Ch. 1 - Our Story

At Tonus Capital, we hate losing money. More than anything else, this is what drives everything we do, which is the strict avoidance of the destruction of our capital.

We decided to write this booklet for several reasons, but our primary aim is to give our clients – or Partners – and anyone else who is interested, a summation of why we do what we do and how we go about it. Tonus Capital just celebrated its 10th Anniversary in 2017, so we also felt this was a timely endeavour now that we have a significant track record to demonstrate how our thinking works, which means we have performance numbers to back up what we say.

We also felt it was time to codify our approach to give readers the clearest understanding of our methodology. In our experience with investing clients' money, you can never communicate too much, and no one can ever read too much about finance. We also wanted a powerful resource to share with newcomers, so they can quickly grasp what our investment philosophy means and how we execute our beliefs. And there is a final intended audience because Tonus Capital gives back to the community through our co-founder, who teaches an equity investing class at Concordia University in Montreal. This text will become an educational resource for new students in the investment field.

Possibly the most important aspect of investing in financial opportunities is that we are largely in the business of making estimates about the future. Most other goods and services can be known and clearly understood before final purchase, like buying a car or ordering a meal, which means that you know what you are getting beforehand. Not so with investing in financial securities because we do not know what tomorrow will bring.

Ergo, we work very hard to make good decisions and generate attractive returns with our choices. However, the future is unknowable and therein lies our greatest challenge, i.e. predicting what will happen with our investment in the future! We do not profess to know exactly what tomorrow will bring, but we believe there are probabilities that can be sensibly calculated. Will the sun rise tomorrow? Almost 100% certain, as it always has been, but still not entirely sure. And that's one of the surest estimates we can make. As you move on to less certain ideas, it is then important to adjudicate what is the possibility of up versus down, good versus bad, profit or loss, etc. We do believe we can work within reasonable boundaries to estimate the future with our probability models!

So how does that work? Well, we do all our own research to determine our own scenarios and the likelihood that they will occur as expected. We will explain this in more detail in the next chapter, but it means we are always updating our models to verify if our thinking on any investment no longer applies. Why do we do this? Well, in the simple words (purportedly) of the famous economist, John Maynard Keynes,

> "When events change, I change my mind. What do you do?
> When the facts change, I change my mind. What do you do, sir?
> When my information changes, I alter my conclusions. What do you do, sir?
> When someone persuades me that I am wrong, I change my mind. What do you do?"

We live in a dynamic world and life is in a constant state of flux, hence we are required to monitor developments continuously and we have to make adjustments when there are material changes in the

circumstances we previously knew. It is this laser-focused attention on our investments that serves us well in protecting the money we manage.

This leads us to the claim Tonus Capital makes, which is that we will deliver superior returns to the markets by using our long-term, deeply researched, and strictly disciplined approach. Sounds sort of simple, doesn't it? The reality of this mission is more complicated than we make it seem, however we have cumulatively outperformed the stock markets since inception, hence we still stand by our ambitious claim. We are very pleased to have delivered double-digit returns on average since we began, because at the end of the day, this is really all that matters for everyone concerned.

Of course, relatively speaking, we are a young-ish firm and we are a small-ish firm. However, we prefer to keep things simple, wherever possible, and so we have built a sustainable strategy for the long term. This means that we are already well positioned to continue growing our assets under management (AUM) up to several hundred millions of dollars (we are currently below $100million). We tell you this because it is important to explain that our business model is scalable and replicable as it is today, i.e. we are built for long-term success now. And while the first decade has been very exciting despite being filled with some of the most trying and demanding circumstances in the history of investing, we are confident that our approach and methodology will weather well whatever is coming next.

The story of Tonus Capital began in the mid-2000s and involves two senior investment professionals, Steve Boutin and Philippe Hynes. There is so much that has occurred in global finance since opening our doors in October 2007 that it is hard to encapsulate the entire story succinctly, but it turns out that our style works well through up and down markets. We are proponents of a strategy known as "value investing", which is exactly how the world's most famous investor, Warren Buffett, makes his decisions. What does value investing mean? As they say in the movies, "Buy low. Sell high!", although this is another one of those aphorisms that rolls off the tongue easily, but quickly dies in practice in the real world. To us, it is as simple as looking for deeply discounted bargains.

