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FOURTH QUARTER 2023 - NEWSLETTER

Dear Partner,

We are very pleased to share with you our portfolio review and commentary for the fourth quarter of 2023.

Performance

During Q4, the TONUS PARTNERS FUND registered a gross return of **9.1%**. For the year, the Fund's gross return is **25.2%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a gross annual compounded rate of return of **10.3%**, compared with **7.4%** for the benchmark.[2]

Up and Up

We finished the year with a very strong return of +9.1% in the fourth quarter and +25.2% for the year. This is the second-best annual return in our Fund's history and it is 11% above our blended benchmark of small- and large-cap North American indices. While excellent on its own, our performance is even more impressive on a two-year track record. Most funds shining in 2023 were heavily weighted in technology stocks and benefited from growth trouncing value by a huge margin; the Russell 3000 growth index returned 40.0% whereas the Russell 3000 value index generated a mere 9.0%.

Most of these funds only managed to recoup their huge losses incurred in 2022 when growth stocks were down -29.0%. On our end, we protected your capital in 2022 and managed to finish that year with positive returns. Analyzing performance over this 2-year period, North American markets are relatively flat (+0.9%) while our fund is up more than 29% ! **Relative to other equity-focused mutual funds in Canada, we rank 1st out of 565 on 2-year return basis**.

Keeping a Long-term View

While our 2-year performance is great, it is worth remembering that a better timeframe is to judge our fund over (at least) a three-to-five-year period. Over the last three years, per annum, the Partners Fund has delivered 14% and over the last five years, 13%. Throughout these periods, there have been months when events brought down our portfolio (and sometimes the market) substantially, ergo there can be <u>no guarantee</u> that recent results will be replicated in the future. What we can <u>guarantee</u> you is that we will use the same approach and rigour before deploying

[1] Please see page 5 for a description of the Composite.
[2] Please see page 5 for a full description of the benchmark along with its historical returns.

your capital. We focus on maximizing the value we can reasonably expect to receive relative to the price we pay while minimizing the risk of permanent capital destruction. Over the long-term, we expect our outperformance relative to the general market's return can continue to compound using this approach.

Our long-term performance demonstrates that we have beaten the common alternative investors can use, which is index funds, all while providing much more stability during the times when it matters the most, i.e., in down markets. It bears showing again a table we presented to you last year which highlights our results when the markets realized annual losses.

Returns during Years of Negative Returns for the Benchmark since Inception			
	Tonus Return	Benchmark Return	Relative Outperformance
2007*	2.0%	-4.3%	6.3%
2008	-4.0%	-29.6%	25.6%
2011	3.8%	-5.7%	9.5%
2018	-11.7%	-6.7%	-5.0%
2022	3.5%	-10.4%	13.9%
* partial year			Average Outperformance 10.1%

We cannot predict what market performance will look like over the next ten years, let alone during this new one just starting, but there will definitely be blistering up years and frightening down years. Taking 2022 as an example, being the most recent year when we remained positive while the markets were negative, we cannot guarantee a repeat of such numbers were we to face a substantial market drawdown. We will certainly try, but short-term asset prices are out of our control. We focus on our disciplined *process* and ask our partners to do the same.

Bipolar Market in the Final Quarter

On a broader market level, there was a moment of mild panic that occurred towards the end of October. At the time, many companies were priced very attractively, which brought to mind the first half of Ben Graham's[3] famous adage which goes: "*In the short term, the market is a voting machine*…". At the beginning of November, we saw values ascribed to some companies as being too low; those we owned and those we didn't. We tend to look for stocks that can reach our estimate of fair value in three-to-five years. When the market snapped back to reality in November, some of the names we bought reached those values in three-to-five weeks! Which brings us to the second part of Graham's adage, "…i*n the long term, the market is a weighing machine*." And that came true quite quickly.

Has the time arrived for small caps to shine ?

We kept our focus on small and mid-cap stocks, and we witnessed another year during which large caps trounced small caps by a wide margin. This was driven by huge returns in the so-called Magnificent 7[4]. What is puzzling is that their stock prices went up significantly while, for the most part, their financial performance was only slightly improved.

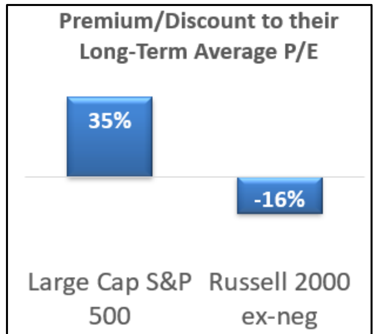
Take Apple, for example, which claims the largest year end market value amongst these names. It was up 48% for the year. Have they quickly grown revenue during the year? No, in fact, their revenues shrunk in 2023. Have they grown profits fast? No, at best, their earnings will be only slightly up. Have expectations for their future profitability improved dramatically? No, they are the same as they were a year ago. As a result, the large gain this year is all attributed to the P/E

[3] Benjamin Graham was a renowned value investor, lecturer, financial securities researcher, and mentor to billionaire investor Warren Buffet. He is considered a founder of stock analysis and particularly value investing.

[4] Bank of America strategist Michael Hartnett coined the term "Magnificent 7" stocks for the most dominant tech companies. The group is made up of mega-cap stocks Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA)

valuation (the price-to-earnings ratio) moving materially higher. Let's not forget it is riskier to buy stocks when they are expensive (higher valuation) because they offer little margin of safety to absorb bad news. Things can always work out but, considering the lofty valuations of these seven darlings, the odds are not favourable and thus, we prefer to fish elsewhere for opportunities.

