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THIRD QUARTER 2020 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the third quarter of 2020.

Performance

During the third quarter of 2020, the TONUS PARTNERS FUND increased **6.54%** (gross of fees). 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 **5.75%.**

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound rate of return of **8.12%**, compared with **7.56%** for the benchmark.

Quarterly review

We wrote last quarter that the portfolio was positioned for a gradual, not a quick, recovery of the economy. Through the summer, macroeconomic data—on unemployment, consumer confidence, and manufacturing activity— largely bore out our expectations. There is no denying, however, that the economy has been doped up by government stimulus. With many of the relief programs slated to expire soon, social distancing still an ongoing concern and businesses cautious about capital spending, we continue to believe that it will be a while yet before the economy returns to pre-COVID levels. We thus remain highly skeptical of the optimistic profitability projections cast by analysts for 2021 and beyond.

Markets were up roughly 5% in the third quarter, with tech darlings and growth stocks stealing the show again (a phenomenon discussed at length in our last letter). Tesla is a prime example of such a growth stock. At the start of the quarter, it had a market value of $200 billion. By the end of it, its share price had doubled, bringing its market value to $400 billion.[2] By comparison, Detroit's Big Three automakers—General Motors, Ford and Fiat Chrysler—finished the quarter with a combined market value of $91 billion. Together, they sold 17 million cars last year. Tesla? 367,500!

No profit? No problem!

In the U.S. small-cap index, one quarter of the companies make no money. Yet, year to date, their shares are up 15% on average. Meanwhile, the profitable companies in the index have

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[1] Please see page 5 for a description of the Composite

[2] In early October, Tesla released their Q3 vehicle delivery numbers. They reported 139,300 units sold, exceeding market expectations. Yet, the stock fell 7% on the news, erasing $35 billion of value by the same token. This shows that the market has already discounted much of Tesla's future growth. The stock is clearly sustained by a large dose of hype and speculation, with the downside risk far outweighing any further upside.

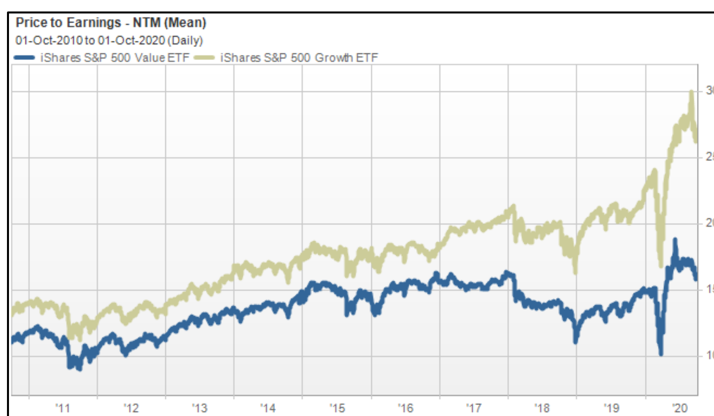
seen their stocks drop 17%. As long as speculators ride the wave, valuation risks will continue to rise dangerously. Our approach has not changed in the face of all this. We will not buy stock on the simple premise of recent momentum. It is not a reliable indicator of future gains. Given the prevailing hype for what we consider higher-risk stocks, our index-beating +6.5% return on the quarter is a fantastic result.

Allow us to say a few words about our benchmark. As you know, our aim in managing the portfolio is to make money while protecting your capital, that is, our focus is on positive, absolute returns. We do not pick stocks based on their inclusion or weight in a specific benchmark. As it has been challenging for us to match the S&P 500's tech-driven performance of late, we decided in-house to measure how well our picks performed against an index more representative in terms of style and size. We were pleased to see that we fared better on average over the past five years and significantly outperformed in the past 12 months[3]. This gives us confidence that our approach works when comparing apples to apples.

Growth stocks have had an extraordinary run, so much so that many analysts presently situate them in bubble territory. Speculation is rampant and risks are high. We have stayed clear of these stocks at the potential cost of temporarily underperforming the market. We have remained disciplined, lowered our risks, and held fast to our investment philosophy. When will the pendulum swing back in our favour? Hard to tell. However, investors cannot keep pricing fast-growing companies ever higher and looking down on slower-growing value companies as worthless forever. The tide will turn. Until then, we will stick to our guns.

Cracks emerging

If stocks in March were priced for disaster, by August many were priced for perfection. Then, in September, the market did a reality check and the momentum broke. We witnessed a rotation out of growth into value, so much so that the NASDAQ dropped 10%. It turned out to be a great month for our fund. Though these developments are encouraging, the **value discount remains huge**. As shown on the graph, growth stocks have historically traded at a slight premium to value stocks. Of late, this premium has tripled, with growth stocks now trading at 27x forward earnings. Such a multiple is reminiscent of the last tech bubble, which did not end well for growth stocks.



