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SECOND QUARTER 2024 - NEWSLETTER

Dear Partner,

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

Performance Review

During the second quarter of 2024, the TONUS PARTNERS FUND obtained a gross return of **0.8%**. Year-to-date, the Fund achieved a gross return of **18.7%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **11.2%**, compared with **7.8%** for the benchmark[2].

Portfolio Review

While relatively looking small, our 1% return in the second quarter was slightly above the performance of the North American markets. Over the past year, our fund is up 28% and our 5-year compounded annual rate of return is 17% (historical performance detailed on page 4). For the first half of 2024, our fund generated a gross return of +19%, more than double the markets' performance. We beat all major benchmarks, including the roaring S&P 500.

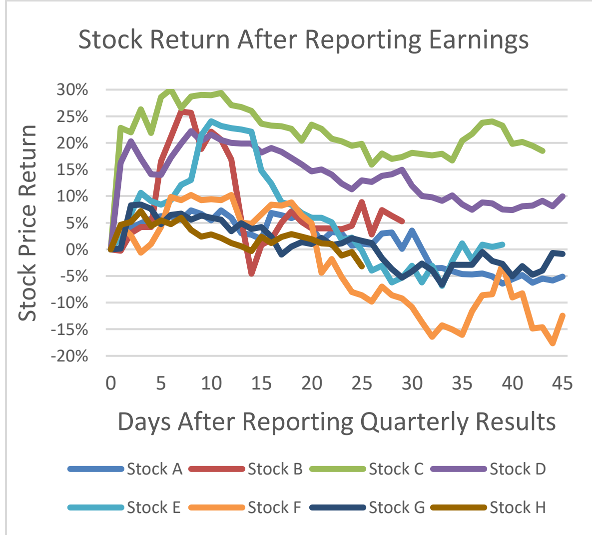
Our results are impressive given a) only 18% of fund managers are beating the S&P 500 this year, a historical low; and b) a handful of mega cap technology/AI stocks propelled the index, a segment of the market we are currently not invested in (in fact, almost a third of the return of the S&P 500 was driven by one stock: Nvidia). The equal-weighted S&P 500 index, which gives a more comprehensive picture of the broader market, was up 4.1% in the first half, a performance relatively similar to small cap indices. As we have written in the past, small caps, which represent the core of our investment strategy, have lagged for the past few years, but eventually they will rebound and we should then benefit greatly.

While in the long-run a company's stock price will be determined by its profit growth, in the short-term, supply and demand (how many investors are interested in buying/selling) will also drive its price. With less to show recently, small caps are currently shunned by most investors and the pool of buyers is diminishing. Consequently, during the recently completed quarter, we observed more instances of stocks moving up after reporting earnings, only to give back some, or all, of these gains in the following weeks.

[1] Please see page 4 for a description of the Composite.

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

The following graph depicts this phenomenon using eight names we own. On day 1, the day they reported good results, their respective stock prices appreciated by 8% to 30% only to then give back some of these gains in the following 40 days. While somewhat frustrating, this dynamic is also creating interesting buying opportunities as prices sometimes disconnect from the fundamentals. Ultimately, this is short-term noise and as long as our holdings continue to make higher highs and higher lows, our returns will continue to be favourable.



Why would we not sell a stock that jumps up in price after reporting their earnings? In most cases; we have a longer term thesis underpinning our investment decision. We are not in the business of speculating on short-term price movements and in most instances, even after a quick bounce up in price, our holdings remain somewhere between cheap and fairly priced. Trying to make short-term trades to lock in small gains could lead to missing the big prize over the longer term.

A Well-Timed Trip

We travelled to the Southern U.S. in April and our timing was fortuitous. **PlayAGS (AGS - $11.50)**, a manufacturer of gaming cabinets and table products based in Nevada, was a company we were eager to visit. We initiated a position in 2023 on the premise that prior years' internal investments would start bearing fruit. After attracting highly skilled engineers, the management team decided to increase its R&D budget significantly, which ultimately led to the release of its Spectra43 product last year. This cabinet outsold competing products for the first 7 months of the year; an impressive feat considering their two largest competitors have sales and R&D budgets 10x their size.

