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SECOND QUARTER 2020 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the second quarter of 2020.

Performance

During the second quarter of 2020, the TONUS PARTNERS FUND increased **15.01%** (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 **16.12%.**

Year to date, the TONUS PARTNERS FUND is down **-7.21%** against **-2.85%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **7.73%**, compared with **7.24%** for the benchmark.

Quarterly review

What a change we have witnessed in the market in the past three months! Back in March, the market experienced its quickest 20% drop in history. Then, it went through its biggest 50-day rally ever! Our fund followed suit, posting its best quarter with a 15% gain. Brushing aside the short-term freeze Main Street is having to cope with, Wall Street is betting that government stimulus will be enough to jumpstart the economy. Truth be told, a few fortunate winners have generated big gains that have doped indices and fed the misperception that losses have been minimal. In fact, most stocks are down this year, many by 20% or more. The result is a mixed market that is not as irrationally exuberant as it might appear (with the exception of technology stocks, as explained on the next page).

“Better than feared” does not equal “back to normal”

We believe that, while the doomsday scenarios envisioned earlier by some will likely prove overly pessimistic, the V-shape recovery anticipated by investors is highly optimistic. The sustainability of this recovery, fueled by delayed purchases and government stimulus, will be tested in the coming weeks. Cracks have begun to emerge of late with case counts on the rise and the demand rebound taking a step back. Generous weekly cheques sent by the government are scheduled to end this month in the United States and next month in Canada.

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

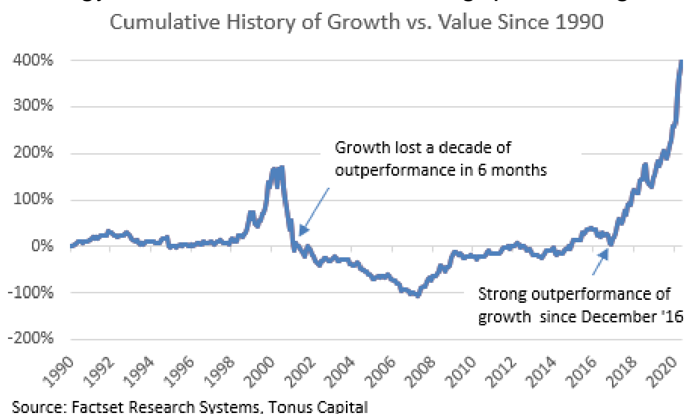
Unemployment has slid down from its peak, but 18 million people are still out of work and it will likely be years before we get back to pre-pandemic full employment as many companies have implemented cost-cutting measures that will prove permanent. Take La-Z-Boy, for example. The iconic furniture maker laid off 70% of its 10,000 employees in March. While production is now back, the company announced that only 6,000 of the 7,000 employees would be recalled. We have heard similar stories from various companies that we recently talked with.

With unemployment still high, government stimulus slated to end soon, and confinement measures on again off again, we find it hard to justify the market's expectations that 2021 will surpass 2019 in terms of profitability. This is the risk of investing now: Expectations might simply be too high, especially in tech. Any reversal may carry stocks lower but value stocks should fare much better, and potentially increase, in this mixed market. Our views are more cautious and we have positioned the portfolio to benefit from a gradual recovery, not a quick one. Moreover, we have sold investments in segments where investors are, in our view, much too enthusiastic about the rebound.

Markets seem flat: picture blurred by tech

This euphoria continues to be concentrated in pockets of the market, namely, large-cap tech stocks. While the NASDAQ is trading at an all-time high and the S&P500 is almost back in positive territory for the year, it is important to note that these indices are overly concentrated in this hot sector (technology represents 49% and 28% of the NASDAQ and the S&P500, respectively). A more complete picture of the stock market is provided by the S&P500 Equal Weight Index. The technology sector accounts for only 15% of this more representative benchmark. The performance gap between the two indices is staggering given that they are both composed of the same companies: The equally weighted index was down 11% in the first half of the year, compared with 3% for the regular index.

Smaller-cap companies and value stocks are faring worse because of investor appetite for momentum. So far this year, value is trailing growth by 24% and small is trailing large by 15%. To put this in perspective, in prior years, a 5% difference was considered big. The market continues to increase the premium for technology names, with the valuation gap reaching levels unseen for more than 20 years, going back to the 1999 dotcom era. Back then, elevated retail investor participation was facilitated by a step change in trading: E-Trade. Today, the Robinhood app and low/no commission trading is having a similar impact. When the market came to its senses in 2000, as shown by the graph, it took a mere six months to erase the multiyear outperformance of growth stocks over value stocks. The gap back then had been 200%; it now stands at 400%.

