TONUS CAPITAL INC.

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FIRST QUARTER 2014 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the first quarter of 2014.

PERFOMANCE REVIEW

During the first quarter of 2014, the Tonus Composite increased **6.07%**. Over the same period, the S&P/TSX Total Return grew **6.06%** and the S&P 500 Total Return in Canadian dollars rose **5.76%**.

Over the past 12 months, the Tonus Composite is up **29.57%**, against **15.97%** and **32.39%**, 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 **13.20%**, compared with **2.69%** for the S&P/TSX TR and **7.79%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The Tonus Composite Portfolio appreciated more than 6% in the first quarter of 2014, a satisfactory performance considering our exposure to the U.S. markets, especially to small-cap stocks, which were down 2% over this period. The portfolio was up 30% over the past 12 months. Markets remain at elevated levels, although volatility has started to increase, which could lead to more mispriced stocks. I *failed* again to bring the portfolio's cash balance down this past quarter, preferring to stick to the discipline of buying new stocks only when they become attractively priced. However, I added new stocks to my "wish list" after completing research on the companies. I like their activities/operations and their business plans but not their stock price, which presents a risk/reward profile that does not justify investing at this point in time. Other low-valuation stocks were examined as well but hardly any met my quality criteria.

One stock cleared both the quality and valuation hurdles: American Homes 4 Rent **(AMH – $16.71)**. This company has acquired a large number of single-family homes across numerous metropolitan markets south of the border and converted them to rental properties. After the real estate market collapsed in the wake of the financial crisis, the opportunity arose to acquire, often through foreclosure auctions, a large quantity of attractively priced single-family homes. AMH bought more than 23,000 such properties and today is the second largest single-family landlord in the United States. The importance of scale is threefold. First, it has allowed internalization of property management functions, which has translated into better quality control and reduced costs. Second, it has allowed portfolio diversification, thereby reducing risk if home prices decline in a given market. Third, it should give AMH access to better financing options, more specifically, the possibility of turning to the securitization market and significantly reducing its cost of capital. Moreover, AMH enjoys a high occupancy rate: over 95% of its properties rent-ready for 90 days or more are leased. Cash flow generation presents upside potential if the company manages to keep occupancies at this level once they begin to push for rent increases, which is in the offing.

AMH boasts a solid balance sheet. It is composed almost entirely of the value of the properties acquired and is lightly levered. As the stock is trading just above tangible book value, our downside is well protected by these hard assets, which some people would argue are worth more than their accounting book value now that the housing market is back on the rise. Lastly, company founders and senior management hold approximately $1 billion of equity ownership, which means their interests are aligned with the objective of maximizing value for shareholders.

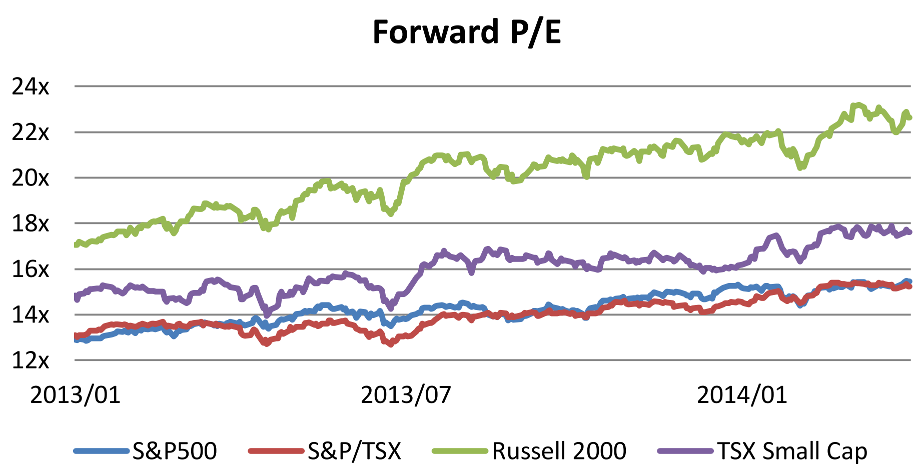
In terms of selling, I have focused primarily on the smaller-cap stocks in the portfolio. Investor appetite for small caps resulted in the Russell 2000 Index trouncing the larger-cap S&P500 by more than 6% over the past 12 months. As this trend hoisted some of our small-cap investments to lofty valuations, I thought it prudent to sell all or part of certain holdings. This was the case for **LoJack Corporation (LOJN - $5.70)**, **Devry Education Group (DV - $42.39)** and **Primerica Inc (PRI - $47.11)**. Where LoJack is concerned, the stock was up more than 50% in the quarter after the company released better-than-anticipated Q4 results! After speaking with management, I believed the stock still presented some upside (which goes to show just how cheap it was prior to moving up) but felt that its weight in the portfolio needed to be reduced in light of its updated risk/reward profile.

