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FIRST QUARTER 2024 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2024.

Performance Review

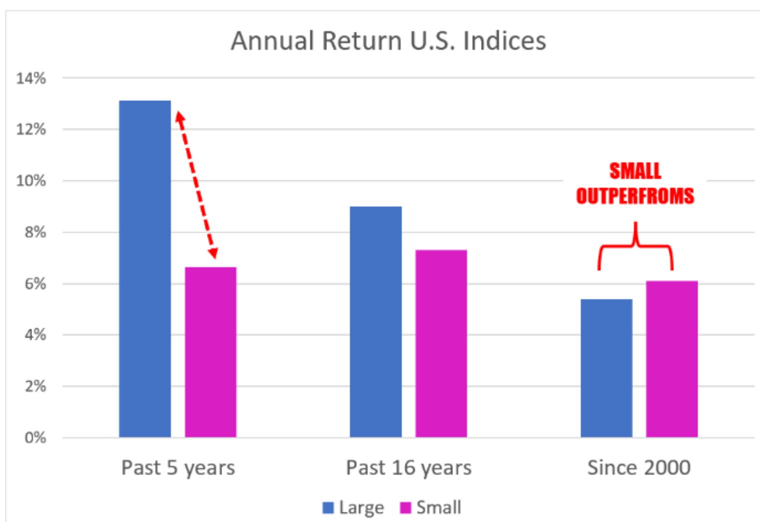
During the first quarter of 2024, the TONUS PARTNERS FUND registered a gross return of **17.9%**. Over the past twelve months, the Fund achieved a gross return of **39.5%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compounded gross rate of return of **11.3%**, compared with **7.9%** for the benchmark[2].

Portfolio Review

For the first three months of the year, our Fund generated its best opening quarter since inception, up **+18%**, while our return over the past year now stands at **+39%**. Our results are all the more impressive given most investors' current lack of interest towards small and mid capitalization stocks, the segment in which we invest the majority of our portfolio. The Russell 2000 index which tracks the returns of U.-S. small caps was up only 5% in Q1. Recently, large-caps have outperformed and for the quarterly performance of large/small caps over the past 5 years, large has fared better in fourteen out of the last twenty quarters (= 70% of the time).

However, over a longer time horizon, the result is different. Since Tonus started 16 years ago, large beats small only 54% of the time. And since the beginning of the century, to the surprise of many, **small performs better than large**. One hundred dollars invested in 2000 in the S&P500 (large) and the Russell 2000 (small) would now be worth $357 and $420, respectively. While the current prevailing wisdom is biased because of the outstanding performance of mega-caps for the past five years, at Tonus we take a more holistic view and the benefits are increasingly evident in our returns.



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

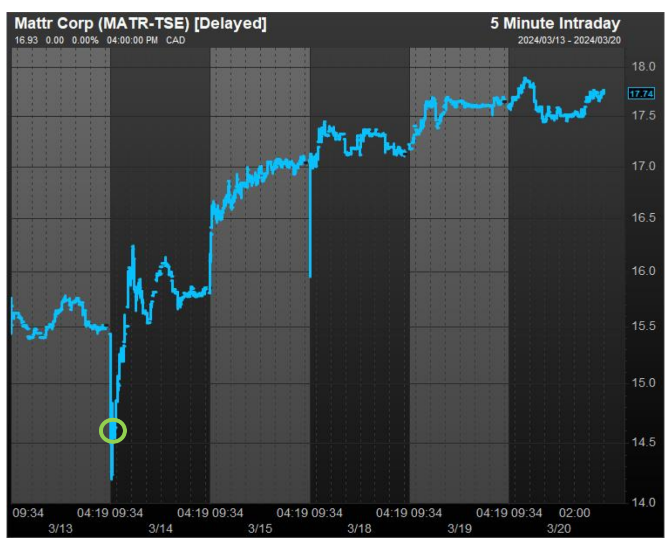
Looking for Underpriced Assets

As you know, our investment policy gives us full flexibility to invest in both large and small-cap stocks. We let stock-specific valuations/opportunities dictate where our research time will be focused. When looking for new ideas, like all other buyers, we seek to find good *deals*, i.e., to purchase an asset below its fair value. For us, this oftentimes means looking for stocks that are either undiscovered (too small for large institutions to look at) or misunderstood (investors failing to appreciate the business model or the earnings power of the business). To find such temporary mispricing, the best place to look is where others are not. A home buyer is much more likely to find a house selling below market value in the less popular neighbourhoods. Fewer buyers mean a higher probability of getting a great price.

Using the real estate analogy, small caps are the “unpopular suburbs” for now, with most investors focusing only on trendy large cap companies. As a result, less (or no) money is flowing to small-cap funds, fewer firms/funds are focusing on this segment and so, fewer eyes are looking at these companies. The efficient market hypothesis, first proposed by Samuelson and Fama in 1965, assumes that financial markets incorporate all important information into current share prices. While we could argue this theory is somewhat valid for large-cap stocks (more investors, more transactions, more price discovery), of late, we are witnessing more and more examples (anomalies) to refute that notion as it relates to small-cap stocks.