We begin by looking for good-to-great companies that have come down in price for short-term reasons, but for which their long-term fundamentals are still strong. Then we model their future financial results and do a scenario-analysis based on our thorough research to assess the risk vs. reward ratio. Only when the downside is limited and the upside looks like it could double in three-to-five years do we decide to invest. This is how we determine the likelihood of making a positive return on buying the company-in-question's publicly-traded shares.

Before we go further into those details, we will discuss the genesis of the firm and how we developed our philosophy on finance. We will also discuss our current principal, Philippe Hynes, who has been watching and analysing stock markets since he was only eight years old! We are not here to talk about his entire life, but it is important to describe how we ended up with the firm and outlook we have today, and that requires going way back to when our passion for investments began.

How did we start?

Once upon a time there were two clever investment professionals working for a pension fund management firm and both were in charge of very specific investment strategies. Let us suppose that a transport company has 10,000 future retirees and $1 billion in their pension fund to pay everyone their pension amounts over the decades to come. When the transport company meets with the pension fund management company, they sit down to analyse how much money needs to be paid out annually, how many people need to be paid, and how the future looks for the life-expectancy of the pensioners, etc. The pension fund manager works with the transport company to determine their investment policy. Once this policy is written in stone, the portfolio managers in the pension fund management company are given their respective responsibilities. One expert might be in charge of U.S. stocks only. Or sometimes an investment manager also pays attention to the size of those companies, which can be things like "small-cap U.S. equities" (or stocks) for public companies that are worth $3 billion or less. And there might be

another expert who oversees all investments in the Canadian stock portfolio for the transport company. It all depends upon the transport company and how much money they need to generate going forward to pay their pensioners. The investment policy drafted between the transport company and the pension manager is sacrosanct and not to be ignored; doing so can lead to serious litigation. However, this policy statement can also work against the aims of the experts, or PMs, who know best how to make returns on the stock markets. What does this mean?

Consider when stock markets look expensive or overvalued compared to the underlying businesses and their profitability. A rational investor might decide to wait for the prices of stocks to come down, or become “low”, which is when you would want to buy. But doing so requires patience - and cash! - and this is where too often the right course of action runs into the wrong policy statement. Clever managers know the cheap price at which to buy, yet they also set a target high price at which to sell out and take profits. This is paramount: it is insufficient thinking to know when to buy if you do not know when to sell.

The clever manager patiently waits for the bargain price to “buy low”, and then the same manager watches the price until it gets to the desired expensive price to “sell high”. That’s it. But if the manager sells when the stock price is favourable, i.e. elevated, it might turn out that other shares in the same category, like U.S. small cap or Canadian equities in general, are all expensive and overvalued, too. This makes it impossible to buy low. What should happen is that the portfolio manager should be allowed to wait for prices to descend to an attractive level to then seek out cheap opportunities again. What do you think happens in practice instead?

The exact opposite! The transport company’s investment policy specifically and bindingly states that all funds are to be 100% allocated, regardless of the current valuations in stock markets. This means, once a smart manager sells high to make a profit, they then risk undoing that work by having to re-invest all the cash from the sale, no matter what the market conditions are like at that moment. This happens because the transport company divides up the investment responsibilities amongst various managers. The transport company will find some managers to handle their pre-determined allocation to public shares, some other managers to handle allocation to their bond portfolios, even more managers to handle allocation to “alternative asset” classes, and then another manager to handle their cash portfolio. The cash portfolio is typically kept separate from the other asset portfolios, which is why the smart managers who don’t manage the cash position are then precluded from holding any liquid funds in their particular portfolios, i.e. they always have to be 100% invested in their mandate with 0% cash, even if this is counter-productive.