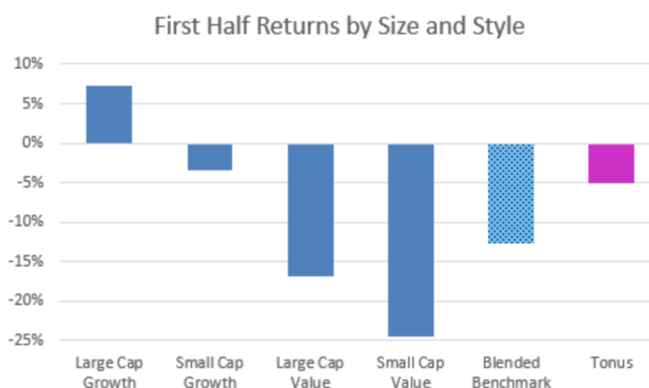


This time around, a COVID-inspired investment bubble is lifting stocks that will benefit from online delivery, work from home, web conferencing and the like. As was the case last time, little attention is paid to current or even future profits, with investors focusing only on revenue growth. We do not shun technology blindly. On the contrary, we recognize that its profit potential is

immense. However, we find it risky and speculative to value a company based on revenue growth, the common metric used by investors today.

To reduce the risk and still participate in this sector, we have invested in companies that are profitable now and have been in the past and that operate without the need to substantially increase scale for the sake of future profits. That is how we match value with technology investing. It is different from simply buying revenue.

In this context, given our small-cap and value bias, our -5% return for the first six months of the year is respectable (for comparative purposes, a benchmark[2] constructed with value/growth/small/large reflecting our exposure produced a -13% return in the first half). We are acutely aware of the impact that the divergence between growth and value has had on the portfolio's performance. The magnitude of the current divergence suggests that small-cap value stocks will enjoy a very robust return in time. The portfolio is set to outperform once the growth bubble begins to fizzle. We made a series of moves in the past quarter and continue to be active to best position our portfolio favourably for the quarters ahead.



New addition from this group

Scouting for mispriced stocks to add to our portfolio, we recently bought shares in **Recipe Unlimited (RECP - $9.27)**, Canada's oldest and largest full-service restaurant company. Without a doubt, the forced closure of many restaurants across the country will inflict damage to the company's short-term financials. In light of this, investors have dumped the stock, which has dropped by more than 50% this year. Our analysis points to investors expecting the long-term profitability of Recipe to remain 40% below where it was prior to the pandemic. We disagree.

First, almost half of its profits stem from royalties received from franchisees operating brands like St-Hubert, Swiss Chalet, and Harvey's. Sales from these locations have actually held up with their home-delivery and drive-through options. We think these profits will decline only slightly.

Second, 20% of profits derive from its retail segment, mainly products sold in grocery stores under the St-Hubert and Swiss Chalet brands. This business is actually growing right now. These two segments alone would suffice to justify an upside to the current stock price.

However, RECP has a third segment, where it operates company-owned locations under such brands as The Keg, Pickle Barrel, and Milestones. Lower traffic will be a challenge for these. That said, in the short term, profit pressures will be partly offset by generous government programs providing wages and rent relief. In the longer term, across the industry, we believe a significant proportion of restaurants might never reopen. As demand gradually comes back,

[2] We constructed the blended benchmark from the portfolio's weight at year-end: 7% in large cap growth, 6% in large cap value, 17% in small cap growth, 48% in small cap value, and 22% in cash. We have used U.S. indices as no Canadian indices exist for growth and value

well-capitalized groups such as Recipe will be poised to capture a bigger share of the market. Looking a year out, we think RECP could generate about $2 of free cash flow per share. It is hard to imagine that the stock will remain below $10 for too long.

Full value means less upside and more risk

On the outgoing side, we sold our stake in **RE/MAX (RMAX - $31.43)** after the stock more than doubled from its bottom price. In this case, investors are expecting a rapid recovery of the North American real estate market. While we may argue on the speed, we share the belief that existing-home sales will recover in time. However, this is not why we sold our shares. In our opinion, to justify the current stock price, in addition to a macro rebound, the company would need to raise its annual dues and expand its margins. We previously thought RE/MAX could achieve this in 2020; we now believe that this is unlikely to be the case and that the company will likely incur additional costs in the short and medium term.

We continue to like the business model but, as a result of the above, the upside/downside ratio turned unattractive as the stock fully reflected the optimistic and best-case scenario. The stock is back on our watch list and price will determine if and when the ratio returns to being attractive.

Good upside left

While societal and industrial spending patterns will no doubt change while we navigate the coronavirus crisis and may very well not revert entirely to how they were once we get past it, the stock prices of certain companies perceived as non-tech have fallen exceptionally low. However, we will eventually renew some of our old habits and needs: eating out occasionally in restaurants, buying a new mattress or a new or used car, upgrading educational qualifications, and using healthcare products and services. This, plus that fact that we are spending more and more time online should translate into good returns for select names that outlast the competition. Our portfolio embraces stocks that stand to benefit from this scenario.

In closing, allow us to re-iterate what we stated in our first-quarter commentary: Our strength lies in our knowledge of small and mid-cap value names. Covid-19 will not last forever, nor will technology's outperformance. Ultimately, profitable companies should outlast unprofitable companies that sometimes exist only as an idea alone. We own high quality companies that will generate good shareholder return over time.

Stay safe,

Philippe Hynes, CFA
July 11, 2020

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

Tonus Composite Performance – As of 6/30/2020

	Tonus Composite (Gross Returns)	*Index*
3 months	15.12%	16.12%
YTD	-7.21%	-2.85%
3 years	-4.37%	8.09%
5 years	1.59%	8.46%
10 years	8.95%	11.46%
Since Inception	**7.73%**	**7.24%**

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.