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SECOND QUARTER 2010 - NEWSLETTER

TONUS SELECT FUND

Dear Partner,

We are pleased to send you this portfolio performance and review, along with commentary, for the second quarter of 2010.

PERFOMANCE REVIEW

In the second quarter of 2010, the Tonus Select Fund declined **2.49%**. Over the same period, the S&P/TSX Total Return dropped **5.51%** and the S&P 500 Total Return (in U.S. dollars) fell **11.43%**. The Canadian dollar lost approximately **4%** of its value against the U.S. dollar.

On a year-to-date basis, the Fund was up **3.26%** while the S&P/TSX TR and the S&P 500 TR pulled back **2.54%** and **6.65%**, respectively

Since the Fund's inception in October 2007, we have achieved a compound rate of return of **1.32%**, compared with **-6.42%** and **-12.16%** for the S&P/TSX TR and the S&P 500 TR, respectively.

PORTFOLIO REVIEW

In the second quarter we acquired one new holding and sold off two. We also completed purchasing our position in **Chubb Corp. (CB - $50.01)**, a company we talked about in our previous letter. As a result, it is now our second largest portfolio holding after Comcast Corp.

In April, we divested our position in **Washington Post Company (WPO - $410.48)** at a price of about $530 per share. The stock had a nice run after an article published in Barron's in early April pegged the company's net asset value at more than $900 a share; the stock at the time was trading below $450 a share. Fortunately for us, the journalist was overly optimistic in his valuation of Kaplan, WPO's education division. No analyst covers the stock, to our knowledge and WPO management certainly does not go out of its way to make it easy for outside investors to understand the company. Most of the available data are drawn from the 10K filings. However, in order to avoid a misvaluation of the company, one must really dig deep and put in the time to figure out the value of each division. For instance, the journalist in question valued Kaplan at two times revenue, a reasonable multiplier to his eyes in light of the fact that certain public companies in the higher-education sector were trading at above that. However, he made the crucial mistake of assessing the value of the division on the basis of the entire $2.6 billion in revenue posted by Kaplan, when more than $1 billion of this amount derived from sources other than higher education, such as test preparation and compliance training. As investors have paid much lower multiples for this sort of revenue in the past, distinguishing where Kaplan's revenue stems from is critical to arriving at an accurate valuation of the division.

However, we did not part with the stock solely on the short-term hype generated by the article. The key point to remember from this is that any under-followed stock can be misunderstood. This is why it is vital to do one's own homework. Otherwise, you risk paying the consequences for somebody else's flawed analysis. Instead, what really persuaded us to sell WPO after the stock spiked was the shifting regulatory landscape for for-profit schools in the United States. Given that most of their revenue comes in the form of federally subsidized loans, the sector is heavily regulated. We have been investing in the sector for more than ten years and we have always kept a watchful eye on developments in Washington and the impact decisions there could have on the industry. The Obama administration has undertaken a full review of the sector and some of the proposals presently on the table could hurt the industry as a whole if enacted into law. Because of this added political uncertainty, a wider margin of safety was warranted. Hence, when the stock shot up on impetus from the Barron's article, we decided to take our profit.

Since we sold our holding in mid-April, most stocks in the for-profit schools sector have plunged more than 25%, including WPO. A number of short sellers have been very critical of the sector and its dependence on federal government money. Probably the most vocal of these has been Steve Eisman of the Frontpoint Financial Services Fund, famous for being featured in Michael Lewis's latest book, *The Big Short*. Needless to say when he talks about shorting something, people listen. Now, we read one of the transcripts in which he bashed for-profit schools at a hedge fund gathering. While many of his industry observations were dead on, his analysis of WPO was way off the mark. In particular, his claim that more than 100% of company earnings flowed from Kaplan was plain wrong. He neglected to mention that WPO owned a cable division, which contributed nearly $300 million in EBITDA in 2009! Moreover, as was the case with the journalist from Barron's, Eisman did not discriminate between the portion of Kaplan profits deriving form higher education and the portion generated by other education segments not affected by changes in regulation in Washington. However, these inaccuracies could play in our favour ultimately. At time of writing, WPO stock was trading at about $400 a share. At this price, it might be worth considering it as a buying opportunity!

The other holding we sold off during the quarter was **Senvest Capital Inc. (SEC - $69.99)**. We discussed the company at length in our December letter. As you might recall, it held plenty of cash and essentially managed two hedge funds. The stock did terrifically well for us. We began building our position in May 2009 when the stock was going for $19.00 a share and its book value stood at about $36 a share. We divested last May at $70.00 a share. For the quarter ended March 2010, the company disclosed a book value of more than $120 a share.

One stock that we did not unload entirely, having sold approximately half of our position, is **Cogeco Cable Inc. (CCA - $ 34.32)**. One of the concerns that we expressed to you when we purchased the stock was that CEO Louis Audet might be tempted back onto the acquisition trail once he believed the problems with Cabovisao, the company's cable television provider subsidiary in Portugal, were settled. We parted with the shares at about $40.00 as it became clear that Mr. Audet's appetite for acquisition had returned. As we foresaw, investors did not react well to the news and the stock is currently trading in the vicinity of $35.00 a share. At this price, the margin of safety is still wide enough that we decided to hang on to the other half of our shares

Once again, I am afraid we must refrain from disclosing the latest addition to our portfolio. It is an illiquid stock and we are patiently accumulating a position. Once the process completed, we will eagerly tell you all there is to know about it and stipulate our reasons for buying.

