TONUS CAPITAL INC.

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FOURTH QUARTER 2016 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the fourth quarter of 2016.

PERFORMANCE REVIEW

During the fourth quarter of 2016, the TONUS PARTNERS FUND increased **5.13%**. Over the same period, the performance of our benchmark (defined as 50% S&P/TSX Total Return and 50% S&P 500 Total Return in Canadian dollars) was **5.20%**.

For the full year, the TONUS PARTNERS FUND is up **24.97%** against **14.38%** for the benchmark.

Since the inception of the Tonus Composite in October 2007, it has achieved a compounded annual rate of return of **12.48%**, compared with **6.99%** for the benchmark.

PORTFOLIO REVIEW

The Tonus Partners Fund returned 5.13% in Q42016 and closed the year with a gross return of 24.97%. This solid performance would have been even better had the hefty contribution of the invested portion of the portfolio not been diluted by the negative impact of the U.S. dollar's depreciation against the loonie (-2.4%) and the meagre return on our cash balance (-7.2%). Indeed, a number of our stocks did exceptionally well, including **SleepCountry Canada** (+72%), **Blue Bird Corporation** (+52%), and **Leucadia National Corporation** (+34%). The increased volatility that marked the period was conducive to a greater amount of trading; for buying when stocks on our wish list reached our target price and for selling when existing positions reached their full value. The strong showing by many of our investments forced us to take profit, but we then had to remain patient in deploying the proceeds as valuations in general rose sharply, especially in the wake of the U.S presidential election in November. Nonetheless, we achieved stellar results while maintaining strict discipline, a process that we believe reduced our risk exposure. Our cash position for the year was 20.3% on average and 28.1% in the fourth quarter, which is significantly higher than in prior years. Buying and selling only when the price is right is at the heart of our risk management strategy. Consequently, we will continue to wait for an ample margin of safety before deploying any cash.

ABC Added in Q4

Despite the growing scarcity of opportunities, we still managed to add a new position in the fourth quarter: **AmerisourceBergen Corporation (ABC - $78.19)**. ABC is principally a distributor of brand-name and generic pharmaceuticals to hospitals, clinics and pharmacies in the United States. The stock enjoyed a nice run in 2013 and 2014 as both branded and generic drug pricing benefited from above-normal inflation. As the subject became a political issue, investor sentiment turned against the industry, and ABC's stock plunged from a height of $120 per share. After conducting our research for several months, the stock finally hit our $70 buy point in October when a competitor announced results that fell well below its own overly optimistic forecast. ABC has the attributes of a great business: It is the leader in a three-player oligopoly, it benefits from long-term contracts with its customers, it will profit from the secular trend of population aging, and it generates a substantial amount of free cash flow. Moreover, its balance sheet is under-levered, a weapon it could use to stimulate growth through tuck-in acquisitions. Finally, their largest customer, Walgreens, is in the final stages of acquiring Rite-Aid, a chain of some 4,500 retail pharmacies. The majority of these will, in time, be transferred to ABC's distribution. The fact that we paid less than 10x our estimated free cash flow per share is an indication of just how good of a deal this was.

Memorable Encounter with Warren Buffett

The fourth quarter was marked by an important encounter for me personally as I had the privilege of meeting legendary investor Warren Buffett in Omaha along with a small group of students from the class I teach at Concordia University. Buffett discussed his views on the financial markets at length. To no one's surprise, he mentioned that few opportunities were present on the market at any given moment and recommended exercising patience in order to seize the rare opportunities when they come along. He also extolled the merits of a concentrated portfolio. These are exactly the advantages afforded by the structure and investment policy of Tonus Capital: flexibility to hold cash until great bargains sprout up and concentrating on no more than 15 to 20 stocks at any given time. For a more detailed account of the meeting, click here.

Ironically, the meeting came only a few months after we liquidated our investment in **Berkshire Hathaway Inc. (BRK-B - $162.98)**, which had been in the portfolio for many years. You might recall that we doubled the size of our investment in early 2010 after the company announced its acquisition of railroad operator BNSF. At the time, BRK stock was trading at about $65 per Class B share and valued at less than 1.2x book, the level at which Buffett later stated he would buy back the shares. Since then, the book value of these shares sprang to $109 and the book value multiple reached 1.5x. However, book value is not a good measure of what BRK is truly worth because, in our opinion, it understates the value of some of its divisions. For example, its railway operations acquired in 2009 are carried on the books at near acquisition cost whereas their intrinsic value based on profitability is very much higher. Similarly, investments in publicly traded companies are reported on the balance sheet at prior period values. Its large positions in Coca-Cola, American Express and Wells Fargo were reported most recently at $48 billion instead of their current fair market value of nearly $58 billion. Therefore, rather than focus on the accounting value of BRK, we preferred to evaluate the company based on the sum of its parts, which we believed provided a better reflection of its intrinsic value. We valued BRK's five main business groups on different metrics:

Business	Value per A share	Valuation metric
Insurance	$99,000	Multiple of book value
Railway	$42,000	Multiple of EBIT
Berkshire Energy	$18,000	Multiple of EBITDA
Manufacturing	$43,000	Multiple of EBITDA
Other	$23,000	Multiple of book value
Total	**$225,000**	

On these grounds, we arrived at a fair value of $225,000 per Class A share (or $150 per Class B share). Though we are long-term investors and are drawn to great businesses, we are not married to any of our holdings. Consequently, when they reach their full value, we sell and thus reduce our exposure. We normally place these stocks back on our wish list and continue to monitor how they do. Because we know these companies well, if they become bargains again over time, we could very well initiate a new position. When BRK reached our target price last year, we did not hesitate to sell. We are now keeping our eyes open for another entry point with a more favourable upside/downside potential.

Uncertainty Persists into New Year, Patience Called for

Looking ahead to 2017, expectations are high that the positives promised to investors by Trump in the course of the U.S. presidential elections will come to pass, and sooner than later at that. However, if 2016 taught us anything it is that what was expected did not happen, and what could not happen, did. The coming year will likely be marked by a fair degree of uncertainty. Uncertainty means risks. With risks come opportunities. And opportunities will be grasped by those with the cash to do so. Interest rates are moving up, massive government spending could spur inflation, and populist nationalist policies are gaining ground. Meanwhile, with possible tax cuts in the United States, consumer confidence is mounting and companies are generally upbeat on the year ahead. Markets rose late last year and we enter 2017 with high valuations. We believe that multiple expansion is likely over and that stock returns will be driven by earnings growth going forward. Finally, volatility smiled upon us in 2016 and we anticipate more of it this year. It normally bodes well for our investment style and, with shares no longer moving in tandem, it could bring more stocks to attractive price levels.

Wishing you all a great 2017.

Philippe Hynes, CFA
January 23, 2017

Tonus Composite Performance Report
As of December 31, 2016

	Tonus Composite Gross Return	Benchmark Return
3 months	5.13%	5.20%
6 months	13.22%	10.71%
YTD	24.97%	14.38%
1 Year	24.97%	14.38%
2 Years	14.88%	9.93%
3 Years	11.33%	12.24%
5 years	18.57%	14.49%
Inception	12.48%	6.99%

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 50% S&P/TSX TR Performance ($CAD) + 50% S&P500 TR Performance ($CAD)
S&P500 TR ($CAD) is 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 50/50 CAD/USD split as it is for the benchmark. 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. The firm maintains a complete list and description of composites, which is available upon request. For more information on the investment strategy and complete terms and conditions relating to an investment in the Fund, please consult the Offering Memorandum available on request.