TONUS CAPITAL INC.

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FIRST QUARTER 2023 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2023.

Performance Review

During the first quarter of 2023, the TONUS PARTNERS FUND registered a gross return of **5.7%**. Over the past twelve months, the Fund achieved a gross return of **13.8%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compounded gross rate of return of **9.7%**, compared with **7.2%** for the benchmark[2].

Portfolio Review

Our fund registered another strong performance in the first three months of the year, posting its third consecutive quarterly return above 5%. While the broader indices were up as well, most gains were driven by technology and growth stocks that rebounded from a dreadful -30% showing in 2022. The rally was quite narrow, with three stocks accounting for half the S&P 500's advance over this period. The equally weighted index, which is a far better measure of stock returns, was up a mere 2%. Over the past year, <u>our Fund is up 13.8% compared to -5.5%</u> for the North American indices.

Investors, who feared missing out early in the year, flocked to the largest and most popular tech names, but paid little attention to their expensive valuations. Moreover, because stocks are indexed by market capitalization, passive indexing funnels money to these same large firms, regardless of their financial performance or valuation. This increases the price swings of these stocks. Nice on the way up, but the same phenomenon will accentuate the losses on the way down.

Run on the Banks

The stories that defined the quarter were without a doubt the bank failures in the United States and the last-minute bailout of Credit Suisse in Europe. While banks typically constitute a decent portion of the value investor's portfolio, we owned no banks heading into this crisis, as we deemed their risks too high. The extreme exodus of depositors at Silicon Valley Bank (SVB) marks the first casualty of the steep interest rate hikes of the past year. It also exposed the gamble many banks took betting heavily on long-term government bonds, which last year plunged in value when the Federal Reserve raised interest rates. As you might expect, stocks falling off a cliff caught our eye and we spent time analyzing the situation. When we examined SVB's financial reports and valued their investment portfolio at fair market value, the results showed all their shareholders' equity

[1] Please see page 5 for a description of the Composite.
[2] Please see page 4 for a description of the benchmark

was wiped out all of its equity, that is, its liabilities outweighed its assets. Many other banks we looked at were in a similar position. The fate of investors rested on depositors not withdrawing their money.

That so many investors were caught off guard last month bears witness to the fact that few do their homework and take the time to parse financial statements (SVB's upside-down balance sheet dates back to September 2022!). We do. It's part of the job. We comb through these regulatory reports very carefully before making any investment decision. So, at this point in time, after sifting through the records of some of these institutions, we remain uneasy with the many risks still present, particularly the quality of their loan books. Consequently, we will seek to take advantage of the current dislocation by turning our sights on other areas of the financial sector we consider less risky.

We found one such alternative in **Jefferies Financial Group (JEF - $31.74)**. While its profile defines it as bank, Jefferies is an *investment bank*; it does not take deposits and does not lend money to individuals. Its *bankers* act as advisors to mergers, acquisitions, and restructuring operations, and its brokerage segment sells and trades stocks and bonds. Mainly because it is a financial stock, its share price dropped 16% in March and we were able to buy under $30, which is below its tangible book value per share of $31.51.

Just as they have done in the past, we believe Jeffries will take advantage of the current disruption to gain market share and potentially acquire distressed assets at bargain prices. When the capital markets return to some form of normalcy, we expect Jeffries to earn a good return on equity, which should propel the stock to its prior peak. In the meantime, we will gladly collect our 4% dividend yield.

The acquirer is acquired

One of our Fund's quarterly highlights was the proposed acquisition of **Uni-Select Inc. (UNS - $46.60)** by LKQ. As you might recall, Uni-Select is a distributor of auto parts and paint to repair and body shops. We began purchasing shares a year ago and it eventually grew to be one of our largest positions. We expected its financial results to be boosted by inflationary pressures, and we also expected the new management team to make strategic acquisitions on the strength of a fortified balance sheet. Results were good and the share price performed well. The icing on the cake came in late February when LKQ, a U.S. player in the salvage parts market, offered to buy our company at $48.00 per share.

We were hoping for a higher take-out multiple, but this was still an adequate premium given the current climate. We intend ultimately to tender our shares and vote in favour of the acquisition. At the time of writing, the stock was still trading in the low $46 range. For now, we are hanging on to our shares and may even add more, seeing how we currently stand to yield 8% if we stick to our estimated closing date. Not a bad return in these challenging markets!

We took advantage of another similar situation earlier in the year. **Summit Industrial Income REIT (SMU – $23.50)**, a trust focused on managing light industrial properties in Canada, received an offer to be acquired by GIC, Singapore's sovereign fund. Once the deal was approved by the Canadian government and the funding was in place, the risk of the deal not closing was practically nil. However, from a fiscal perspective, U.S. investors who owned the units would be penalized by the tax treatment of the transaction. They were better off selling before the deal closed. We snapped these units up, held them for 12 days, and made a nifty profit. On an annualized basis, this trade yielded a 37% gain!

