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FOURTH QUARTER 2017 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the fourth quarter of 2017.

Performance

During Q4, the TONUS PARTNERS FUND increased **3.54%**. 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 **5.63%**.

For 2017, the TONUS PARTNERS FUND is up **2.90%** against **11.38%** for benchmark.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved an annual compound rate of return of **11.50%**, compared with **7.41%** for the benchmark.

Annual review

We ended the year on a strong note, with the fund up 9% in the last four months of the year. All in all, however, 2017 was bitter-sweet. On the one hand, this was our 9th consecutive year of positive returns and assets under management swelled to over $75 million. On the other hand, certain external and internal factors pulled our returns below where we would have liked them. These included the heavy negative impact of currency movements, the fact that small-cap and value stocks delivered practically no return, and the poor showing of a couple of our holdings.

The past few months were marked by a frenzied rise in speculative investing in sectors and stocks with plenty of promise, but zero profitability or no track record. Biotechnology (up 54% last year) and crypto-currencies were at the top of this class. Meanwhile, the absence of volatility[2] turned our terrain of opportunities into a desert land. Though we hold a sizeable amount of cash in our fund, we will not deviate from our rigorous discipline in order to make forays into red-hot sectors. We will remain true to ourselves, as you have come to expect over the years. The 1% we earn on the cash is surely unspectacular, but it will prove a lot more valuable when opportunities begin sprouting again, as we saw in early 2016.

[1] Please see page 4 for a description of the Composite

[2] The last time the S&P 500 gave up at least 2% in a session was nearly two months prior to the 2016 U.S. presidential election. There were only four days in 2017 when the index fell at least 1%. In the previous three decades, 1% drops occurred every seven or eight trading days, on average, and there were 2% drops about ten times a year.

Factors driving lower returns

Let us consider the factors that had a negative impact on results this year. The most significant was the depreciation of the U.S. dollar. Indeed, the greenback recorded its steepest annual decline since 2003. This ended up wiping away two-thirds (**4.8 percentage points**) of our gains in 2017.

Other negative factors were more under our control. Two of our holdings were down sharply in the year, paring **3.1 percentage points** from our return. The first, **Mediagrif interactive Technologies (MDF - $11.05)**, fell 42% after the company's profit margins deteriorated following management's decision to invest more heavily in the short term in order to drive long-term organic growth. Although we expected some margin erosion, it was larger than forecast and we must now wait for sales growth to rebound. At current levels, we feel there is very little downside left given that the company generates a healthy level of free cash flow. The stock should see much better days in 2018 when organic growth increases and margins bounce back from trough levels. The second, **PHI Inc (PHIIK - $11.57)**, was down 35% in 2017 despite stable operations and a significant acquisition. Earnings are set to grow in 2018 and asset value is still significantly above the current market valuation (as discussed in our 1Q17 letter). Consequently, we expect a nice rebound in the share price in time. We still own both investments because the current ratio of upside potential to downside risk remains extremely appealing.

Relative performance compared to the large cap benchmark

Fig. 1. **Performance of Large Cap vs Small Cap for Canadian and US markets ($CAD)**

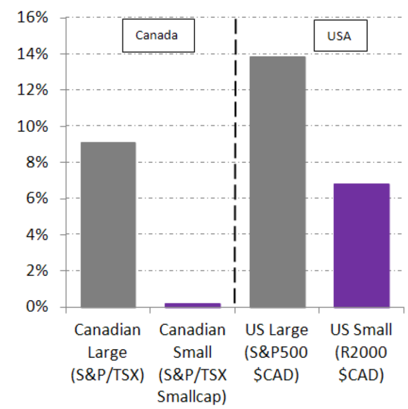
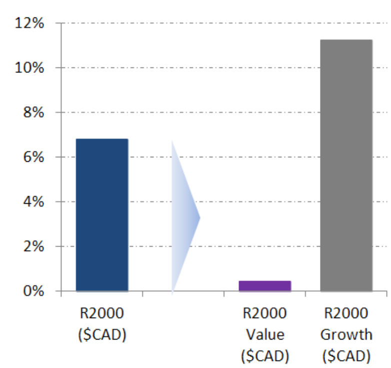


Fig. 2. **US Small Cap. Performance Breakdown ($CAD)**



Finally, our relative performance last year clearly lagged the large-cap benchmark we have cited in the past. As you know, we do not manage your money by tracking our exposure relative to an index. Neither do we lend much importance to whether we undershoot or outdo an index over a period of time as short as just one year. However, given the "record levels" reached by the S&P 500, the Dow Jones, and the Nasdaq this year, not to mention the strong returns posted by equity markets worldwide, it is fair to ask why our returns did not fly above the market's.

