TONUS CAPITAL INC.

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SECOND QUARTER 2023 - NEWSLETTER

Dear Partner,

We are very pleased to share with you our portfolio review and commentary for the second quarter.

Performance Review

During the second quarter of 2023, the TONUS PARTNERS FUND obtained a gross return of **9.7%**. Year-to-date, the Fund achieved a gross return of **16.0%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **10.2%**, compared with **7.2%** for the benchmark[2].

Portfolio Review

Our Fund posted another strong performance in the second quarter. It was up 10%, bringing its return to 16% for the half year and 39% for the 12 months ended June 30. We are pleased that our Fund's June unit value was more than twice the special net asset value that we struck on March 17, 2020, at the outset of the pandemic. Partners who bucked the trend then when investors were panicking picked a great time to plow more money into the Fund. In the span of a little more than three years, all our Partners have seen their investment grow twofold with a compounded annual rate of return of 22%.

We were able to achieve this by keeping our focus and sticking to our investment philosophy. This allowed us to purchase some great, deeply undervalued stocks. What we learned over the course of this past cycle will serve us well going forward. As we look to double your money again in the years to come, the big winners of the past might not be the ones to carry us in the future. However, we have identified characteristics and patterns that worked well for us and we are seeking out stocks with similar profiles.

Strong market (no plural)

Many investors adopted a cautious approach at the start of the year. Since then, interest rates have risen steadily, a banking crisis led to three large bank failures, the U.S. government dodged a debt default, and the war in Ukraine rages on. Yet, the S&P 500 is up 15% this year driven by large-cap technology stocks, which are up 40% on the buzz generated by AI (artificial intelligence). This has become a very crowded position. We wrote in our last letter that stock

[1] Please see page 4 for a description of the Composite.
[2] Please see page 4 for a full description of the benchmark along with its historical returns

returns are a function of financial outcomes relative to investor expectations. There is no doubt that the massive investments in AI will benefit the financials of some tech companies. However, the bar (i.e., expectations) has been raised considerably while mounting stock prices have lowered potential returns. Consequently, the risk for disappointment has grown immensely.

Unfortunately, one sector's dazzling surge has created the impression that stocks in general have done well this year. The truth is that, while the S&P 500 might be up 15%, the Canadian index is barely in positive territory (Canadian small caps are actually down 3%) and U.S. small caps are up a mere 6% and actually down 1.5% since the end of January.

What we are seeing is a heightened appetite among investors to take on riskier positions and chase some of these high-flying stocks. The Meme ETF (ticker MEME) being the preeminent example of this. The lessons of 2022 already seem to have been forgotten. Inflation is still running above target and interest rates may climb further yet. If we consider that the rate on a risk-free two-year T-bills hit a 16-year high at 5.15% earlier in July, we think investing in expensive growth companies today is ill-advised and bordering on folly.

Where valuations are concerned, the price-to-earnings ratio of the S&P 500 has shot up to 20.4x from 17.6x at the beginning of the year. At this level, investors are anticipating a 10% increase in corporate profits in 2024. This seems highly aggressive at a time of credit tightening, slowing industrial production, and persistent wage pressure. The core question for us is how much longer can companies protect profits by passing on rising costs to customers who have already put up with multiple price increases.

What is more likely to happen is that EPS (earnings per share) expectations will be lowered, there will be corporate layoffs, and unemployment will rise. While this would solve one problem—inflation—it would create another— disappointment with profit warnings. In such a context, **the price we pay for stocks is crucial**. We believe we can still make money by being extremely selective. True to our principles, we will pass on fat frothy valuations lazing in the open plain and continue to survey our favourite hunting ground—small caps—where more interesting game abounds in the underbrush. More on this below.

Focusing on our core

Our strong performance this quarter was not driven by overexposure to the tech sector, but by carefully selected stocks, some of which had positive developments during the period. **Mattr (MATR - $19.16)** is a case in point. While it may not ring a bell, it is not an unproven start-up. In fact, Mattr is the rebranding of Shawcor, a company we had invested in back in December 2020. We found value in the stock again when investors misunderstood the changes afoot. Our investment thesis was based primarily on the market assigning zero value to one of the company's three divisions.

Recognizing the problem, management sold some of the smaller pieces of this segment and are in the final stages of selling the largest one, their pipeline coating business. Once done, the company will have changed its name, industry classification (away from energy), and balance sheet (no more leverage). They will then have the capital to invest in their two remaining divisions. One specializes in the production of storage tanks for water and fuel and the other is a world leader in the manufacture of highly engineered wires and cables. When the new management team visited our offices last month, it became clear to us that they understood how to create shareholder value. Future capital deployments should generate great returns for the benefit of investors. The stock has had a stellar run this past year, up 200%. We trimmed our position by half but still like the company's long-term prospects.

We bought a few new stocks in the second quarter. One of these was **HP Inc. (HPQ - $30.71)** which we bought in late June. Although many people associate the name with its PC business, two-thirds of its profits are generated by its printing business. The stock fell 25% in the past year as industrywide computer shipments dropped off following the pandemic surge. While we believe we are approaching trough levels, HP has been performing better and gaining market share.

What's more, the average person's burgeoning engagement with AI carries with it the possibility of higher future unit sales and of those units having higher price points owing to the need for greater computing power. In printing, its most profitable business, sales have been stable. HP holds a dominant market position and is in the early innings of expanding its subscription business for both ink and paper. This more stable revenue model could lead to a higher multiple, although this is not something that we are banking on.

On the capital allocation front, HP's management has bought back about 40% of its shares outstanding in the past seven years and grown free cash flow 30% over that time span. We picked up shares at under $30, which means that we paid less than 10x this year's earnings at a time when its two main businesses are sitting at interesting inflection points.

Our investment thesis is predicated on the fact that, even in an uncertain year, the business and its management team will ensure high free cash flow generation that accrues to shareholders. The business has such a dominant position that it would be difficult to perform badly even if they tried. We stand to benefit one way or another: Either profits go up, the multiple goes up or, not unreasonably, Xerox swings back to take a second shot at buying HPQ. In any event, we are unlikely to see much downside at our entry price and welcome the optionality this affords.

Small cap resurrection

After a long period of relative underperformance, January and June were great months for small caps (+9% and +8%, respectively). We are starting to see stronger demand for U.S. small caps on account of their much lower valuation. Their price-to-earnings ratio sits at 13.7x compared with 20.4x for large caps. In seven of the past nine years, large caps trounced small caps' annual return. The time has come for revenge. We are encouraged by the green shoots that are emerging south of the border. We remain active looking for dislocated prices among both small and large companies as long as the opportunities present a low downside risk and potential good upside over the long run.

To conclude, we would like to share our insights on Berkshire Hathaway's annual general meeting held in May. Our colleague Aaron went to Omaha to hear the Oracle himself, Mr. Warren Buffett. You can read up on what he heard and learned by clicking on this link. For more information, feel free to contact him. He would be more than pleased to discuss his experience with you.

Sincerely,

Philippe Hynes, CFA	Aaron Warnongbri
Partner	Partner
July 14, 2023	

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

Tonus Composite Performance – As of 06/30/2023

	Tonus Composite (Gross Returns)	*Index*
3 months	9.7%	1.4%
6 months	16.0%	6.3%
1 year	38.9%	13.4%
3 years	21.0%	12.3%
5 years	8.7%	7.2%
10 years	9.6%	10.1%
15 years	10.7%	8.0%
Since Inception	**10.2%**	**7.2%**

Source: FactSet Research Systems, Inc.
Returns are gross of fees and 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).
U.S. performance 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 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.