This temporary mispricing can last minutes, weeks, or whole quarters, and it is often exacerbated when public companies report their results. With this in mind, every three months, our research team analyzes the published financial reports of all the companies we own in our Fund (as well as many others on our focus list). In addition to comparing the revenues/profits reported with our internal estimates, we will assess if the report, along with management’s comments, changes our long-term intrinsic value estimate of the enterprise higher or lower.

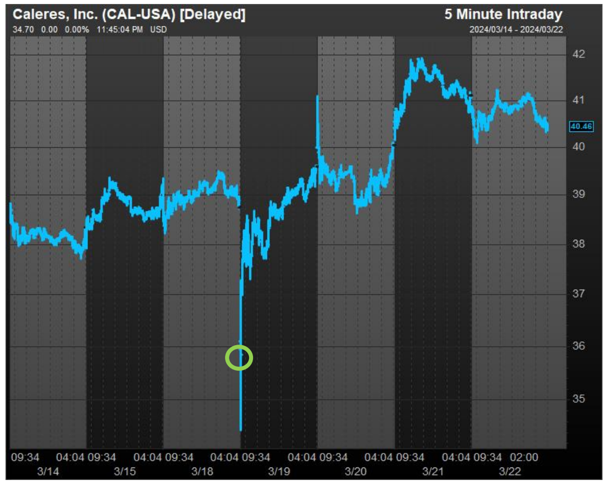
More often than not, the short-term quarterly result is noise relative to the longer-term value creation we expect from our investment. Nevertheless, when markets open at 9:30AM, we need to have an updated opinion on the value of the company and the price at which we want to buy or sell shares. On most occasions, we will do nothing. The market will appropriately adjust the stock price with the newly released information and the price movement will not be large enough to hit our (potentially revised) targets. However, more and more we are witnessing huge volatility in small-cap names which can lead to transaction opportunities. Let’s highlight a couple of these from the quarter just ended.



Shorter-Term Buying Opportunities

We have detailed in prior letters our bullish views on **Mattr (formerly Shawcor Ltd – MATR - $17.76)**. We expect this stock to be worth significantly more in the years to come as management deploys the cash generated from recently sold divisions of the enterprise. We met the company at its December 2023 Investor Day, which reinforced the upside potential in the company’s earnings power. Investors’ shorter-term view had pushed the stock down as many shied away from the stock after management commented in November that 2024 would be a “transition year for its profitability.” Uncertainty on Q4 results and flattish prospects for the year ahead meant a low bar to clear when they reported results in March. We read and analyzed those results, the short-term risks were appeased, and our long-term view was reinforced. We had been waiting for a price of $14.75 to add to our holding, but we expected the stock to perform well that day. To our surprise, when the markets opened, the stock was down 7% and hit our target buy price, so we jumped on the occasion to buy more shares. By midday, the stock was above $16, up more than 10%. It continued to climb and finished the quarter much higher.

Caleres (CAL - $41.03), a shoe retailer and wholesaler which we profiled in our 4Q22 letter, is another example. After a good quarter, their good guidance for the upcoming year coupled with good long-term prospects and an improving balance sheet should have driven flat-to-up prices. Instead, the stock opened down -10%, quickly rallied, and finished up 20% two days later!



We are not trying to convince you that we are great short-term traders. The point we want to highlight is the inefficient market phenomenon we are increasingly witnessing with respect to small-cap stocks. We continue to conduct thorough research on the companies we analyze. For the ones meeting our quality criteria, we establish a target price at which we would be buyers and wait for the quoted market price to get to that level. This price, based on our expectation for the value of the company in three-to-five years, is derived from the free cash flow generating capability of the company and management’s prowess in reinvesting that cash wisely. If the market is more inefficient and volatile, it creates more opportunities for us to act and deploy our cash.

Longer Term Buying Opportunities

While short-term price moves can slightly improve our returns, inefficiencies that take longer to correct, but which can yield much bigger returns, are more interesting for our investment style. **Mix Telematics (MIXT - $14.55)** is a company we originally bought at $3.87 in April 2016. It went up to $20 per share, but retreated below $10 following the pandemic shutdown and the significant devaluation of the South African rand.

MIXT valuation remained depressed for four reasons. First, it was overly exposed to South Africa. Second, it had failed to post significant organic growth in other regions. Third, because its main listing is in South Africa, many institutions cannot buy it. Fourth, investors had given up on management’s ability to make a significant acquisition that could boost growth.

