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FOURTH QUARTER 2020 - NEWSLETTER

Dear Partner,

Herein our portfolio review and commentary for the fourth quarter of 2020.

Performance

During Q4, the TONUS PARTNERS FUND registered a gross return of **21.32%**. 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 **7.94%**.

For 2020, the TONUS PARTNERS FUND is up **19.94%** against **10.89%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved an annual compound rate of return of **9.53%**, compared with **8.03%** for the benchmark.

Quarterly review

It was a remarkable year on all fronts and we are very pleased to have delivered a strong performance in spite of the many challenges imposed upon us by the pandemic. After outperforming during the market plunge in early March, our Fund went on a tear. It shot up 64% from the low hit on March 23 and culminated with a 21% gain in the fourth quarter, hoisting our unit value to an all-time high. Thanks to an extremely volatile market, this was our most active year ever, with a total of 15 new stocks added. We were able to bring in new high-quality companies at bargain prices and liquidate holdings trading at or above their full value.

Our most active year

While many people perceive volatility as a measure of risk, we see it as a measure of fear and greed, factors that cause securities to be mispriced. Our patience and discipline were rewarded when panic selling drove prices down in the spring and when numerous overlooked small-cap stocks lagged the broader market in the summer/fall. We acquired shares in past winners like **Alimentation Couche-Tard (ATD.B – $43.38)**, **SleepCountry (ZZZ - $26.47)** and **Berkshire Hathaway (BRK.B – 231.87)**. We initiated positions in previously analyzed companies on our wish list when they hit our desired entry point. These included **Goodfood Market (FOOD - $12.12)**, **KAR Auction Services (KAR - $18.61)**, **Recipe Unlimited (RECP - $16.75)**, and **SS&C Technologies (SSNC - $72.75)**. We also researched many new names, a few were purchased, some were put on the wish list, and many others did not meet our investment

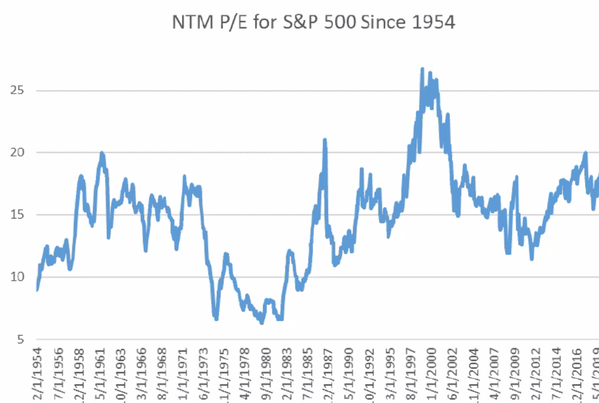
[1] Please see page 5 for a description of the Composite

criteria. We stayed the course through it all, which is to say that we sought out quality companies temporarily mispriced, analyzed their financial statements, examined management's capital deployment strategy, identified upcoming catalysts, and defined our own differentiated investment thesis.

Skepticism about the rally

With the covid case count trending up relentlessly, many people are doubtful that the markets will any time soon surpass the peaks reached at year end. The impression that the general public might get from glimpsing the headlines is that all stocks must have gone up this year. The truth of the matter is that, if the S&P500 closed the year up 15%, it was almost entirely thanks to the top 10 technology stocks. Almost half (40%) of the 500 stocks in the index were down on the year, the median return of the 500 constituents was a mere 5% and the gap between growth stocks (+32% on the year) and value stocks (-1.4%) remained extremely wide!

Why were growth-oriented tech stocks so popular? It was due in part to the positive impact that the pandemic had on their businesses (e.g., e-commerce, online platforms, work from home) and in part to low interest rates that boosted their P/E multiples significantly. As a result, expectations are high, especially for these growth stocks. As the graph shows, only once before since 1954 was the S&P500 this expensive on forward earnings. This does not mean that stocks will necessarily drop from here, but it definitely limits the potential gain in the years ahead and renders the market vulnerable to negative catalysts.



While large caps are as expensive as they have ever been, small caps are relatively more appealing. Aside from trading closer to their historical average multiples, they stand to benefit more when the economy re-opens. Earnings will rise and, in turn, their share price as well. That said, certain pockets of small caps have also been prey to speculation. The Biotechs, for example, counts no less than 25 stocks that were up 150% this past year[2]. Companies devoted to the development of electronic vehicles saw their stock prices explode. Obviously, these companies, whether involved in e-commerce, vaccine development, or transportation electrification, are well positioned to grow in the coming years. However, there is more to investing than just predicting the future. It entails looking down the road from the perspective of what is already priced into a stock.

Heading into 2021, we see significant danger in specific sectors should results fail to live up to the market's very high expectations. Indeed, the recovery could very well stagnate, leaving expensive stocks vulnerable to sharp declines. Protecting your capital is our first and foremost concern at the Fund. Consequently, under the circumstances, we prefer to focus our attention on stocks that present lower risk, namely, small[3]- and mid-cap stocks that are trading at fair valuation and companies that will grow stronger and more profitable in the post-covid environment.