By 2005 or so, while managing corporate assets for various clients of the pension fund manager, Philippe Hynes started to notice something funny between the professional work he was doing for the clients and the performance of his own personal investment portfolio. As you can imagine, most portfolio managers tend to manage their own hard-earned money directly. So, as he sold the client’s shares to take profits, he was frustrated at times to be instructed to then re-invest the proceeds, even if the timing was terrible. And, of course, Philippe was not making the same investment choices with his own money, which is when it started to become morally challenging for him to continue working with the pension fund manager firm. Essentially, Philippe was making better returns for himself than he was allowed to make for the clients. Clearly, this business model is compromised, but it is common in society for people to blindly do what they’re told without any question because “that’s just the way it’s always been done.” At Tonus Capital, we have a contrarian philosophy and prefer to think for ourselves instead.

Anecdote: The Monkeys and the Electric Banana

There was a room with a banana hanging from the ceiling with a ladder directly beneath it. Monkeys were allowed into the room and the first monkey to climb the ladder learned that the banana gave you an electric shock when you grabbed it. A second monkey tried to take the fruit and learned the same lesson. After a third monkey was shocked attempting to take it, the rest learned to leave the electric banana alone.

But when a new monkey was introduced into the room, it ignored the others sitting under the banana and immediately went up the ladder to grab it, and learned the hard way that it wasn't for taking. A couple of newer monkeys were introduced, who suffered the painful shock and learned to sit on the floor without the banana. But by the time a fourth new monkey was introduced, the creature worked out that if no one else was going for the banana, there was probably a good reason not to try, so it stayed away from the ladder and just stared at the food along with the rest of them. And so it went with all the future new monkeys, who entered the room and simply looked up at the banana without ever trying to ascend the ladder to take it.

The same thinking occurs regularly with many folks in business. Too often, employees join an existing company and learn how things "have always been" and settle into the existing patterns and behaviours without ever questioning why things are done the way they are? The monkey metaphor is all too powerful in the finance industry, where too many practitioners continue with the same old, traditional mindset, and never ever question why they're doing things a certain way nor ever consider there might be more optimal ways to work, especially from their client's perspective.

We are not those monkeys.

If the job was to make positive returns for the clients – and those clients are not experts in financial investing hence why they pay for the service – Philippe found he was prevented from making the best possible returns because of antiquated thinking in the transport company's investment policy. Now, it must be said that pension funds can have slightly different objectives from a private individual's investment goals. This is also why Philippe was making bigger, more handsome returns with his own money because he did not have to follow those sub-optimal principles for his own investments. Yet the pension clients were not getting the same results. This presents a moral quandary for those with a conscience: how can I continue in good faith to deliver sub-optimal work to my paying clients when I know there is a smarter path to greater success?

The two managers got to talking about these problems and they simply decided to offer the same powerful returns and out-performance to people and investors who trusted the two PMs to manage third-party money exactly as they would manage their own cash. And so Tonus Capital was born.

Why the name Tonus Capital? We needed a name that works in English and French.

Once Steve and Philippe agreed that they should start a business whereby they managed their own funds first, while offering outside parties the chance to invest alongside them, the company began to take shape. And, when we look at the most successful investment managers throughout history, this tends to be the first, most important consideration, aka "skin-in-the-game". This is the simple concept that you should only invest your money with people who also have their money in the same investment. Sadly, this is the exception to the rule in Canada, so most banking clients are offered investments that their advisors do not already own themselves. While the morality of this industry practice is not in question, i.e.

it is conflicted, our dignified approach allows us to work with our interests perfectly aligned with our clients' interests.

The decision was made to start Tonus Capital with an initial seed investment and the firm was created in 2007. With the support of a seed client, the firm launched and the first assets were received in late 2007, right before the great recession. Notwithstanding the tough conditions, the investment management aspect of the firm went smoothly, but external factors soon started working against the firm when new assets were not forthcoming as anticipated, which was an industry-wide conundrum for a few years.