In addition to expecting an acceleration in revenue growth, our investment thesis was centred around a reduction of leverage driven by a more disciplined approach to capital deployment. At our purchase price of $5.55, the stock was trading at only 5x EBITDA; a small increase in profitability combined with a reduction in net debt would be enough for the stock price to move up.

Our recent visit to the PlayAGS facilities was meant to give us a better understanding of the improvements made to their cabinets. Seeing first-hand the product evolution in their showroom was telling. Our ensuing discussion with management centred on their priorities for deploying free cash. As their views were aligned with ours, and with the stock still trading at a discount to our estimated fair value, we bought more shares at $8.89. A couple of weeks later, the company received a take-private proposal at a price of $12.50, or 97% above our average cost.

During the same trip, we attended an industry trade show with the objective of gaining a better understanding of a stock we own and detailed in our 2Q22 letter: **Napco Security Technologies (NSSC - $51.95)**. To complement our analysis of financial statements and business strategy, we are always seeking additional information to improve our understanding of an investment. Attending trade shows enables us to speak with various industry participants, including customers, suppliers, competitors, and non-investor facing employees of the company. For example, we were interested in speaking with competitors to get insights about Napco's competitive positioning. We were very pleased with the positive feedback we heard at the Las Vegas security trade show. Not only did we come back with a more favourable view of the company, we also found a new investment idea through our discussions with competitors and suppliers.

Artificial Intelligence (AI)

We were recently asked to come up with an image representing our market view. Given investors seem to only care about artificial intelligence of late, we decided to generate our image using an AI LLM (Large Language Model, e.g.: ChatGPT). Our desire was to create an image that would convey three messages related to our investment approach.

One, we observe that most investors are following trends that have recently worked and are thus concentrated in technology and AI-related investments.

Two, while not very well represented on the image, we wanted to depict that it feels lonely to be a small-cap value investors these days. While we have posted strong returns of late, the category has been a huge relative underperformer. The pendulum will eventually revert which will serve as a tailwind to our performance.

Three, we generated the image using AI to demonstrate our openness towards technological developments. We are not ignoring this revolution and the new investment ideas emerging from it. Our underweight exposure to technology stocks stems from our discomfort with the elevated expectations currently underpinning their valuations. It is difficult to find an undervalued AI stock right now.

The exercise of generating this image gave us a first-hand experience that AI, while revolutionary, is still a long way off from replacing human labour when it comes to many tasks. The final image is far from the one we had in mind when the process started. With the help of experts in the field, we attempted to improve it many times, but each LLM we tried had its limits. By no means do we want to simplify the AI revolution to our rudimentary image exercise; there are much more robust models that are (or will be) solving much bigger problems. But this unsatisfying experiment was an eye-opener. Billions of dollars are being spent to create a massive AI infrastructure. If the returns prove not to be exceptional, the speed at which these companies are deploying the technology could slow; a nontrivial investment risk given the current elevated expectations.

Our Approach

In the second quarter of 2023, we highlighted a new position we had taken in **HP Inc (HPQ – $35.02)**. Part of the thesis was the expectation that AI would drive a new generation of personal computing devices with advanced hardware and, consequently, higher price points. Underpinned by its market-leading position in printers, this gave us a way to be exposed to AI well ahead of this possibility. The market has started to recognize this potential dynamic this year. We are happy with the early returns and see this as an example of buying a good company, at an attractive valuation, with an embedded option for growth in AI.

As always, we will keep our open mind AND our discipline. There are different ways to make money in this market and we will maintain our recipe of seeking overlooked or unknown companies and buying them when our downside risk is limited!

Sincerely,

Philippe Hynes, CFA
Partner
July 10, 2024

Aaron Warnongbri
Partner

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

Tonus Composite Performance – As of 06/30/2024

	Tonus Composite (Gross Returns)	*Index*
3 months	0.8%	0.8%
6 months	18.7%	9.7%
1 year	28.0%	17.3%
3 years	13.7%	5.5%
5 years	17.2%	10.6%
10 years	9.6%	9.1%
15 years	13.0%	11.0%
Since Inception	**11.2%**	**7.8%**

Source: FactSet Research Systems, Inc.
Returns are gross of fees and 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% Canadian Large Cap TR + 25% Canadian Small Cap TR + 25% U.S. Large Cap TR ($CAD) + 25% U.S. Small Cap TR ($CAD).
U.S. performance adjusted for US dividend withholding taxes