immediately be another stock trading at a price I am willing to pay. Is this strategy working? Let's see.

In the past 3.5 years of bull market, the Tonus Composite and the North American markets have generated an annual compounded return of 16.1% and 9.4%, respectively. Over this period, the Tonus portfolio kept a cash balance of 30% on average. Had the portfolio been fully invested in the same stocks (i.e., bigger weights), the annual return would have been slightly above 20% as these performed exceptionally well. Consequently, it is possible to outperform the markets in bullish times even while holding high levels of liquidity if you carefully invest in a few great companies that offer strong long-term return potential.

To do this, however, a manager must have the flexibility afforded by available liquidity to jump at buy opportunities when they emerge. The last time this happened was in the summer of 2011 when a crisis loomed large in several countries in Europe. North American markets were down 12%. The downturn culminated in September 2011 when markets fell more than 5%. During that difficult month, the Composite, instead, was up slightly. Why? Because when investors were panicking and selling off their stocks, it created great bargains. Between August 5 and August 11, 23% of the portfolio that was in highly liquid bankers' acceptances was invested in ten new and existing positions. Truth be told, some of these continued to decline after they were purchased. The fact of the matter is that timing when a market will bottom out is always impossible. However, since this opportunistic buying spree, all but one of these ten stocks are up more than 50% from their purchase price. By comparison, the markets are up only 18%.

I hope this clarifies why liquidities sometimes build up in the portfolio. Rest assured that I remain focused on finding the next stocks with the potential for returns of 50% plus. However, I will continue to exercise my habitual patience and prudence before pulling the trigger in order to buy at what I deem to be the right price.

Sincerely,

Philippe Hynes, CFA
April 11, 2013

Tonus Composite Performance Report
As of March 31, 2013

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	14.52%	3.34%	12.86%
6 Month	19.79%	5.11%	13.77%
Year-to-Date	14.52%	3.34%	12.86%
1 Year	26.40%	6.11%	15.84%
2 Years	20.19%	-2.15%	13.79%
3 Years	16.07%	4.87%	12.72%
5 Years	11.43%	2.07%	5.58%
Since Inception (Oct. 31, 2007)	10.41%	0.41%	3.78%

Source: Bloomberg Finance L.P.
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.