Although they had raised almost $20 million to begin, after about four full years in business, there was simply not enough revenue for two senior portfolio managers to make a decent living during such a chaotic period of uncertainty and fear. And certainly not with two young and growing families in tow! So, after steering Tonus Capital onto solid ground, co-founder Steve made the decision for his family to move on to another opportunity, which is when Philippe became the sole principal of the firm.

Why would anyone would want to run an investment management firm on their own? When you consider the implications of being entrusted with other people's life savings, it is a daunting proposition for any decent person of integrity to undertake. But what if someone was a lifelong aficionado and truly fascinated with stock markets? They might be the ideal character for taking on such enormous responsibility. This is who runs Tonus Capital today.

It was as that young boy of eight years that Philippe first learned about stocks from his father. Once he learned the basic principles behind what was a "share", or "stock", and how they were priced, he was immediately fascinated by the business of seeing if a stock price would go up or go down. And as he began to understand that it was possible to research companies and use their financial and performance data to determine what was the real share price – or "intrinsic value" – he was hooked for life. It was at that point that Philippe started to do a lot of his own work on building models to calculate the intrinsic prices for different stocks.

As he delved more and more into this work, he found he loved reading about and studying finance, too. And over time, he found the writings of Benjamin Graham and Warren Buffett to be the most compelling ones that resonated most with him and his nascent ideas about investing. For Philippe, the most important lesson was about discipline. This does not just mean we have a fixed strategy and stick to it; instead it means we work tirelessly to develop our investment model while we also maintain strict focus upon improving our system for calculating stock prices as the circumstances dictate.

How did he do it?

By the end of high school, Philippe knew he wanted to study finance, so he enrolled in the John Molson School of Business (JMSB) at Concordia University in Montreal to earn his first accreditation in finance. It was also at this time the university established a new program for financial studies, the Kenneth Woods Portfolio Management Program, from which Philippe was one of its first graduates, and he has gone from strength to strength ever since.

Philippe was also mentored by one of Canada's greatest financial visionaries, John Dobson of Formula Growth. For those who do not know him, Mr. Dobson was a legendary Canadian investor who, in 1960, started one of Canada's earliest mutual funds, the Formula Growth Fund, which went on to become one of the most successful long-term mutual funds in Canadian history, if not the world. The strategy was known for its impressive track record of global, bottom-up, growth stock investing with its original long-only product.

Mr. Dobson graduated from McGill University with a Bachelor of Commerce in 1949 and then he received his Master of Business of Administration from Harvard in 1952. Following which, he went on to establish entrepreneurial programs and business think tanks across Canada for promoting regional and national networks of educators and small business interveners, thereby creating unprecedented synergy

and cooperation all over the country. Philippe spent many hours with Mr. Dobson, learning about finance, obviously, but also about entrepreneurship and the value of hard work in turning your aspirations into reality. The spirit and vision of Mr. Dobson lives on through Philippe and the operational ethos of Tonus Capital.

In 2000, Philippe began studying with the first cohort of students to enter the Kenneth Woods program at Concordia University. Over the course of the next two school years, the students were entrusted with managing cold, hard cash. In fact, they were given $1 million to invest with the intent being to clearly demonstrate the power of investing – and gains and losses – in dollar terms. There were eight students in this first group, who each worked as an analyst, and they had to write research reports that they then used to convince their seven peers of their investment thesis. This laid the proper foundations for Philippe to head out into the professional realm of investing because the Kenneth Woods program allowed him to work exactly like the industry role-models he esteemed.

After the peer-review phase, the program then required that each student present their investment rationale to a Client Committee of eight established financial experts in Montreal. Philippe had to show the "client" that he had done all the necessary work and analysis, as well as holding group discussions to justify and understand why they wanted to make the investment. This clever program was the perfect training ground for embarking upon a lifelong career in finance.

It was also during his time at JMSB/Kenneth Woods that Philippe was selected for the work-coop stream to work with a national insurance company. That also went well, and so he continued to work there throughout his undergraduate degree, which in turn led to his first job in finance after graduation.

