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SECOND QUARTER 2019 - NEWSLETTER

Dear Partner,

Performance

During the second quarter of 2019, the TONUS PARTNERS FUND decreased **-1.29%** (gross of fees). 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 **2.28%**.

Year to date, the TONUS PARTNERS FUND is down **-1.60%** against **14.78%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **8.64%**, compared with **7.46%** for the benchmark.

Quarterly review

Market returns swung wildly month-to-month in the second quarter, first up 3%, then down 6%, and finally back up 5%. Though our portfolio grew in local currency terms, we ultimately posted a -1% return after the U.S. dollar lost 3% of its value late in the period. In this slow-growing but still healthy economy, low interest rates have had a caffeine effect on investors, who are more and more willing to take on risk and, thus, are pushing up asset prices. Fundamentals, commonly defined as profitability, are worse than they were at the start of the year, as investors have lowered their earnings expectations for 2019 and beyond. This risk-on approach keeps making it hard for value investing to shine. Growth continues to trump value big time, as evidenced by the persistent predilection for faster growing tech stocks. A recent analysis by J.P. Morgan concluded that the valuation gap between companies that investors love (growth stocks) and those that they loathe (value stocks) has never been wider.

Is value investing dead?

The question has often been raised of late in the press. If value investing is dead, then what are we doing sticking to our guns in a losing cause?[2] To our eyes, investment is like war, where careful planning, reliable intelligence and timeliness of action are the keys to victory. You might lose a few battles in the short term, but you have a better chance of success over the long term by playing it smart, biding your time, and avoiding needless risk. Value to us consists of buying stocks at prices that present little downside risk and that will deliver long-term gains when

[1] Please see page 3 for a description of the Composite

[2] In Canada, value stocks as gauged by the Dow Jones Canada Select Value Index have underperformed the S&P/TSX by 6.1 per cent in the past year and by an annualized 1.7 per cent over the past five years. In the United States, the S&P500 Value Index has underperformed the S&P500 Growth by more than 5 per cent in the past 12 months and by an annualized 3 per cent over the past five years. Global value stocks as measured by the Morningstar Developed Markets ex-North America Target Value Index have underperformed the MSCI EAFE by 10.3 per cent over the past year.

business fundamentals and/or investor sentiment improve. We believe there are more and more stocks that are fitting this profile as investors dump value stocks in favour of growth stocks. When these value stocks start to turn, they will deliver <u>similar, if not better, returns than growth stocks</u> are currently providing. Our investment in **Dollarama (DOL - $46.07)** made back in 3Q18 when investors were questioning its business model is a case in point. The stock has since jumped by 50% in less than a year!

We have also witnessed a change in investor sentiment toward **Cascades (CAS - $10.54)**. Its share price bottomed out at $7.84 in April but traded recently at $12, up 50%, after the company finally saw a decline in its raw material costs and announced a deal to scoop up the assets of a bankrupt competitor. Its business fundamentals improved only somewhat, but the market was so pessimistic about the stock that the slightest positive development triggered a massive rally in its price. Though there is no way of pinpointing when such a change in investor fondness will occur, we believe many of our stocks stand to benefit from such a reversal in the coming months.

The recent increase in mergers and acquisitions is another sure sign that bargains presently abound in the sea of value stocks. Opportunistic buyers have been casting their lines, hoping to land a big one that has been growing quietly in shaded waters. The airlines Transat and WestJet (up 140% and 67%, respectively) and the auction house Sotheby's (up 60%), an old holding of ours, received very attractive acquisition offers recently. We can expect this trend to continue and we can hope for it to impact our portfolio.

New acquisition: Real estate broker RE/MAX

In addition to enhancing the potential upside of some of our holdings, the dichotomy between growth and value is also feeding our pipeline of stocks that could be added to our portfolio. Thanks to this, during Q2 we acquired shares of real estate broker **RE/MAX Holdings (RMAX - $30.76)**, a company we had been watching since it went public back in 2013. RE/MAX boasts a 10% share of the home resale market in the United States and a huge share of the Quebec and Ontario markets as well (40% and 25%, respectively). As a franchisor, its business model is asset-light and generates great cash flow derived primarily from annual dues collected from agents. After more than doubling in price over the first four years of trading, the stock gave it all back, plunging from $67 to under $30 when investors were spooked by the cooling of the U.S. real estate market. While growth has slowed, we believe that the business's long-term fundamentals remain robust and that the stock price at present overly discounts the short-term macro trends.

Contrary to its main competitors, RE/MAX generates the bulk of its revenues from annual dues charged to agents rather than by taking a large slice of the commissions generated by each transaction. Aside from reducing its dependence on transaction values, this enables the company to attract some of the best agents in the industry, who are said to "graduate to RE/MAX". It focuses on high-producing, mature agents who approach the business as a profession with a more nuanced view of the real estate cycle. As the company recently provided agents with additional tools, we believe it is in a great position to be able to raise annual dues in the coming years.

Regarding profitability, we estimate the company will earn $2.25 per share this year, for a valuation of 13x earnings. Almost half of its earnings are given back to shareholders in the form of dividends (yield of 3%). The company is wisely using the remaining cash to buy out some of its independent franchisees, which will increase earnings. Seeing how its balance sheet is in great shape, we believe another special dividend is potentially in the cards.

Finger always on the trigger

As the summer rolls on, we will monitor the stocks on our wish list with a sharp lens as they go through the quarterly process of releasing their results. We believe there could be greater volatility this time around given that investors have been looking for direction in the past few months. In the event of any short-term over-reaction, we will pounce opportunistically and deploy some of the cash we currently have on hand.

Thank you for your continuing support!

Philippe Hynes, CFA
July 18, 2019

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.