

FIRST QUARTER 2020 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2020.

Performance Review

During the first quarter of 2020, the Tonus Partners Fund's gross return was **-19.32%**. 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 **-16.33%**.

Since the inception of the Tonus Composite¹ in October 2007, it has achieved a compound gross rate of return of **6.68%**, compared with **6.10%** for the benchmark.

Portfolio Review

The world has changed dramatically over the past few weeks, and the markets with it. From the beginning of this year to mid-February, the stock market held the same course it sailed over the previous year on a sea of low-volatility, with big money single-mindedly chasing a small pod of large-cap growth stocks. Then the world economy was put on hold by a microscopic virus and the decade-long bull market was brought to its knees in just 19 days, a new record. That is how long it took for the market to drop 20% from peak, which, by definition, makes it a bear market. From their highest levels reached on February 19 to the end of the first quarter, large-cap indices plunged 28% in Canada and 22% in the United States, while small-cap indices plummeted a staggering 39%. For small caps, this was the worst quarter of all time!

Through this turbulence, from this same peak to the end of the quarter, our fund fell 20%, which is less than any market index. This is all the more noteworthy given that more than half of our assets are invested in small caps, the stock category hardest hit by the coronavirus shock.

With public health measures forcing most people to isolate at home, there is no denying that the economy is now in recession. In the coming weeks, companies will issue financial updates marked by sharp revenue declines, cancelled or postponed growth projects, substantial layoffs, and lower or sublimated profits. Most companies will abstain from making projections for 2020 as they have no idea how long the containment measures will remain in effect and how significant the economic repercussions will be on their operations.

¹ Please see page 4 for a description of the Composite.

In this context, investor sentiment has diverged widely. At one end, optimists believe that economic activity will recover quickly in the summer. At the other, pessimists are foreseeing a long and deep recession. The lack of consensus is what has been driving the extreme volatility witnessed recently.

Our response to the crash

While we abstain from trying to call the bottom of the market, its abrupt downturn has increased the pool of potential prospects trading at low multiples. However, under the current circumstances, it is critical for us as responsible investors to weigh the short-term liquidity risk that companies face against the long-term opportunity that their lower stock prices represent.

Consequently, the first thing we did was to assess the risk of seeing the companies we hold run into liquidity or debt covenant problems. Given that we are normally averse to levered balance sheets, most of our holdings passed this test easily. In early March, however, with volatility and uncertainty mounting, we deemed the risk too high for two of our positions and promptly sold them.

Then, as almost all stocks significantly declined in the following days, we went on the offensive to deploy some of our cash on hand. Part of our work consists in building financial models for the companies that catch our eye. We used these to stress test balance sheets and cash flows and to set a floor price to mark our entry point. We also modelled profitability under the assumption that we will eventually return to normalcy. As these positive scenarios generally resulted in fair value above current levels, our objective was to identify stocks offering sizeable upside gains and limited downside risk.

Instead of undertaking research from scratch on new names less familiar to us, we initially deployed our cash on a) some of our existing positions that had declined; b) stocks we sold in the past owing to expensive valuations; and c) companies we previously researched but whose price did not provide a significant margin of safety. Accordingly, we increased the weight of five existing positions, re-introduced three former holdings, and added two new names from our wish list. We will refrain from disclosing these two new names and explaining our thesis on them on account of the fact that we are still buying their shares now in April.

Former winners back at lower valuations

The three stocks that are back in the portfolio had all been sold on valuation grounds. The first of these is **SleepCountry (ZZZ - \$10.01)**, or Dormez-vous in Quebec, a small-cap stock we sold in July 2016 at \$30. We were able to buy the shares for less than \$10 in March. No doubt, with its stores closed since March 22, sales will suffer in the short term. Moreover, a recession and a drop in consumer confidence will likely pressure the medium-term results. However, mattress sales will not sink to zero because some dwellings will always be in need. Their online bed-in-a-box business, Endy, continues to do well. Our stress test of their balance sheet showed that their debt load could peak at \$200 million; within their existing credit facility. Smaller competitors will likely struggle going forward while ZZZ market share will continue to increase. We believe our downside risk is limited while the upside is substantial.