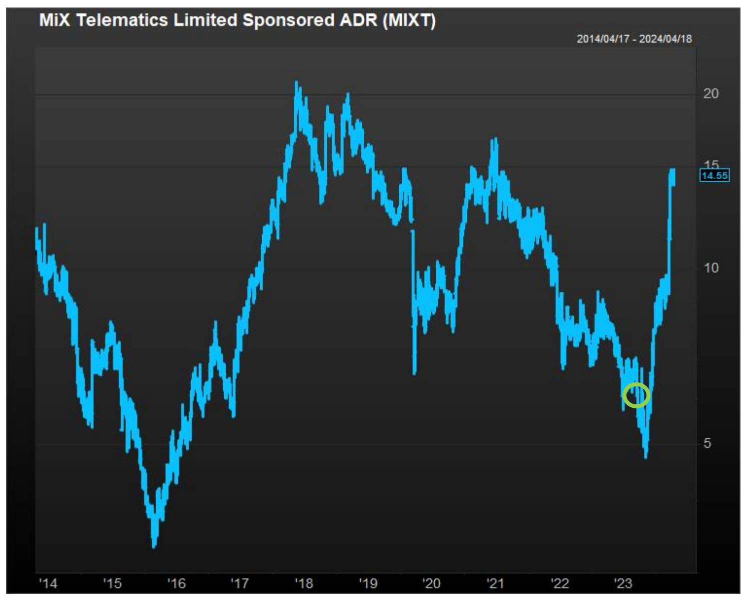
Meanwhile, in September 2023, we met with **PowerFleet (PWFL - $5.34)**, another company operating in the telematics industry. While we were impressed by its recently appointed management team’s strategy, we did not want to own two stocks within the same industry that lacked operating scale and market liquidity (both fetching a market cap too small for many investors to look at). PWFL’s poor balance sheet, resulting from an awful financing done in 2019, also kept us on the sidelines. We stuck with our lower-risk investment in MIXT.

A month later, MIXT announced it would merge with PowerFleet: a perfect match, in our opinion. The transaction solved MIXT's problems of geographic concentration and foreign primary listing while resolving PWFL's balance sheet leverage. Short-term, material cost savings will significantly improve profitability.

Looking longer term, the new entity can now offer a full end-to-end suite of products to compete against market leader Samsara, another public company with a much larger market value of $20 billion. While Samsara has a better offering for now, it is extremely expensive, currently trading at 17x forecasted revenues (by comparison PWFL is trading at 2.5x). On top of being much cheaper, the market capitalization of the combination of MIXT and PWFL will be closer to $500 million, bringing more liquidity and potentially an inclusion in the small-cap index.

While the deal made a lot of sense when it was announced, MIXT's share price dropped 15%! This is another striking example of the inefficient market. What's more, given it was a stock deal (meaning MIXT shareholders would receive shares of PWFL), arbitrageurs could buy one stock and short the other, securing a risk-free profit if the deal were consummated.

Usually, the spread in such situations remains quite low, i.e., in the single digits. Because of its size, its atypical structure, and the fact some work/calculation was needed to derive the ratio of PWFL shares MIXT shareholders would receive, the stocks were trading at a spread of more than 20%. The only risk remaining was MIXT's shareholders' vote (75% of shareholders needed to approve the deal). On February 28th, we were granted permission to log into a webcast during which the vote's positive result was announced; the merger would go through. We purchased more shares in October after the announcement and the stock has more than doubled since. The merger has since concluded, we are PWFL shareholders, and we expect significant value creation in the years to come.



Awaiting their rebound, we find good deals in small caps

We do not know exactly when small-caps will be popular again. As detailed at the beginning of this letter, history tells us that small caps and large caps returns tend to converge over the long-term. Given that we are in the eighth year of the "*Large beats Small*" period, we should be closer to the end than the beginning. Eventually, small-caps will rally, and rally hard, which should serve as a terrific tailwind for our returns.

Meanwhile, we will continue our detailed research for companies that offer great long-term value appreciation. Fewer investors looking at smaller companies has created an increasing number of dislocated prices. As we have seen over the past few months, this should lead to an increasing number of opportunities for us to buy great companies with good long-term prospects at prices that significantly reduce our downside risk.

Sincerely,

Philippe Hynes, CFA
Partner
April 11, 2024

Aaron Warnongbri
Partner

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

Tonus Composite Performance – As of 03/31/2024

	Tonus Composite (Gross Returns)	*Benchmark*
3 months	17.9%	8.8%
6 months	28.6%	18.1%
1 year	39.5%	17.9%
3 years	16.3%	7.5%
5 years	16.8%	10.6%
10 years	9.9%	9.4%
15 years	13.1%	12.1
Since Inception	**11.3%**	**7.9%**

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% Canadian large cap TR + 25% Canadian small cap TR + 25% U.S. large cap TR ($CAD) + 25% U.S. small cap TR ($CAD).
Performance of U.S. indices 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.