● TONUS CAPITAL INC.

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THIRD QUARTER 2013 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the third quarter of 2013.

PERFOMANCE REVIEW

During the third quarter of 2013, the Tonus Composite increased **4.97%.** Over the same period, the performance S&P/TSX Total Return was **6.25**% and that of the S&P 500 Total Return in Canadian dollars was **2.55**%.

Year to date, the Tonus Composite is up **25.38%**, against **5.31%** and **23.67%**, 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 compounded annual return of **11.18%**, compared with **0.70%** for the S&P/TSX TR and **5.06%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The third-quarter performance of the Tonus Composite was satisfactory. Despite a cash balance averaging 21% over the period and the U.S. dollar losing 2.5% to the Loonie, the Fund gained almost 5% and was up more than 25% year to date. The past three months were very quiet on the trade front, with no new positions initiated. As mentioned in previous letters, I continue to exercise the utmost discipline in my search for greatly undervalued stocks with strong long-term potential. The markets' general advance over the past several quarters has been fuelled primarily by the willingness of investors to pay ever higher multiples for earnings. As a result, bargains have become a rarity. However, rest assured, the day will come when opportunities become plentiful again. At that time, our readily available liquidities will prove an invaluable asset.

So, what drove the portfolio's return in the quarter? Our best performers were mostly on the Canadian side, as the TSX outperformed (finally!) the S&P500. The four Canadian stocks in the portfolio posted an average return of 17%. Leading the pack was **EGI Financial Holdings Inc (EFH - $13.00)**, which was up 40% year to date and recently attained what I considered to be full value. At time of purchase, the stock had been trading at a discount of 30% to book value owing to poorly executed growth initiatives outside of the company's core market of non-standard auto insurance in Canada. EGI has since ceased underwriting new business in the United States and has exited numerous specialty programs that generated underwriting losses. This took a weight off book value per share, which is what drew new investors to the stock.

Though most insurance companies trade at or above book value, I sold EGI just shy of 1x BV for two reasons. First, I believed additional reserves might be needed to cover the liabilities of the exited programs. Second, management expressed the desire to pursue new growth initiatives, which heightened the inherent risk in the investment. With a much narrower margin of safety on valuation, I deemed it prudent to take our profit.

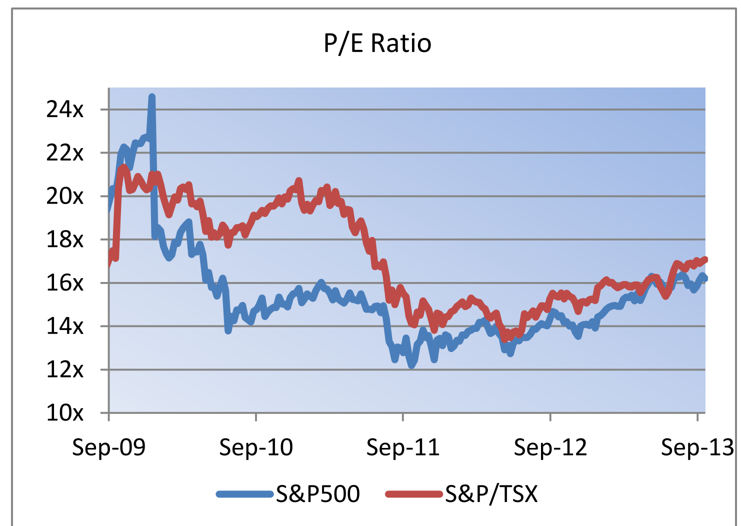
The top performer in the quarter was **Carbo Ceramics Inc (CRR - $99.11)**. Our history with this holding illustrates my investment method perfectly. I am often asked whether I manage the portfolio risk using stop losses or pre-defined prices at which to sell off an investment. For me, volatility is an ally. Consequently, it makes no sense to unload a stock only because it is down from its original purchase price. Carbo, a manufacturer of ceramic proppant used in fracking oil and gas wells, is a case in point. The original investment was made in February 2012 (see 2012Q1 letter) after the stock had dropped from $180 in mid-2011 to less than $100. The main reason for the slump was that proppant prices had begun to fall on account of (i) lower demand following a drop in the number of rigs drilling and (ii) increased supply from Chinese competitors. My decision to purchase rested on two elements. On the one hand, I believed that overall industry demand was poised to recover as higher oil drilling would more than offset lower gas drilling. This, combined with longer and larger fracks, would generate higher proppant demand. On the other hand, as Carbo was adding capacity, I felt the company would gain market share and bump the low-quality Chinese proppant. Having said this, I knew that it was hard to predict in the short term exactly where prices would bottom out, as an imbalance in the demand/supply equation is never an easy situation to gauge.