The second stock is **Alimentation Couche-Tard (ATD - \$33.15)**, which we had sold at \$42. A year later, we scooped it back up at a price 25% lower. Their outlets will remain an essential service as long as the pandemic persists. While kilometres driven are down with people staying

at home, fuel margins are up and in-store sales, which account for more than half their profits, should remain relatively stable. Its valuation is back to levels seen when we originally bought the shares. Over the long run, operations will stabilize, margins will remain healthy, and ATD will get back on track to achieving its goal of doubling its fiscal year 2018 EBITDA within five years, a target we still see as realistic.

The third stock that we bought back is **Berkshire Hathaway (BRK - \$182.83)**, which we had sold in 2016 at a price of \$146 per share. Over the past three years, the stock has lagged the broader market as Warren Buffett closed fewer deals. However, it holds a fortress balance sheet with \$128 billion of cash on hand to invest. It is in times like these, when liquidity dries up, that they can make their best investments. This is exactly what they did during the last recession: In the five years that followed, BRK outperformed the S&P500 by 40%. This past month, the stock slid back to 1.0x book value, that is, the accounting value of all its businesses. Given that accounting standards force them to value their assets at the lower of cost (acquisition price) or market (current fair value), the sum of all its holdings is always underestimated. The last time BRK traded at book value was in 2009, when the market bottomed out! We took advantage of these depressed levels to invest in this great company once again.

Where existing holdings are concerned, we increased our position in **RE/MAX Holdings (RMAX - \$21.92)**. As you may recall, this business has historically commanded a premium market multiple on account of the strength of its business model. While a recession will no doubt impact residential real estate, we are confident that it will affect them less severely given their lower debt relative to their competitors, the strong cash flow that they generate, and, most importantly, the professional nature of their agent base. In our Q3 [letter](#), we mentioned a competitor called Compass that has grown almost irrationally on the basis of “free money” financed by low interest rates. When the free money stops flowing down the road, the brokerage industry will return to a semblance of normal competitive dynamics². RE/MAX stands to gain share when that happens.

Finally, one of our trades deserves special mention. We were able to sell our position in **Cineplex (CGX - \$11.70)** before the market collapsed. Thanks to our flexible investment policy, which sets no limit on the amount of cash that we can hold, we decided to sell our stake in CGX when it was trading at about \$33.80, just 20 cents below the proposed acquisition price from a foreign suitor (see our [2019Q4 letter](#)). Other portfolio managers would not have been able to liquidate under their fund’s investment policy. Instead, we sold when the upside became very limited. While cash was a drag on our results in the final leg of the bull market, it came in handy in the first quarter.

An optimistic outlook

In the middle of this crisis, as most people remain holed up in their homes and as small businesses struggle to make payroll, it is hard to see the light at the end of the tunnel. That said, COVID-19 will not last forever. It may take time, but a vaccine will be developed, and we will be able once again to socialize, eat out, and travel. When the outlook improves and fear abates, the segment of the market likely to enjoy the best returns is small caps. In past downturns, they have tended to lead out of the trough. In the five years that followed the last bottom, small caps outperformed their larger counterparts by 73%!

² It was reported in March that Compass laid off approximately 15% of its 2,500 employees in an attempt to mitigate the impact of the economic slowdown on its business and to preserve cash to fund its unprofitable operations

Our knowledge of this segment will serve us well. With many companies refraining from trying to predict their near-term future and provide revenue and earnings guidance, we expect our potential pool of investment prospects to grow. The information asymmetry where small-cap companies are concerned might prove particularly pronounced, so much so that the “street” or the wider investment community will find it extremely hard to price a stock accurately in the absence of guidance. This is where our edge lies, in the analyses that we carry out based on our own models and on our conversations with management, suppliers, and peers.

In closing, please allow me to write a few words on our operations. Throughout the crisis, we have been able to continue working uninterrupted. Our families are safe, our workload is full, and our optimism is high in the face of current valuations.

Stay safe.



Philippe Hynes, CFA
April 11, 2020

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

Tonus Composite Performance – As of 3/31/2020

	<i>Tonus Composite (Gross Returns)</i>	<i>Index</i>
<i>3 months</i>	-19.32%	-16.34%
<i>1 year</i>	-16.21%	-7.74%
<i>3 years</i>	-9.23%	2.62%
<i>5 years</i>	-0.70%	4.99%
<i>10 years</i>	7.21%	9.07%
<i>Since Inception</i>	6.68%	6.10%

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.