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SECOND QUARTER 2012 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the second quarter of 2012.

PERFOMANCE REVIEW

During the second quarter of 2012, the Tonus Composite increased **0.83%**. Over the same period, the performance S&P/TSX Total Return was **-5.67%** and that of the S&P 500 Total Return in Canadian dollars was **-0.81%**.

Over the past 12 months, the Tonus Composite is up **18.77%**, against **-10.25%** and **11.46%**, 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 **6.99%**, compared with **-2.02%** for the S&P/TSX TR and **0.99%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

After seeing the S&P500 trend upward steadily for six months, we were reminded in the second quarter that the market is not a one-way street. At one point, both the S&P500 and the S&P/TSX were down 10% from their respective peaks at the beginning of April. The Tonus Composite portfolio remained in positive territory in the quarter thanks to strong performances by our largest position on each side of the border. In Canada, **Shawcor Limited (SCL.A - $36.85)**, whose weight was increased at the end of March, was up 17% in the quarter. On the U.S. side, **Primerica Inc (PRI - $26.73)** fared well rising 6%. I hiked its weight mid-quarter when the price dropped for no company-specific reason.

In the belief that the grass is not always greener on the other side of the fence, I looked in our own backyard and invested 10% of your assets in four stocks already in the portfolio at the start of the quarter. The smaller size of the assets under management affords an advantage that can quickly be exploited when stock I am perfectly familiar with is, in my eyes, mispriced by the market. Smaller positions that did well–**Marriott Vacations Worldwide (VAC - $30.98)** and **Wal-Mart Stores (WMT - $69.72)**–were sold in the course of the past three months, thus rendering the portfolio even more concentrated.

Two new stocks were added in the quarter. The first, **Total Energy Services (TOT - $14.39)**, is a small-cap energy service company operating three businesses in Western Canada: equipment rental, drilling rigs, and gas compressor fabrication. The lion's share of the profits (70%) is generated by the first segment, which consists of renting tanks, completion equipment, loaders, power generators, and more. TOT also has a fleet of 105 heavy trucks to transport equipment.

A fact little known by investors is that TOT is the largest equipment rental company in Western Canada with more than 9,200 pieces of equipment and 20 locations to serve its customers. This affords a huge competitive edge in today's environment where operators move quickly from one basin to another in search of the best return on investment. TOT can transfer its rental equipment between branches and thus attain a higher utilization rate and reduce risk exposure to a particular basin. The other aspect of the business model that enables the company to earn EBITDA margins of more than 50% and ROA of more than 35% in this segment is its service component: TOT installs, maintains, and repairs equipment for their customers. At a time when skilled labour is in short supply in Western Canada, the company's staff of 400 employees constitutes a key asset that competitors are hard put to match.

Besides a sound business model, perhaps even more important for an asset-intensive business is being able to count on a strong management team. In this regard, TOT is in good hands, as I was able to ascertain this past May when I met CEO and founder Dan Halyk. He owns more than one million shares and boasts an excellent track record. For the past five years, TOT ranks second among the 42 companies in the Canadian energy services sector in terms of average return on equity. The company is now almost debt free and Halyk plans to grow the business organically or, as in the past, to make timely acquisitions during the trough in the commodities cycle. In the meantime, the company is buying back shares. As far as valuation attractiveness goes, TOT currently sits in the top quartile. I bought the stock at a P/E multiple of 5x. Finally, unlike others in its peer group, TOT is unlevered and can grow in an environment of flat rig counts.

The other stock acquired in the quarter was **PHI Inc. (PHIIK - $27.81)**, the largest helicopter operator in the Gulf of Mexico and the third largest air medical transportation operator in the United States. I expect the company to generate meaningfully higher EBITDA in the next 12 months on account principally of resumed drilling in the Gulf of Mexico. The BP Macondo spill in April 2010 and the ensuing moratorium had a huge negative impact on demand for helicopter services. Prior to the accident, 32 deepwater rigs were operating in the Gulf; in mid-2011, they were down to 12. The number was back up to 26 in early 2012 and should exit 2012 above 35. Two heavy helicopters are required to service a deepwater rig and each of these helicopters will earn approximately $9 million in revenues per year and an EBITDA margin of 25%. PHI owns more than half of the heavy helicopters operating in the Gulf and has new deliveries scheduled over the next 18 months. I expect PHI's EBITDA in this business to double over the next two years from the $63 million posted in 2011.

