TONUS CAPITAL INC.

Tonus Capital Inc.
999 de Maisonneuve Ouest
Suite 799
Montréal, Québec H3A 3L4
Tel: (514) 844-4443
www.tonuscapital.com

THIRD QUARTER 2023 - NEWSLETTER

Dear Partner,

We are pleased to send you our portfolio review and commentary for the third quarter of 2023.

Performance Review

During the third quarter of 2023, the gross return for the Tonus Partners Fund was **-1.1%**. Year-to-date, the Fund has achieved a gross return of **14.7%.**

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **9.9%**, compared with **7.0%** for the benchmark[2].

Portfolio Review

The markets began the third quarter much like they left the last one; pushing up broad indices on the promise of artificial intelligence (AI) as well as enjoying an optimistic expectation of soon-to-come interest rate cuts. You will recall that we wrote about the crowded trade into tech stocks in our 2Q23 letter, a trend which continued into the early part of the summer. After that, most asset classes saw pullbacks and all North American indices posted negative returns for the third quarter.

Expectations for a Goldilocks scenario with no bears in sight (pardon the pun) and a soft landing were tested, with the 10-year US Treasury close to 5% (over 4% in Canada). Given that we are late in the current economic cycle, investors' expectation for eventual rate cuts are elevated and many are lowering their expectations about the rate of return they are demanding to take on risk. Our investment horizon remains long-term and small changes to risk-free rates are not changing what we require as our own rate of return to deploy our capital. In fact, it never has.

Our Fund continues to protect your capital, as it is designed to do, and it is down only 1% for the third quarter. On a year-to-date basis, all equity and bond indices are now down or relatively flat, with the exception of the S&P 500 (more on that later). Our **+15%** gain so far this year is a testament to our style. When we can find and buy stocks at good or very good, i.e., low prices and valuations, our downside is limited and our upside can be significant, due to either an increase in the valuation of the stock or as we have witnessed twice this year - and twice last year - the company is bought outright via acquisition. This is noteworthy because we have generated positive returns despite being cautious all year, having positioned the portfolio to navigate this uncertainty.

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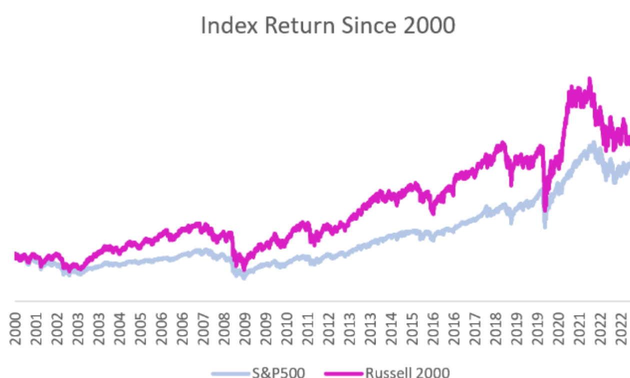
[1] Please see page 5 for a description of the Composite.

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

Sticking to the Tried and True

While our favoured hunting ground remains in the small and mid-cap enterprise sectors (e.g., companies with a market value of between $200 million and $5 billion), we have also had success this year with larger companies. Our investments in **Dollarama (DOL - $93.58)** and **Comcast (CMCSA - $44.34)** have both been great performers in 2023, up **+27%** and **+18%** respectively. We continue to shy away from popular mega-cap technology names that have propelled the S&P 500 again this year. The issue is not that we do not believe these are great companies that should continue to grow in the future, but every asset has a fair price, and we find it very difficult to evaluate how much to pay for such elevated growth expectations. Simply put, the probability these shares decline is appreciable, but more importantly, the magnitude of the potential drop is extremely hard to quantify.



Investor memory is woefully short and folks tend to forget quickly that large-cap growth stocks are not always strong performers; think of 2022 as a very recent example! It might be hard to believe today, but since 2000, small-cap stocks have outperformed larger cap names by approximately +0.6% per year. Looking at the market performance for the last several years, we are reminded of the quote, "If it's worth doing, it's worth overdoing." We pass no judgment on the merits of this momentum-driven investment philosophy but, given that large-caps have outperformed small-caps in eight of the past 10 years, it would seem the market deemed mega-caps to be the next obvious choice for trend followers.

And so money has kept flowing towards the same mega names of late, now referred to as the "Magnificent Seven", which include: Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia, and Tesla. Many investors have chosen the safety of the herd by paying high prices for these trendy stocks, whose gains were sparked by the illusion that generative AI would lead to booming revenues (N.B. only one of these seven firms is seeing substantial revenue growth this year). These seven stocks have contributed so much of the index return that, without their performance, the S&P500 would be up only +1.8% this year (instead of +13% with the Mega names), a performance reflected by the S&P 500 equally weighted index which is flat for 2023.