With small and mid-cap funds continuing to see outflows in 2023, our favourite pond remains very attractive. While small-caps did well during the final quarter of the year and were up 14%, *they remain well below their long-term valuations.* Some investors have started to notice, so more allocators are looking at the category. The current situation is akin to a coil compressing, i.e., money flew out, prices declined, and valuations shrank. Eventually, the coil will unwind and small-cap prices will jump again. Green shoots were observed late in the year, and we think the coming quarters have more in the offing.



Large caps are 35% more expensive than their historical level while small caps are 16% cheaper(more attractive)

4Q Winners

We want to highlight a couple of stocks that performed well during the last quarter. The first is **Secure Energy Services (SES - $9.43)**. The company's environmental waste management infrastructure helps their customers recycle, treat, process, and dispose of waste in a safe and environmentally conscious manner. We have known SES for more than a decade and finally decided to invest in the stock this past spring, when the stock dropped to $6 following a negative ruling from the Canadian Competition Tribunal. The court requested the divestiture of 29 of the 103 sites acquired by Secure in its 2021 acquisition of Tervita.

We had previously discussed this potential outcome with management and believed SES could successfully sell the sites if required to. While it would reduce the earnings of the company, obtaining a good price for the assets would be favourable on two fronts. One, the cash received would enable them to pay back the debt incurred upon the acquisition and reduce their interest expense. Second, it would highlight the low valuation investors were putting on their remaining assets. In our model, a deal of $850 million or more would produce a very favourable outcome for shareholders. Meanwhile, when we were buying at $6, our downside was limited by the strong free cash flows which supported a $0.40 dividend and a yield of 6.7%. In December, SES announced they had sold the assets mandated by the Tribunal for $1.15B, a very good price. The stock was up 26% in Q4 and was a nice contributor this year.

Another stock that defined our quarter was **Napco Security Technologies (NSSC - $34.25)**, a stock we initially discussed in our 2Q22 letter. Napco manufactures commercial locks, intrusion alarm control systems, and fire alarm connectivity radios. With thousands of these radios connected to the cellular network, Napco has a growing proportion of recurring high margin service fees, a feature that had yet to be fully recognized by investors when we bought the stock for $18 in 2Q22. As the year went on, NSSC posted strong results and the stock blew past our target price of $36 in March 2023. Keeping our discipline, we sold our shares.

When we can buy low, as was the case in early 2022, our upside/downside to positive/negative news and surprises is tilted in our favour. Through 2022, competitors' supply chain challenges concurrently with the sunset of Verizon's 3G network were bigger positives for Napco than anticipated. These factors drove sales, and in turn the stock price, much higher. At our selling price, the margin of safety had disappeared. We were then nervous about investors' high expectations for continued torrid growth in the quarters to come. The stock could continue to rise at a fair, but lower rate over the long-term. That being said, any hiccups along the way exposed us to potentially significant losses. The valuation had changed, therefore so had our risk exposure.

In August 2023, upon reporting its financial results, the company surprised the market by announcing an accounting restatement related to errors in inventory calculation for the prior three quarters. With the stock trading at $37, there was no room for error; it got clobbered, eventually dropping 50%. Are we lucky we had sold our shares beforehand? Yes and no. On the one hand, this news could have been reported earlier, when we still owned the stock, and it definitely would have reduced our gains. On the other hand, the drop would have been much smaller as the valuation was not as rich.

As is regularly the case when we are analyzing opportunities, we picked up the phone and contacted management. We needed further explanation of the issue and, more importantly, an understanding of the changes to be implemented to rectify the situation. We were satisfied by the answers provided and the actions that followed. With the stock back at $18, we again liked the risk/reward and reinitiated a position in the stock. After a clean quarterly report, investors' enthusiasm quickly returned, and the stock was up 80% from our purchase price!

No Crystal Ball

The year is starting with "experts" making their best educated guess on where markets will go in 2024. Recall that a year ago, most were forecasting a recession and anemic returns for the year. Just two months ago, in October, very few predicted the year-end rally. This was yet another example that it is useless to try to time the short-term direction of the market. That being said, we can foresee with high certainty two offsetting drivers in the year ahead. The rise in interest rates is likely over, which is good for stocks (it should increase the price-to-earnings multiples). But general economic growth is slowing down, which is bad for stocks (it should reduce earnings).

As always, *it comes down to price* and understanding what expectations are already baked in. Small caps have been out of favour for seven years in a row (since 2016 !), thus most of them are starting the year with a lower bar to clear. At some point, the group will be in favour and valuations should improve. If we focus on paying a fair price for great businesses managed by competent managers, we tilt the odds in our favour that we will generate a sizable return on our portfolio.

Wishing you all the best in the year to come.

Sincerely,

Philippe Hyn

Aaron

Philippe Hynes, CFA
Partner
January 6, 2024

Aaron Warnongbri
Partner

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

Tonus Composite Performance – As of 12/31/2023

	Tonus Composite (Gross Returns)	*Index*
3 months	9.1%	8.6%
6 months	7.9%	6.9%
1 year	25.2%	13.6%
2 years	13.9%	0.9%
3 years	14.0%	7.4%
5 years	12.9%	11.3%
10 years	8.7%	9.1%
15 years	11.3%	10.9%
Since Inception	**10.3%**	**7.4%**

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% Canadian large cap TR + 25% Canadian small cap TR + 25% U.S. large cap TR ($CAD) + 25% U.S. small cap TR ($CAD).
Performance of U.S. indices 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 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.