As it turned out, demand from clients has recovered and, to this day, the size of fracks and the quantity of proppant being pumped continues to grow. What put pressure on prices was the much longer time it took for frackers to get rid of their Chinese inventory as many had committed to large purchases with long delivery lead times. I estimated that proppant prices peaked at 38 cents a pound at the end of 2011. They had slid all the way to 32 cents in early 2013. I model price every quarter and, based on my research, I believe that the all-in cost for Chinese manufacturers to deliver their product to the United States is approximately 30 cents a pound. At the end of 2012, with the stock down 25% from its original purchase price, I did not liquidate the position. Instead, I bought more at below $70. Since then, it has rebounded to above $100 and the company is returning to near full capacity utilization as clients switch back from low-quality rival products. That said, my forecasted earnings per share of $6.00 have been set back a year as proppant prices are taking longer to recover. The company's balance sheet is still pristine and, in September of this year, they introduced a new product that could mark a further widening of the gap between Carbo and competitors. Long-term investors were rewarded in the third quarter as the stock shot up 47%.

COMMENTARY

After the panic drop of 2008 and the quick bounce from bottom in mid-2009, markets have been less volatile in the past four years. Over this period, the portfolio has recorded a compounded annual return of 16.5%, compared with 9.7% for North American indices, an annual outperformance of 6.8 percentage points on average. The main driver behind this has been stock selection, which resulted in numerous big winners and practically no stock sold owing to permanent value destruction. Some investors have wondered whether this outperformance was essentially the fruit of a fortunate choice of asset allocation strategy, which is to say that the excess return over the benchmark was merely due to the U.S. market's larger weight in the portfolio. Now, if I end up investing a larger percentage of the portfolio funds in the markets that happen to perform best, it is because my investment approach led me to focus on those that

offer the most value. Luck has nothing to do with it. My decision to concentrate my research and investments in one country rather than another is based solely on valuation and not some rigid, predetermined asset allocation strategy. As shown in the graph, in the past four years, the U.S. market has traded at a lower valuation than its Canadian counterpart in terms of price-to-earnings ratio. If there is a higher prevalence of undervalued stocks in the United States because the market there is generally cheaper, then there is where my priority will lie.



To satisfy the sceptics, I compared the portfolio's returns against a benchmark proportionally weighted to the portfolio's composition. In other words, if 65% of the portfolio was invested in the U.S. markets in a given month, 65% of the index was used to calculate the benchmark's return for that month. On this basis, the portfolio's compounded annual return of 16.5% still outperformed by far the *new* benchmark's return of 10.6%. This proves that the Fund's alpha (or excess return) is clearly the result of stock selection. I next pushed my analysis further by examining individual contributors to the higher return. What I noted was that no single stock or sector could be identified in the past four years as being responsible for the majority share of the return. Digging deeper still, I next looked at the largest contributors to performance on an annual basis. These are presented in the following table:

Period	Portfolio Return	Excess Return	Largest Contributors	
Sept. 2009 to Sept. 2010	9.80%	5.50%	Cogeco Cable	Amstrong Industries
Sept. 2010 to Sept. 2011	-0.10%	-0.20%	Penn Millers	Comcast
Sept. 2011 to Sept. 2012	29.10%	10.60%	Shawcor	Comcast
Sept. 2012 to Sept. 2013	31.10%	11.70%	Jacobs Engineering	Primerica

As we can see, these contributors included companies from both Canada and the United States, small caps (Penn Millers and Primerica) and large caps (Comcast), and companies in a variety of industries spanning energy services (Shawcor), industrials (Jacobs Engineering) and building materials (Armstrong Industries). What do they all have in common? Their valuation was very attractive at time of purchase. I am careful to avoid industries that do not meet my criteria for quality companies with the potential to generate a significant return on capital over time. After that, I let valuation dictate where to focus my research, independently of country or market capitalization. I am convinced that, over the long run, we will all benefit from this flexibility.

Sincerely,

Philippe Hynes, CFA
October 11, 2013

Tonus Composite Performance Report
As of September 30, 2013

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	4.97%	6.25%	2.55%
6 Month	9.49%	1.91%	9.58%
Year-to-Date	25.38%	5.31%	23.67%
1 Year	31.15%	7.12%	24.67%
2 Years	30.11%	8.13%	23.95%
3 Years	18.84%	4.09%	16.20%
5 Years	11.77%	4.81%	9.35%
Since Inception (Oct. 31, 2007)	11.18%	0.70%	5.06%

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.