TONUS CAPITAL INC.

Tonus Capital Inc.
999 de Maisonneuve Ouest
Suite 799
Montréal, Québec H3A 3L4
Tel: (514) 844-4443
www.tonuscapital.com

FOURTH QUARTER 2014 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the fourth quarter of 2014.

PERFORMANCE REVIEW

During the fourth quarter of 2014, the Tonus Composite decreased **-3.51%**. Over the same period, the performance of the S&P/TSX Total Return was **-1.47%** and that of the S&P 500 Total Return in Canadian dollars was **8.75%**.

Over the past 12 months, the Tonus Composite is up **4.54%**, against **10.55%** and **23.93%**, 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 **11.51%**, compared with **3.00%** for the S&P/TSX TR and **9.33%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW & COMMENTARY

The Tonus Composite closed 2014 with a sub-standard return of 5%. We are not in the least satisfied with this performance and even less so with our showing in the final quarter of the year, which was deeply impacted by our exposure to the energy sector. Having an active manager in the control room allows us to hold a much more concentrated portfolio, which is to say, very large positions in few stocks. Consequently, our performance is largely uncorrelated with the sector weights of any index. Given our long view to investing, there will inevitably be periods when our investments are “out of favour”. In the long run, however, our strategy has proved effective in achieving above-average returns. Unfortunately, it worked against us this past Q4. Generally speaking, the under-performance was not due to poor stock selection but rather to our exposure to certain sectors and asset classes. The table below gives the returns of the major North American indices for the year, as well as our own, and indicates the factors that adversely influenced our performance:

Major North American Indices	2014 return		2014 return
S&P/TSX (large cap Canada)	10.55%	Tonus Composite	4.54%
TSX SC (small cap Canada)	-2.34%		
S&P 500 in $CAD (large cap US)	23.93%	Impacted from:	
Russell 2000 in $USD (small cap US)	4.89%	High cash balance	-3.90%
Money-market returns	1.10%	Exposure to Energy sector	-4.86%

As mentioned in our letters throughout 2014, with markets trading at high multiples, our steadfast discipline in selling stocks when fully valued and making new acquisitions only at bargain prices resulted in significant cash holdings during the year. These averaged 26% of the portfolio's assets. The cash was placed in low-risk bankers' acceptances, which offer woefully low returns. Had it been invested in stocks, instead, our return would have been 3.9 percentage points higher. This is the cost of waiting for the right pitch before swinging: our relative return will be negatively affected now and again. However, our game plan is not to do as others do merely to reduce our volatility versus an index or to be fully invested at all times. As we saw in October when markets were selling off, our portfolio held up and some *wish-list stocks* came close to our buy price target. The market snapped back quickly, though, and we were able to deploy only a small amount of capital at the time. Other such opportunities will surely arise in the future.

The other major factor that negatively impacted our return was our exposure to the energy sector. This cost us 4.9 percentage points. Our quest for value had led us to focus on this sector as valuations grew increasingly attractive. Unfortunately, we bought some shares mid-year just before the price of oil crumbled. Nonetheless, we still very much like our investments and their long-term return potential. Before laying out our view of the sector, let us examine the recent decline against gains made in prior periods:

	Performance			
Stocks	4Q14	2014	2013	Since purchased
Shawcor	-25%	0%	9%	17%
Total Energy Services	-38%	-37%	38%	-9%
BlackPearl	-45%	-49%	34%	-31%
Hornbeck Offshore	-21%	N/A	N/A	-32%
PHI Inc	-6%	-6%	38%	63%
S&P/TSX oil and gas index	-30%	-25%	10%	
PHLX Oil Service Index	-21%	-25%	27%	
Total gross impact on portfolio	**-6.5%**	**-4.9%**	**7.5%**	