First, small-cap stocks registered returns on average 8% lower compared with large caps (see figure 1). We tend to uncover most of our investment opportunities amid smaller caps, where our proprietary research and modelling allow us to unearth hidden value. As the majority of our portfolio is invested in small- and mid-cap stocks (only 16% is in large caps), we did not benefit as much from money flowing into the S&P 500.

Second, if we parse the market's performance by comparing growth stocks and value stocks (see figure 2), it turns out that, where small caps are concerned, the latter lagged the former by 11% in 2017 ! The last two times the spread was this wide was in 2007 and 1999. Both times, however, value stocks significantly outperformed growth stocks afterwards. We believe the same will happen now.

To illustrate the difference in the two investment strategies, let us look at two stocks: **BlueBird Corporation (BLBD $19.25)**, the school bus manufacturer (value stock that we own), and **Bluebird Bio (BLUE - $178.10)**, the biotech company developing transformative gene therapies for severe genetic diseases and cancer (growth stock that we don't own). When we bought BLBD in 2015 at less than $10 per share, the company had been in business for 88 years, controlled 30% of the school bus manufacturing market, generated $35 million in free cash flow per year, and was trading at less than 10x its free cash flow. It was a solid, well-managed company with some growth (not explosive but steady), trading at a low and very appealing valuation. BLBD posted a 21% return in 2017 and is up 90% since we bought it. Last year's return was excellent, but it pales against BLUE's return of 189%. Yet, BLUE is losing $300 million annually, is trading at 45x 2021 earnings, and has seen its CEO sell off $35 million worth of personal shares in the past six months, which is typically a bearish indicator.

While both *birds* gained altitude last year, the speculative investment in BLUE was the hands-down winner over the short term. You can rest assured, however, that we will not stray from our style, buy BLUE, and venture into assessing the probability of a cancer drug being successful. It is important to recognize, though, that these types of stocks, like BLUE, which offer high promises but also carry very high risk, are the ones that drove the markets to record levels in 2017.

Holdings that did well in 2017

Let us turn now to the positive. The vast majority of our stocks fared well over the year. Indeed, the overall return in local currency was 9.1%. New stocks added this year did fine and we expect further gains in 2018 and beyond. Moreover, we feel very strongly about our largest holdings, so much so that we increased our investment in four of our (current) top five positions in the second half of 2017. We purchased more shares in these companies after their respective stock price declined for reasons we believed were unfounded or short-term in nature. We cannot predict how quickly the market will reprice these securities, but we are confident that, over the next three to five years, they will generate substantial gains.

In our continuous quest for value, we often turn our attention towards sectors that have temporarily fallen out of favour. Accordingly, we spent more time in the second half of 2017 in the retail sector, where valuations are clearly at depressed levels. After purchasing shares in restaurant franchisor **Freshii Inc (FRII - $7.34)** in Q3, we acquired shares of **Sally Beauty Holdings (SBH - $18.76)** in Q4. Sally is an international retailer and distributor of professional beauty supplies, mainly hair care and hair colour products, to retail consumers and professional stylists. With more than 5,000 locations in 12 countries, Sally is able to negotiate exclusive lines with manufacturers and to distribute its own line of private-label products, which account for almost half their sales. Sally did not escape the negative sentiment plaguing retailers over the past few months: its share price plunged from a high of $35 in 2016 to a low of $15 in 2017. While we do not expect Sally to register a spectacular jump in revenue, we do believe that market participants over-reacted to a slowdown in growth and turned a blind eye to the company's sound fundamentals. We purchased shares at 8x earnings and expect earnings per share to continue to rise in 2018. The company is extremely shareholder-friendly, returning the majority of its free cash to shareholders in the form of massive share repurchases, and the company CEO personally bought 60,000 shares over the course of 2017, which is typically a bullish indicator.

10th anniversary

While we certainly would have liked our 10th anniversary to be marked by stronger results, we have little control over the portfolio's performance over a 12-month period. We prefer to look at our long-term record based on over 10 years of returns since we made our first trade on October 31, 2007. Over this time horizon, we have achieved an annual return of 11.50%, which is significantly above the large-cap benchmark's performance of 7.41%. (The small caps have performed less well over this period.) Our firm is on solid ground, with assets under management in our North American strategy now in excess of $75 million. We would like to thank all our partners for their trust and support over these first ten years and we look forward to the next decade with the same unflinching enthusiasm and ambition as ever.

Sincerely,

Philippe Hynes, CFA
January 15, 2018

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

Tonus Composite Performance – As of 12/31/2017

	Tonus Composite (Gross Returns)	*Index*
3 months	3.54%	5.63%
6 months	3.05%	7.86%
YTD	2.90%	11.38%
1 year	2.90%	11.38%
2 years	13.38%	12.85%
3 years	10.75%	10.41%
5 years	14.71%	14.75%
Since Inception	**11.50%**	**7.41%**

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.