At his new, paying job in finance, Philippe was given his first professional mandate in equities, which involved analysing publicly-traded Canadian oil-and-gas companies. After a couple of years doing that, he moved on to the pension fund management company, where his portfolio management work focused upon small-cap U.S. stocks, i.e. those public shares of companies with a market capitalisation of $3 billion or less.

While it is important that any portfolio manager be keenly interested in studying stocks, it is best if that same individual has a few other necessary character traits. The four qualities that best sum up our co-founders' style and approach – and also the firm's - are:

1. Hard-work every day
2. Efficient in approach and activities
3. Unwavering discipline with every step of the process
4. Focused upon a healthy life-balance of professional and personal endeavours

These qualities might seem basic, if not obvious, but the truth of the financial industry is that the consistency of these ideals is too often lacking. First of all, following our investments in stocks, while simultaneously being alert for new opportunities, is a limitless occupation, i.e. you can always be working on these activities, hence requiring vast amounts of hard work. And as we learn and grow, we vigorously try to avoid repeating mistakes, which is what allows us to continuously become more efficient in our execution. We find we are quite successful with the first two pursuits.

The third criterion is where the best intentions come undone. Earning money is hard work for most people. Managing to have any savings left over after paying all the bills in your life and the ongoing personal expenses is a huge achievement, so it is important to then make sensible choices with our savings. The history of stock markets everywhere is an endless collection of individuals falling victim to

the vagaries of their heightened emotions and personal biases. “Buy low, sell high” still works in the movies, but not for the majority of investors. The ethos at Tonus Capital is predicated upon moving against the herd, otherwise called being “contrarian”. When others are fearful, we tend to find we are excited. Where other investors see panic and turmoil, we see opportunity. One sharp analogy sums up beautifully the reality of investing during downturns: if this year’s newest BMW was selling for 50% off, you would likely consider making the purchase. Yet somehow in the stock market, when equities fall 50%, people suddenly think the valuable investment they made no longer offers the same value, so they consider selling their whole position. Many times, the emotional investor does sell and thereby crystallises their losses forever. We do the exact opposite. If we see something has lost a significant amount in price, we dig deeper to see why we shouldn’t take advantage of such an opportunity. Seen in another light, while so many are fearful and terrified to see the stock markets going **red** as shares drop and lose value, we roll up our sleeves and get ready to go to work and buy cheaply for potential growth in the future. Sounds so simple, yet surprisingly, so many others get it completely wrong, which is one of the reasons we enjoy such relatively terrific performance.

The proof of our methodology is evident in our relationship with the institutional salespeople who come through our offices weekly to show us their brightest projects for investing. We patiently hear them out and then get to the real work of learning about contrarian ideas that are less in vogue.

When to buy? No! When to sell!

The finance industry makes a lot of money working with corporations to get them credit and to source investments in their business. One way they do this is through selling shares in the company on the open market. The whole process starts with the Initial Public Offering, or IPO, when the company first sells equity – or shares – in the corporation to the public. Banks love working on these projects as there are typically huge fees to collect. The financial firms create bright presentations that their sharpest reps then peddle to anyone and everyone with deep pockets. And they are quite convincing when selling these ideas.

The problem?

They never talk about when to sell. So, while we all know it’s a great opportunity that no one should miss getting in, there is rarely any lip service paid to when we will get out and sell the position for a profit. This is a huge problem for most investors, whereby they get caught out by holding on to shares for too long because they do not have a targeted exit price at which they should sell.

Which is why when the institutional folks come around, we wait to hear about their latest ideas, and then revisit the contrarian ideas they showed us previously. This is often when we find opportunities to buy cheaply and subsequently make handsome returns.

The final point in our list of qualities we espouse is to remember that there is more to life than work. Now, you are unlikely to enjoy the life you want without hard work, so we are diligent in how we handle our daily and ongoing responsibilities, but not to the detriment of being with family and having time to recharge. However, rather than the clichéd “work hard, play hard” mantra, we would prefer to show you what is required to do this work of managing our clients’ investments. What follows in the next chapter is a breakdown of daily, weekly, monthly, quarterly, and annual activities we execute for running Tonus Capital.