As we can see, Q4 was negative and wiped out some of our earlier gains but, generally speaking, we are still up on our investments in the sector. This is true before even counting dividends and profits realized on stocks sold. Our two largest positions, **Shawcor Ltd (SCL - $42.40)** and **PHI Inc (PHIIK - $37.40)**, fared relatively well against sector returns. Indeed, the TSX Oil & Gas Index was down 40% in the second half of 2014 and 25% for the year, while the PHLX Oil Service Sector Index, which tracks U.S. energy service companies (in U.S. dollars), was down 32% and 25%, respectively, over the same periods. Both Shawcor and PHI derive most of their business from production rather than drilling. Moreover, most of Shawcor's projects involve natural gas, the price of which has remained relatively unaffected by the glut in oil supply. In addition, only 30% of their business is tied to drilling and, to some extent, the slowdown will enable them to relocate supply to satisfy international demand. Where PHI is concerned, one-third of their profits spring from the air medical side of the business, which is obviously unaffected by the drop in oil prices, and most of their business in the Gulf of Mexico is tied to production platforms, not exploratory wells. This notwithstanding, we are well aware that their customers are large oil and gas companies that, in the current commodities environment, will seek to cut spending and obtain price concessions from their suppliers. However, we believe this is already discounted in the current share price.

So why should we stick with the sector? Let us look at the supply/demand situation. On the one side, demand per day has grown slowly but steadily by one million barrels each year on average since 2007 and today stands at 92.5 million. On the supply side, non-OPEC production per day has increased on average by two million barrels each year over this same period, which explains the imbalance and the inventory build-up worldwide. Of these two million extra barrels, 1.8 million have come from North America. This quantity was expected to continue growing as more drilling for shale oil was planned. Easy access to cheap money from equity deals and high-yield debt was funding the large increases in capital spending. Indeed, energy currently accounts for 20% of the junk bond market. Seeing no end in sight to production growth in North America, OPEC decided to play hardball and force the swing producers to cut production. With the spectacular fall in oil prices, cheap financing has dried up. This combined with a sharp decline in cash flow from operations will translate into a 20% to 50% decrease in capital programs in 2015. Production will ultimately be reduced. Supply, however, will not diminish immediately, as wells recently drilled will still begin production. Historically, it usually takes eight months for production to respond. If so, this should take us to the middle of the year.

Consequently, the first six months of 2015 should be volatile. Thereafter, we can expect oil prices to stabilize at levels where shale production will become economically viable again. OPEC does not wish to crush U.S. production, only slow its growth and maintain it at its current rate of 9 million barrels a day. If producers stop drilling completely, production will fall by 2.5 million barrels a day (-28%). Drilling won't stop completely. Clearly, with oil at $50 a barrel, most wells are not economically viable. Companies need the price to be in the vicinity of $70 a barrel to justify spending. Finally, excess capacity is so small (one million barrels out of the worldwide production of 92.5 million) that it will not take much to balance the market. Consequently, we believe the upside from current prices is substantial.

Our current holdings are well positioned to benefit from this recovery. For the most part, our exposure to the energy sector is on the service side with companies that hold a dominant market position, boast strong balance sheets, and generate positive cash flow. In the short term, activity levels will sag and margins will be tested, but these companies can withstand this downturn, gain market share, and generate handsome returns. We are not alone in seeing this value. In recent weeks, the CEOs of Shawcor, **Total Energy Services (TOT - $12.98)** and **BlackPearl (PXX - $1.16)** have all personally bought more shares of their companies on the open market.

In closing, we are actively seeking new investments in which to deploy our liquidity. Our focus has shifted over slightly to Canadian companies, a number of which should benefit from lower oil prices and the loonie's depreciation.

Sincerely,

Philippe Hynes

Philippe Hynes, CFA
January 19, 2015

Tonus Composite Performance Report
As of December 31, 2014

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	-3.51%	-1.47%	8.75%
6 Month	-4.09%	-2.05%	15.39%
Year-to-Date	4.54%	10.55%	23.93%
1 Year	4.54%	10.55%	23.93%
2 Years	20.93%	11.77%	32.32%
3 Years	21.09%	10.20%	25.67%
5 Years	16.04%	7.52%	17.79%
Since Inception (Oct. 31, 2007)	11.51%	3.00%	9.33%

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.