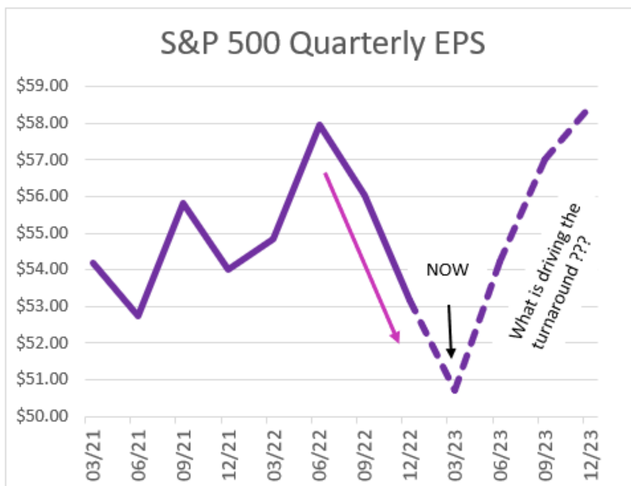
Margin of safety

In our most recent Q4 letter, we broached the topic of value investing and broke it down from both the practical standpoint of how we rotate stocks in the portfolio and the philosophical standpoint of how we look past the market prices in periods of exuberance to gauge just how much of a margin of safety a prospective acquisition affords us. Four companies we held at the end of last year reached our full value estimate in the first quarter. We maintained our discipline and sold them. High investor growth expectations for the quarters ahead lifted the price of these stocks to levels where we could no longer justify holding on to them. We still like these stocks a lot, which is why we placed them on our wishlist. If and when their prices drop to the right level, we would certainly consider purchasing them again.

We are able to make investments in times of falling prices because we have a strong conviction in our style and in our method. The value investing well from which we draw ideas is deep. Of course, we seek to buy earnings at a low valuation. However, we may also find our margin of safety in stocks such as the aforementioned Summit Industrial. At other times, we may discover value using a sum-of-the-parts approach. In other words, value can be found in many forms and in many places. This is why we are constantly on the lookout, scanning far and wide through the many goggles and lenses in our armoury.

Proceed with caution

While investor expectations have begun to sag lately (estimated 2023 earnings growth for the S&P 500 has decreased from +6% to +1%), we still feel they are overblown. Too many management teams have expressed optimism for a second half of the year rebound without explaining to us how and why it would occur.



There seems to be a disconnect. First, while many economists are predicting a recession or at least a slowdown, it is amazing that ALL sectors are expected to post earnings growth from the first to the second half of the year. Second, the expected champion is once again predicted to be the information technology sector. While it is true that many firms in the sector have announced massive layoffs and cost control measures, we believe that most are trying to maintain their profits rather than grow them significantly. Plus, let us not forget that company A’s expense cuts are company B’s lost revenues.

Anecdotally, the further we got into the quarter, the more we heard that companies are feeling top-line pressure. We would not be surprised to see more conservative growth assumptions or even declines as the year unfolds. Revised expectations are what ultimately drive stock prices. **Value investors like us like to fish in a pond of low expectations**. Lower corporate guidance and estimates in the coming months might just see our population of potential catches flourish.

Our cautious stance is further supported by the multiple we are currently paying on these earnings expectations. The commonly used S&P 500 price/earnings ratio has retreated from its peak but still stands at a lofty 18.2x. This level is well above its historical average of 15.5x and ranks in the 81st percentile going back 40 years. With few bargains in plain sight, we believe investors need to be patient and wait for large swings to create a margin of safety at attractive prices. Small caps may again be an area prone to higher volatility, which should ultimately afford better opportunities. The earnings multiple for the S&P SmallCap 600 Index is sitting much lower at 13.3x, near its historical average. We'll be looking at both large and small caps but, in all cases, we will wait for prices to reach a level that limits our downside risk should the uncertain economic environment cause lower growth and profits.

In closing, we do not know how many more quarters of negative market impact the current interest rate environment will bring. Several analogous periods come to mind, but one in particular stands out, namely, the 2001-2003 tech bubble pop, which coincidentally marked the beginning of a multiyear period of outperformance for value stocks! This was especially true for smaller market cap companies, which is the space where we generally ply our trade. Benjamin Graham, the father of value investing, often spoke of seeking an **adequate return as a function of the context** in which the return was to be earned. Our positive performance in a decidedly disastrous 2022 is an excellent case in point. As we mentioned in our January investor call, for much of the past decade, the environment was ripe for growth stocks and during that period, we posted adequate returns. We treaded water well during a rising growth tide. Now, we feel we may have the chance at last to break out and swim.

Sincerely,

Philippe Hynes, CFA
Partner
April 11, 2023

Aaron Warnongbri
Partner

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

Tonus Composite Performance – As of 03/31/2023

	Tonus Composite (Gross Returns)	*Benchmark*
3 months	5.7%	4.8%
6 months	17.6%	11.4%
1 year	13.8%	-5.5%
3 years	23.0%	19.6%
5 years	7.7%	8.4%
10 years	9.1%	10.0%
Since Inception	**9.7%**	**7.2%**

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 25% S&P/TSX TR Performance + 25% S&P/TSX SmallCap Index performance + 25% S&P500 TR Performance ($CAD) + 25% Russell 2000 TR Performance ($CAD). S&P500 TR ($CAD) and Russell 2000 TR ($CAD) are 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 the benchmark. The benchmark was changed to the current format starting in 2021. Prior to 2021, the benchmark presented was calculated by taking 50% of the performance of the S&P/TSX and 50% of the performance of the S&P500 in Canadian dollars. Would you like to see the historical benchmark returns, please follow this link. 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.