For value stocks as a category, the multiple is the same as at year-end 2017. Where small-cap value stocks are concerned, they are actually trading **below their long-term average multiple**. The category is still down 10% year to date, on average, with many value sectors still faring very poorly: Energy is down 50%, financials are down 22%, and industrials are down 5%. Adjusting for risk, we believe that investing in these companies is a far more appealing proposition.

[3] Over the past twelve months, the Fund's gross return is 6.81% compared to -3.46% for the adjusted benchmark calculated internally based on size and style.

Tax preparer **H&R Block (HRB - $16.29)**, which we bought in the quarter, is a prime example of what we are talking about. While this industry is very mature, the stock was priced at such a low level that it afforded very little downside and the potential for a good return as we head into the next tax season. Because of COVID, the tax season this year was disrupted, with filing deadlines pushed back a couple of months. As a result, HRB's financials are harder to analyze, and this has led some investors to dump their shares (down 50% in a year). Year in and year out, this business remains fairly steady; its assisted in-store operations may have declined slightly but its do-it-yourself (DIY) segment continues to grow nicely. Annually, they generate more than $2 per share in free cash flow, a portion of which is distributed to shareholders as dividends.

At our purchase price, the dividend yield was above 7%. With the payout remaining constant or growing in the future, we see very little downside on the stock. Our risk lies in the possibility of seeing the share price stagnate at present levels, in which case our return would be limited to the yield. If they manage to grow their share of the DIY market or if they continue to streamline the cost structure of the assisted segment, the stock multiple should go up and this will translate into an attractive return for us. It will not take much for us to do well with this name.

The (in)efficient market

In an efficient market, at any point in time, the actual price of a security will be a good estimate of its intrinsic value.

- Eugene Fama, Nobel Prize laureate for his work on efficient market theory

With thousands of investors and computer algorithms scrutinizing stock prices round the clock, the argument of an efficient market is plausible. When teaching at Concordia University, I am often reminded that this theory is at the heart of many of the classes that my students are taking. However, since the beginning of the year, we have witnessed so many instances of completely irrational pricing as to seriously challenge the hypothesis.

Oddity 1. The best example of this irrationality was provided by Tesla and Apple when they split their shares in August. Now, a stock split is like slicing a pie into smaller pieces. Ultimately the market value of any company is a judgement on the total amount of free cash that the business will bring in from now until eternity. There is no reason that splitting stock into more "pieces" should increase the size of the pie, that is, a company's market value. Yet, that is precisely what happened. On the day of the split, Tesla and Apple shares shot up, increasing their market value, respectively, by $90 billion and $70 billion (yes, billion)! Unsurprisingly, this $160-billion windfall subsequently vanished in less than a week.

Oddity 2. Closer to home, one of our holdings, **Qurate Retail (QRTEA - $7.18)**, has a dual class stock structure. Its class A and class B shares have historically traded within 1% of each other. In September, the company issued an identical special dividend to both stocks. They should have continued trading in tandem. Instead, while the more liquid class A share dipped as expected on account of the size of the dividend, the class B share went up! Over the course of two weeks, the price gap ranged from 10% to 58%! Totally absurd. We took advantage of the situation to turn an "easy'' profit. Both classes of stock are back trading at the same price.

Oddity 3. Finally, more and more investors are turning to Twitter as their source of information for "*thorough*" stock research. As the platform is unregulated, anything can be posted with no accountability. **Houghton Mifflin Harcourt (HMHC - $1.73)**, a stock we own, benefitted from this in July. As HMH is a publisher of elementary school textbooks, posts emerged on Twitter arguing that in-person schooling restrictions would be a bonanza for the company as school districts would have to subscribe to their online offering. All sorts of misleading information was posted and speculators drove the stock up 100% in two days! In actual fact, the pandemic is creating short-term challenges for school district finances. The company will likely not see any potential gains before next year. Patient investors like us are ready to wait, but short-term speculators were quick to dump their shares, thus creating a nice entry point.

Opportunities exist for patient investors

To conclude, the message we wanted to convey in this letter is that many opportunities still exist. Investors have plowed a lot of money into the same mega-cap tech stocks. To us, these investments look overcrowded and exhibit high risks relative to their valuations. When the music stops, losses could be significant. We do not own stocks that exhibit such exuberance.

At the other end of the spectrum, small-cap and small value stocks keep getting cheaper. Index fund outflows and the at-times irrational behaviour of retail investors are increasing volatility on the stock markets, and this is creating new investment opportunities for disciplined and patient investors. We remain positioned for a gradual economic recovery, and we are starting to see more enthusiasm around the names we own. We continue to hunt for high-quality companies that will create shareholder value for years to come. We look forward to closing the year on a high note.

Sincerely,

Philippe Hynes, CFA
October 9, 2020

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

Tonus Composite Performance – As of 09/30/2020

	Tonus Composite (Gross Returns)	*Index*
3 months	6.54%	5.75%
6 months	22.53%	22.80%
YTD	-1.14%	2.74%
1 year	6.55%	7.82%
5 years	3.88%	10.53%
10 years	9.16%	11.11%
Since Inception	**8.10%**	**7.56%**

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.