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FOURTH QUARTER 2021 - NEWSLETTER

Dear Partner,

Herein our portfolio review and commentary for the fourth quarter of 2021.

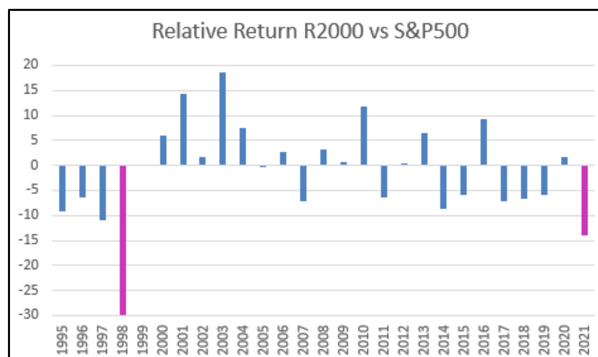
Performance

During Q4, the Tonus Partners Fund registered a gross return of **-1.9%**. For the year, the Fund's return is **14.2%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved an annual compound rate of return of **9.9%**, compared with **8.4%** for the benchmark.[2]

Year-end review

While the year 2021 is behind us, the uncertainty and volatility caused by the ongoing pandemic continues. Investors looked past the short-term impact this is having on our society; equity markets on both sides of the border were up in the past year. The big drivers behind returns in 2021 were oil companies in Canada and mega-cap tech stocks in the United States.[3] Large (and super large, we might add) outperformed small. As shown on the graph, 2021 was the worst year for small caps in terms of relative performance since 1998.



With interest rates low, speculation is prevalent and risk-on approaches were overly rewarded in the past year. As illogical as it may sound, while many North American businesses have difficulty staffing up and need to cope with supply chain disruptions, start-ups with futuristic and innovative business models that have yet to generate any profit (and in some cases any revenues) are attracting multi-billion dollar valuations.

Given the flexibility provided by our investment policy flexibility to hold cash and short shares and spurred by our concerns with inflation and valuations expressed in our previous letter, we

[1] Please see page 5 for a description of the Composite

[2] Please see page 4 for a full description of the benchmark along with its historical returns

[3] Energy was the best-performing sector in Canada, accounting for 22% of the TSX's return. The largest 20 stocks included in the S&P 500 accounted for 54% of the index's return.

took steps, heading into the final quarter of the year, to lower our risk exposure, which already was and remains well below the market's. Consequently, we closed the year with a sizeable level of cash in our portfolio. Under the circumstances, we are satisfied with our mid-teens return for the year, though we could have done better had it not been for a difficult month of November. On a positive note, assets in our fund hit an all-time high at the end of the year.

Our Fund in 2021

The year was a tale of two halves for our Fund. We had an excellent start: up 10% in Q1, 8% in Q2. Our first-half returns were driven by strong showings by small caps in general, with outsized gains from **Information Service Corporation** (housing market), **Photon Control** (acquired by a rival), and **Houghton Mifflin** (schools re-opening). After surging at the beginning of 2021, small-cap indices turned slightly negative for the remainder of the year as investors rotated back to the high-flying mega-cap stocks. At one point in Q4, the small-cap index was down 12% from its peak.

Some of our smaller-cap names registered considerable declines in the second half of the year despite suffering no negative developments in their businesses. Investors were looking for short-term catalysts and sold off the more "boring" investments: businesses that grow steadily over the long term but without eye-popping splashes. The situation only grew worse in November and December when tax avoidance strategies dialed up the pressure on laggards. While this negative selling impacted our returns, it did not derail our long-term value estimates of these businesses. We expect their share prices to quickly readjust to reflect their proper intrinsic value.

That said, our lower returns, particularly in Q4, were also the result of decisions that we made regarding specific investments, particularly two that suffered sizeable declines for company-specific reasons. First, **Comcast Corporation (CMCSA - $50.33)**, the largest cable company in the United States, is one of our largest holdings. In the first half of the year, cable operators thrived as high-speed internet connections at home became a necessity. In the back half, Comcast, like other public competitors, reported slower growth in new customer additions. This sent stocks tumbling more than 20%.

In our opinion, investors wrongly equated a lower rate of new customer acquisition with slower profit growth. Instead, fewer disconnections, combined with fewer service calls and higher pricing, will translate into better earnings down the road. Comcast's stock is trading near the bottom of its historical valuation at a time when its growth prospects are solid and its services are in high demand. As you might expect, we bought more shares at these attractive levels.