[2] Counting only the biotech stocks that are included in the Russell 2000 index

[3] Our sweat spot in small caps are stocks with market capitalization of $100 million +. We are much less active in micro-caps (< $100 million) given the risk associated with their too often lack of liquidity

Small is beautiful

The other reason we like to sift through small caps is they are oftentimes overlooked and mispriced. We had two great examples of this in 2020. First, **mdf commerce (MDF - $12.28)** saw its stock price decline significantly when its new management team pivoted strategy a year ago and decided to invest in and focus on their e-commerce and digital supply-chain businesses. Their timing could not have been any better! Well, the market missed it, and the stock price dropped 60% early in the year and remained in negative territory until late September! By then, it was obvious to us that they would benefit from the shift to e-commerce and we could not understand why its stock was down while competitors saw their share price double and more. Consequently, we increased our position and enjoyed a 38% gain in Q4. Even with that, we believe the stock is still largely undervalued.

Though fewer bargains were to be had later in the year, we continued to discover interesting opportunities among misunderstood small caps. Many initial public offerings (IPO) were completed in the fourth quarter to take advantage of the fact that private equity firms liquidated their holdings in large well-known companies at sky-high valuations. Investors then rushed to buy these hot IPOs, often without paying too much attention to fundamentals and valuation. We spent a great deal of time, instead, analyzing the much less hyped IPO of Montreal-based **Haivision Systems (HAI - $10.40)**, a leading provider of mission-critical, real-time video streaming and networking solutions. Its owners did not take the company public to cash in on high valuations. They sold no shares (they actually bought more) and, unlike others who raise money to repay debts acquired to fund unprofitable operations, Haivision intended to invest the money to grow and strengthen its business.

At the time of the IPO, the company operated in a growing market and was profitable and unlevered. The stock was initially priced at a reasonable trading multiple of 10x EBITDA. We were ready to take the plunge even before being served a bonus by a market that completely missed the boat. Because of tepid demand for the stock, bankers dropped the initial price to $6.00, which translated into an additional 11% discount for us. In light of this repricing, we increased our position. The stock doubled in value by the third day of trading, a super gain stemming from the market's occasional inefficiency when it comes to small cap investing.

Not a perfect year

Not all our stocks performed well in 2020. For example, **Strategic Education (STRA – $95.33)**, a provider of higher education, fell 39%, negatively impacting our return. After an initial surge in online enrollment in the spring, demand dried up in the summer at one of their universities where the core clientele consisted of women of colour, the segment of the population most affected by the pandemic. That said, the company is debt free and flush with cash. Though enrollment is down, it still has 100,000 registered students to start the year and it recently made a strategic acquisition that should boost profits in 2021. As its core clientele gets back on its feet in the post-pandemic era, company earnings should return to historical levels and beyond.

We believe that this stock, like others we own that are still trading below pre-COVID levels, will rebound nicely over the next few quarters. As we continue to shy away from overcrowded momentum-driven tech stocks, we are heartened by the fact that, at year end, many of our holdings were trading far from their peak, had reasonable valuations, had accentuated their competitive advantages, and could deliver better-than-expected financial results in the coming year.

Benchmark

We mentioned in our last letter our intention to review the benchmark that we present to you every quarter. We do not buy and sell stocks based on whether they are included in a particular index, but a yardstick of some sort must be used to determine whether our stock picks add value to the Fund over the long run. With the S&P500 tilting recently more and more towards tech stocks (37.3% of the index[4]), we found it less and less relevant as a measure of our results, especially on a short-term quarterly basis. It also failed to reflect our historical 50% to 70% weighting in small caps. Since this proportion will in all likelihood be maintained going forward, we feel justified in factoring how small cap indices perform into our blended benchmark.

Consequently, we will make two changes starting in 2021. First, we will refrain from emphasizing our quarterly (short-term) performance relative to the benchmark and we will focus instead on longer-term comparisons. Second, our benchmark will now be composed equally of the following four indices: S&P/TSX (Canadian large cap index), S&P/TSX small cap (Canadian small cap index), S&P500 (U.S. large cap index), and Russell 2000 (U.S. small cap index). Had we used this as our benchmark in the past, the benchmark's return would have been slightly different. For example, in 2020, it would have been 13.4% instead of 9.9% and, since the inception of our strategy in 2007, it would have been 7.4% annually instead of 7.9%. If you have any questions regarding this change, please feel free to contact us. We would be happy to provide more details on the matter.

Realistic optimism for 2021

We finished the year on a very good note. Small- and mid-cap stocks and value stocks started doing better once vaccine results were released and optimism for a return to normalcy improved. We think the situation will brighten up even more going forward. In the early goings of an economic recovery, these stocks have historically always performed better. That said, you can rest assured that we will maintain our discipline, wait for the right opportunities to arise, and sell or reduce our positions without hesitation if prices climb to levels where risk/reward is no longer attractive.

Sincerely,

Philippe Hynes, CFA
January 3, 2021

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

[4] We included the weights of Amazon, Facebook and Google which are not technically included in the technology sector as per S&P classification

Tonus Composite Performance – As of 12/31/2020

	Tonus Composite (Gross Returns)	*Index*
3 months	21.32%	7.94%
6 months	29.26%	14.14%
1 year	19.94%	10.89%
2 years	11.41%	17.12%
3 years	3.13%	10.15%
5 years	7.11%	11.22%
10 years	10.62%	11.09%
Since Inception	**9.53%**	**8.03%**

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.