As for Devry, a leader in the for-profit education sector, you will recall that our initial investment at less than $20 per share was made on the argument that we were paying only for their medical and nursing schools and for their Brazilian operations–the rest of the business we were essentially getting for free. Fast forward a year and a half later: the stock has more than doubled. Management made some wise financial decisions to cut expenses further in struggling institutions and to get rid of unprofitable businesses. At the price we sold the stock, I felt the market had fully priced in a) the value of the medical schools, whose performance, it must be said, is starting to plateau, and b) the future turnaround of the business school, where new enrolment declines had yet to stabilize as at the last report. Consequently, as our margin of safety had disappeared with the run of the stock, the shares were sold.

COMMENTARY

Three months into the year, the Canadian market has outperformed its U.S. counterpart on the back of a strong performance from the resource sector. Gold and precious metals are up, on average, by more than 12% year to date, a jump driven by both a reversal following their huge underperformance in 2013 (down a staggering 43%) and the devaluation of the loonie. Our exposure to this sector is nil and will most likely remain so, given its poor long-term return on invested capital. Many other stocks in Canada, especially in small caps, registered large increases as well. This comes as a surprise to me given the harsh, cold winter we experienced. Based on the discussions I have had in recent weeks with various management teams, I expect many companies to blame the weather for lower profitability. First-quarter earnings forecasts for both S&P/TSX and S&P 500 companies are expected to be lower than last year's. This will not help improve valuations, which, as explained in my previous letter, are higher than average. That said, there are always mispriced stocks to be found. Case in point: while the market was up marginally in Q1, six of the 16 stocks in our portfolio were up by double digits. Allow me to push this exercise even further: in 2008, of the 2,000 component stocks underlying the Russell 2000 Index, 330 managed to close the year with a positive return at a time of market disarray (index return for the year was -33%). Though the market might seem expensive to many, there are always gems to be uncovered and, given our portfolio concentration, one or two new additions is all it takes to make an impact.

I again want to emphasize the advantages of our investment policy, which, theoretically, enables me to invest up to 100% of portfolio assets in Canadian equities, U.S. equities, or liquidities. They can all be in small caps or in large caps, which allows me to look for stocks where value can be found. The following graph illustrates how forward price/earnings multiples have increased over the past five quarters. Currently, small-cap stocks, in general, are expensive. The multiple on the small-cap Russell 2000 Index is up from 17x to almost 23x! As mentioned, the weight of small caps in the portfolio has decreased following some selling. Given the flexibility afforded, my research time is now tilted towards finding bargains among larger companies. My goal is to decrease our cash position, which is invested in bankers' acceptances and generating a mere 1.15% annually–clearly a drag on performance (especially if we look at how the indices and our portfolio have fared over the past 12 months!). However, in the present high-valuation environment, patience is warranted.



On a different note, I would like to rectify some misrepresentations in a recent article on Tonus Capital published in *Finance & Investment*. There was some ambiguity in the piece regarding the firm's beginnings. Truth be told, Steve Boutin was its sole founder and he deserves all the credit for laying down the foundations and guiding principles on which Tonus has been built. It was only in 2009 when he began looking for a partner that I seized the occasion and offered to join the firm. Moreover, the article omitted important facts concerning Steve's departure. He left in 2011 when he was approached by Burgundy Asset Management to join their firm. Although it was a difficult decision for him to make, he could not pass up the chance to become a portfolio manager and partner in one of Canada's leading investment firms. It comes as no surprise to me that he has performed tremendously since joining them and I wish him continued success.

Finally, let me conclude with a comment on our common destiny. As of this date, I can affirm that the vast majority of my personal net worth continues to be invested in the Tonus Composite Portfolio. Some of you have asked me to reiterate this very important point periodically. We share the common objective of obtaining long-term returns balanced against a desirable level of risk. I believe our structure is optimal and that our portfolio presents interesting potential for long-term gains. Hence, I have no intention of decreasing my personal investment in the Tonus Composite. On the contrary, I upped my investment recently and will continue to do so in future.

Sincerely,

Philippe Hynes, CFA
April 11, 2014

Tonus Composite Performance Report
As of March 31, 2014

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	6.07%	6.06%	5.76%
6 Month	18.34%	13.79%	20.81%
Year-to-Date	6.07%	6.06%	5.76%
1 Year	29.57%	15.97%	32.39%
2 Years	27.97%	10.91%	23.80%
3 Years	23.24%	3.55%	19.63%
5 Years	19.42%	13.70%	18.01%
Since Inception (Oct. 31, 2007)	13.20%	2.69%	7.79%

Source: Factset Research Systems, Inc.
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.