COMMENTARY

Holding significant liquidity and still achieving good performance in an up market

With the North American market closing the second quarter decidedly in the red, our relative performance looked better in comparison, no doubt thanks in part to our large cash holding representing 43% of our portfolio at the end of the period. As you know, our firm is long-term oriented and absolute-return driven.

Consequently, doing relatively well one quarter is no cause for elation just as turning in a relatively poor performance over a single quarter is any cause for despair.

We realize that holding a large amount of liquidity is controversial and that most firms prefer to invest all their cash even if it means doing so without conviction for half their portfolio holdings. It is easier psychologically to buy stocks you do not truly believe in--and it is probably better for the portfolio manager's career as well--than it is to expose oneself to the scepticism of investors and the wrath of superiors by opting to hold substantial liquidity until better investments come along. But sitting on cash does not necessarily mean that a fund will not do well if the market goes up. We are a case in point: In the past 12 months ended June 30, 2010, our fund grew 15.46% net of all fees. Over the same period, the S&P/TSX TR was up 11.96% and the S&P 500 TR rose 14.43% in U.S. dollars and 4.65% in Canadian dollars. In that time, our average cash holding was approximately 50%. To be sure, the other half of our portfolio invested in equities had to perform extremely well to outdo the indices, to say nothing of the fact that the U.S. dollar shed 9% of its value during this period, that most of our investments were made in the United States and that we do not practise currency hedging.

Some of our large positions did very well indeed. These included **Berkshire Hathaway Inc. (BRK.B - $79.69)**, **Penn Millers Corp. (PMIC - $13.20)** and Washington Post, which advanced, respectively, 38%, 27% and 51% (based on our selling price of $530 per share for WPO). Results of the sort helped us outpace the market this past year. However, what went unnoticed and what is often more difficult to justify is <u>what we did not do</u> that contributed to achieve our performance.

Our investment principles--very important to us but rarely applied by other firms--dictate that we buy only companies that we understand, whose prospects we are convinced of, and that we believe are trading at a cheap price. If we cannot find enough investments that meet these criteria, we will prefer to hold cash instead. Investing this way tends <u>to minimize the costly mistakes</u> (but, unfortunately, never eliminates them completely) repeated by other managers who live by the rule of being fully invested at all time and who aim for the widest portfolio diversification possible. No manager of a portfolio with 60-plus holdings can stand behind each an every stock with the utmost conviction. We will hold fast to this belief until proven wrong. This sort of strategy is more esthetically appealing and easier to market than value investing. Rather than hold cash, many managers will prefer to hang on to expensive stocks or to buy others that they do not fully grasp but look cheap. They do the same mistakes over and over again: They allow overvalued holdings to decline in price and they are taken aback when companies they did not completely understand perform poorly. What is the point of having one stock up 50% if it is offset by another of equal weight that is down 50%? An investor would be better off holding cash and waiting patiently to seize real opportunities.

However, this simple principle is difficult to apply. There is such a negative perception of cash that almost nobody will venture to hold too much of it for any extended period of time. Fortunately, we act differently because our incentives are different from those that drive most other firms. This is because almost all of our own money is invested in the fund. Our aim is to achieve a strong absolute performance over the long run. Most other managers, instead, get compensated on the basis of asset growth or relative performance.

So far, our strategy seems to be bearing fruit. Our fund is almost three years old. Over this short lifetime, the stock market has fluctuated in a way seldom seen over the arc of an entire decade! This allows us to analyze how the fund has behaved in different environments. To date, it has performed much as expected. It did better than most others when the market crashed in 2007-2008, it did not do as well when the market soared without correcting from March 2009 to July 2009 and, despite being only more or less half invested, it has held its own in the past 12 months while the market rose in more moderate fashion. In the end, we have managed to preserve capital in a very difficult environment and we have outperformed the market by a significant margin even though month to month, quarter to quarter and even year to year our results have differed dramatically in comparison. We realize that 32 months is a short lapse of time but, up to now, we are pleased with the performance we have delivered.

We appreciate that you are not getting influenced by the needless bad-mouthing that large cash positions receive from numerous market participants who usually do not share our goal of long-term capital appreciation and that you manage to disregard short-term market movements to remain focused on achieving our objective!

Quarterly statements

We realize that our clients wish to have peace of mind regarding their investments. This is why we are doing everything humanly possible to provide it. As you know, the fund's auditor is the reputable firm of Ernst & Young and its custodian is RBC Dexia, one of the largest firms in this field in Canada. To add another measure of safety for our clients, beginning this quarter, all quarterly statements will be sent out directly by RBC Dexia. The fact that your statements will no longer transit through Tonus Capital will enhance your protection. However, by not forwarding the statements ourselves, we lose out on quality control. Consequently, if you do not receive your quarterly statements in future or if you find your statements are inaccurate, please contact us immediately and we will be happy to remedy the situation.

Enjoy the rest of your summer.

Sincerely,

Steve Boutin, CFA

Philippe Hynes, CFA

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Fund before investing. Important information about the Fund is contained in the Offering Memorandum, which should be read carefully before investing.

Portfolio composition is subject to change at any time and references to specific securities, industries, and sectors referenced in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. The fund is not guaranteed; its value changes frequently and past performance may not be repeated.