The second stock that impacted our returns was **Goodfood Market (FOOD - $4.13)**, the provider of at-home meal kits and online groceries. We were enthusiastic fans of their meal kit offering and viewed their entry into the online grocery business as a free option that could eventually create value for shareholders. While we knew FOOD had to invest in the grocery business to offer a fast and efficient service, we miscalculated the size of the capital required and were surprised by the magnitude of their quarterly losses.

Originally deemed an option on the upside, we came to see this massive endeavor as the chief driver of the company's future share price: Significant losses would be incurred to potentially win the big prize of being a major player in the Canadian grocery business. We did not rule out the possibility of seeing them succeed ultimately, but our original investment thesis no longer held

up and the risk of failure became too large to our liking. Consequently, we quickly, but painfully, exited our position and cut our losses.

To keep or not to keep

These two examples highlight in contrasting fashion our decision-making process when it comes to declining stocks. Anytime a holding loses 20% in value since our last transaction, our investment team examines why and re-assesses the original investment thesis. If our long-term view remains intact, we hold our position and even often increase it. History has shown us that today's losers can be tomorrow's big winners.

Case in point: **Houghton Mifflin (HMHC – $16.10)** saw a huge rebound in 2021 after slumping 29% in 2019 and another 40% in 2020. School boards were then facing uncertainty regarding their funding and the return of students to classrooms. Not only did we believe that schools would eventually return to buying educational material for students, we also felt that HMHC stood to benefit from the industry becoming more digital. Their business is now back to where we expected it to be and their stock is up 383% from its low.

A good SEAT to watch the economy re-open

One of the stocks added in the quarter was **Vivid Seats (SEAT - $10.88)**, a company that will profit once economies re-open. Vivid operates an online platform where tickets for sporting events and concerts can be sold and exchanged. The model works if they can offer both low-price tickets to fans and a secure and efficient platform to resellers. While this is a competitive industry, we believe that SEAT has an edge over its rivals: More than 50% of resellers already use their free point-of-sale and ticket management software. This affords the company a unique view on inventory and pricing across various platforms.

As is the case with all investments tied to the re-opening of the economy, we analyzed the expected financials against their 2019 levels. Sporting events were almost back to normal by mid-2021 in the United States and concerts should see a significant uplift in the year ahead as most bands are eager to resume touring. 2022 is set to be a record year for live music that will surpass pre-pandemic levels by far. Not only are we expecting the industry to top 2019 levels, we think that Vivid has the potential to significantly increase its market share (estimated at 20% in 2019) given that its largest competitor, StubHub (historically with 40% market share), stumbled in 2020.[4] These two positive drivers lead us to believe that SEAT is poised to generate $1 per share of free cash flow, making our stock purchase below $10 a steal.

Bullishness on small caps

Over the past five years, it has been frustrating for us at times to observe large-cap growth stocks whose strong performances were due, in part, to interest rates declining to near nil. Now that inflation is running high and the economy is thriving, rates have finally started to move in the other direction, which should cause valuations to decline. This allows us to be optimistic about the relative strength that small caps could enjoy in the coming years.

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[4] After the ill-timed acquisition of StubHub on February 13, 2020, their new owners, Viagogo, entered the pandemic with little cash and lots of debt. When customers demanded refunds en masse during the COVID lock-downs, the company had no money, upsetting their customers and tarnishing their brand.

After all, the valuation gap is huge—small-cap stocks have never been cheaper relative to their larger counterparts (see chart).

What's more, the most pronounced negative impact of higher interest rates should be felt by high-growth models whose profits will be generated only years in the future. Once the price of failure is no longer low, if not zero, we can expect to see money flow out of mega-cap growth stocks and into smaller, profitable, more value-oriented companies.

As mentioned at the beginning of this letter, in 2021, small caps had their worst performance relative to large caps since 1998. Back then, they went on to outperform large caps in seven of the next eight years. We believe that the context is again likely to favour smaller companies that trade at much more attractive valuations. In such a context, we are delighted to invest in businesses with established revenue/profit models that some people might qualify as "boring". Our team is fired up to find great investments that will generate strong returns for you in the years to come.

Sincerely,

Philippe Hynes, CFA
January 13, 2022

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

Tonus Composite Performance – As of 12/31/2021

	Tonus Composite (Gross Returns)	*Index*
3 months	-1.9%	5.5%
6 months	-4.4%	5.1%
1 year	14.2%	21.8%
2 years	17.0%	17.8%
3 years	12.3%	18.7%
5 years	5.2%	11.1%
10 years	11.7%	12.4%
Since Inception	**9.9%**	**8.4%**

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 a 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.