Price to forward earnings ratio			
	20y average	Current	Over/under
Large Cap Growth	18.8x	24.4x	30%
Small Cap Value	16.8x	14.1x	-16%

This context makes a great setup for those who dare to step out. For us, this means looking at small/mid-cap companies that are now trading at much more attractive valuations. Historically speaking, large-cap growth stocks and small-cap value stocks trade at similar price-to-earnings ratios. The divergence is now extreme: with large-caps' +25% gain this year, they are now trading way above their historical multiple while small caps, down -30% from their peak in 2021, are now trading far below normal levels. There are plenty of stocks in this group that are now trading at very attractive valuations but, given the uncertain macro environment, we continue to be very selective in

deploying our liquidity. We centre our research on companies with strong free cash flows, long-term sustainable competitive advantages, and management teams that are focused on creating shareholder value.

Stock Movements

One such example is a stock we recently purchased: **Ag Growth International (AFN - $53.24)**. The company is a provider of equipment and solutions required to support the efficient storage, transport, and processing of food globally. AFN is poised to benefit from the long-term growth in grain production from regions outside North America playing catch-up to upgrade their infrastructure in order to maximize capacity and efficiency. To tap into this favourable macro outlook, AFN embarked on an aggressive acquisition strategy between 2014 and 2020 to broaden its product portfolio and expand its geographic coverage. While investors initially bought into this plan and drove the share price higher, heading into 2020 they became less enthused as margins deteriorated and debt levels ballooned. This was not an ideal position from which to enter the global pandemic. Consequently, the stock price was cut in half.

However, the pandemic and ensuing global supply chain bottlenecks led many governments to look into their country's food supply and storage needs. Demand has recovered strongly and AFN is growing its international sales at double-digit rates. A new management team is at the helm and their focus is clear. They will pause acquisitions while improving their profit margins by centralizing purchasing and driving manufacturing efficiency. Combined with strong demand, this is leading to a sizable increase in profits and free cash flow, which, when applied directly to reduce their debt, should increase the value of equity within the enterprise. However, the stock is still trading at less than 10x earnings. We expect that by the middle of next year, the multiple should move up as investors come to appreciate the sustainability of higher margins and the much-improved balance sheet. Combined with earnings moving up, this stock could move materially higher.

In the last quarter we also sold, with a 40% profit, our stake in **Caleres (CAL - $28.76)**. If you recall from our 4Q22 letter, CAL is one of the best operators in the family footwear category. At the time of our investment, we were protected by a low valuation as well as earnings that would likely endure or increase slightly. In recent months, the market gained the same confidence we had that the business is well managed.

That said, from a risk-reward framework, we are cognizant that the road to a much higher stock price will not be linear. The stock rose quickly and once it reached in the high $20s, we felt it prudent to take our profits and put the stock back on our wishlist. We might have left some gains on the table, but we believed the downside in the current environment could be significant. We will monitor future developments with the aim of getting another very favourable entry point to buy in again.

Being Paid for Taking Risk

There are many uncertainties in the current environment. We know the economy is less robust than it was a year ago. We know higher interest rates are having an impact on credit availability and buying decisions. And we know earnings expectations for 2024 remain elevated. In such a context, we think investors are putting too much emphasis on trying to predict the timing of an eventual recession rather than thinking about the level of risk to which they are exposed. As we

have mentioned before, investing comes down to comparing the current price paid relative to risk and the expected level of future earnings.

If no one wants any risk, then holding cash or very short-term government debt is the way to go (although with a third consecutive year of negative returns for bonds in 2023, many are realizing bonds are risky assets too!) It is important to understand that being long, i.e., exposed to, risk entering a recession can be fine; it can actually be a very profitable place to be. **It comes down to being properly compensated for the level of risk taken.**

Even if we enter an economic slowdown, our holdings currently do not seem financially vulnerable and are trading at prices that suggest an interesting medium-term return. We particularly like companies that can benefit from consumers switching to their more affordable products. Consumer discretionary companies, some of which have been beaten down this year, are offering up names with unique characteristics that could benefit from a tighter consumer wallet. We will continue to avoid expensive areas of the market, in particular growth stocks, and keep our focus on companies that are trading below their historical valuations.

Charlie Munger, Warren Buffett's business partner, once said, "The big money is not in the buying and the selling, but in the waiting." We feel this applies to both the nature of compounded returns on a security that we own, and the patience to wait for the right price to purchase it in the first place. With fewer investors allocating capital to small/mid-cap companies nowadays, volatility, and thus mispricing, has increased markedly. These heightened swings in stock prices allow patient investors, like us, to find appealing ideas that meet our criteria. Our game plan thus remains the same: conduct thorough research, understand our risk exposure, and wait for a price that compensates us handsomely for taking calculated risks.

Sincerely,

Philippe Hynes, CFA
Partner
October 12, 2023

Aaron Warnongbri
Partner

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

Tonus Composite Performance – As of 09/30/2023

	Tonus Composite (Gross Returns)	*Index*
3 months	-1.1%	-1.5%
6 months	8.5%	-0.2%
YTD	14.7%	4.6%
1 year	27.6%	11.2%
3 years	18.1%	9.8%
5 years	8.5%	6.6%
15 years	10.0%	8.8%
Since Inception	**9.9%**	**7.0%**

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% S&P/TSX TR Performance + 25% S&P/TSX SmallCap Index performance + 25% S&P500 TR Performance ($CAD) + 25% Russell 2000 TR Performance ($CAD). S&P500 TR ($CAD) and Russell 2000 TR ($CAD) 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 a 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.