The other interesting characteristic of PHI is the value of its assets. Helicopters are very special as an asset class by virtue of the fact that, over time, they tend to lose very little of their value. As a result, their accounting "book value" understates their true market value. Why? Because almost every major cash outlay spent on a helicopter over time is expensed rather than capitalized. Major expenses, including blade and engine replacements, are expensed when incurred and major overhauls are required by law. The value of the asset in the balance sheet is mainly that of the frame of the aircraft, which has a very long life expectancy; it does not reflect the maintenance performed on the helicopter. In the past 15 years, publicly traded companies have reported the following "accounting gains" on the sale of helicopters:

Gain (or loss) on asset sales over the past 15 years

Operator	Sum of "gain on sale"	# of years reported "loss on sale of asset"	Enterprise value
PHI Helicopters	$56 million	1 out of 15	$610 million
Bristow Group	$177 million	1 out of 15	$2,000 million
CHC Helicopters	$1 million	4 out of 12	Not public
Canadian Helicopters	$6 million	0 out of 10	$410 million
Era Aviation	$49 million	0 out of 9	Seacor division
Total	$289 million	6 out of 61	

Source: Bloomberg L.P. and Tonus Capital Inc.

With this in mind, investors consider the hard book value (ex goodwill and intangibles) of such companies as a floor valuation. Prior to the 2008 recession, these companies had hardly ever traded below book value. With the exception of PHI, which was impacted by the Gulf moratorium, they are all now trading at above book value. PHI's book value in March 2012 was $30.79; I bought the shares at a significant discount to this amount while competitors Canadian Helicopters and Bristow were trading at 1.8x and 1.25x book value, respectively. With rigs now returning to the Gulf of Mexico and margins on the company's medical transportation segment expected to improve further, the stock should trade at above book value in short order. What's more, CEO Al Gonsoulin owns 2.3 million shares of the company and discussions I had with industry players revealed a keen interest in acquiring PHI assets were they to come on the market.

One major position, **Brown and Brown (BRO - $27.27)**, was sold during the quarter with a nice gain on its acquisition price. At time of purchase, it was expected the stock would react positively once the company began generating positive organic growth after five years of negative quarterly internal growth. This is precisely what happened in the first quarter of this year. The second leg in BRO's business model is to deploy its capital to acquire other insurance brokers. Having reported $1 billion in revenues in 2011, the company has to seek out bigger targets. This means integration will be more challenging, synergies will be harder to come by, and acquisition multiples will be higher. In this light, I felt new acquisitions, especially the major one completed in late 2011, would not generate BRO's historical return on capital.

COMMENTARY

The second quarter was a difficult one for stocks on account of a looming global economic slowdown. Year to date, energy was the worst performing sectors in North America. The Tonus Composite portfolio is highly concentrated and, as I keep reminding you, its performance on a quarterly or even annual basis can differ significantly from that of an index. However, I am convinced that our strategy of carefully selecting the companies to invest in and of buying new positions and adding to existing ones when the right opportunity arises will allow us to outshine any benchmark over the long term.

The first half of the year is a good case in point. The portfolio presently holds three stocks in the energy sector and here is a review of their performance. The first, Shawcor Industries, constitutes one of the portfolio's largest positions. Though the sector in Canada is down over 9% year to date, Shawcor is up 28% on company-specific contract wins attributable to a superior product offering and wise capital allocation by management (see the 2011Q4 letter for a complete discussion of Shawcor's competitive advantages). The second stock, Total Energy Services, also Canadian, was added during the quarter; it is up slightly from its purchase price and outdoing the index. The third stock is **Carbo Ceramics (CRR - $76.73)**, currently the smallest weight of the three. This stock has underperformed the index slightly since being purchased earlier this year, as the move towards oilier basins has resulted in greater margin contraction than expected. I still believe the stock will do well over time.

The point is that volatility can play in our favour by rendering valuations more appealing and creating buying opportunities for new investments in the portfolio. Indeed, even when a market or sector is down, it is still possible to make money. After all, the elements that make a stock outperform in the long run are company-specific drivers, sound capital management, and financial results. With this in mind, I will remain patient and agnostic in terms of index weights and I will continue to focus instead on the long-term attractiveness of business models and to assess stocks for their potential return on investment.

Sincerely,

Philippe Hynes, CFA
July 13, 2012

Tonus Composite Performance Report

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
1 Month	2.52%	1.10%	2.48%
3 Month	0.83%	-5.67%	-0.81%
6 Month	10.96%	-1.53%	9.62%
Year-to-Date	10.96%	-1.53%	9.62%
1 Year	18.77%	-10.25%	11.46%
2 Years	12.92%	4.15%	15.10%
3 Years	13.91%	6.69%	11.39%
4 Years	8.59%	-2.53%	3.88%
Since Inception (Oct. 31, 2007)	6.99%	-2.02%	0.99%

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.