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FIRST QUARTER 2019 - NEWSLETTER

Dear Partner,

Here is our portfolio review and commentary for the first quarter of 2019.

Performance Review

During the first quarter of 2019, the Tonus Partners Fund's gross return was **-0.32%**. 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 **12.22%**.

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **8.96%**, compared with **7.41%** for the benchmark.

Portfolio Review

The first quarter of 2019 got off to a slow start for us. We were up in local currency terms, but the decline of the U.S. dollar erased these gains and we ended the period flat. <u>Most of our shares had positive returns but their gains were offset by two of our largest holdings</u>, which were severely punished by the market following disappointing quarterly results (more on this later). Given that our portfolio is concentrated, how our largest holdings perform can sometimes have a disproportionate effect on our bottom line and translate into increased volatility for the portfolio. Lately, this has worked against us. On other occasions, however, it has contributed to lift overall returns substantially.

We saw nice rebounds and good stock performance from some of the value stocks that we own. **Alimentation Couche-Tard (ATD - $78.72)** and **Comcast Corporation (CMCSA - $39.98)**, to name a couple, were both up close to 20% in Q1 as their respective prices (multiples) finally climbed back to historical levels. We liquidated some stocks that reached our target prices, while others remained overly discounted by investors who continued by and large to shun value investments. In Canada, most of the gains registered by the indices were attributable to three groups: banks, railroads, and cannabis stocks. In the United States, high multiple technology stocks were (again) the primary engine of progress, driving 50% of the year-to-date returns. We will keep exercising patience while indices flirt with historical highs, propelled by the momentum in these sectors. Meanwhile, our attention remains focused on interesting opportunities sprouting in less popular areas of the market where there is no paucity of new prospects for us to research.

[1] Please see page 3 for a description of the Composite.

Two large holdings negatively impact returns

Two of our largest holdings dragged us down in the quarter after releasing quarterly earnings below market expectations (and below ours). One of these was **Uni-Select (UNS $13.86)**. We mentioned in our Q3 letter that the Board of Directors had undertaken a strategic review of the company. The timing was not ideal as the lacklustre financial results at the end of 2018 meant more time would be needed to shed light on the course to plot, going forward. We still believe that the sum of the parts of Uni-Select is worth substantially more than the current stock price suggests, whether under its current structure or after divestitures. Needless to say that the Board's prime focus right now is enhancing shareholder value. Positive developments can be expected in this regard later this year.

The second stock that dropped off significantly during the quarter was **Qurate Retail (QRTEA - $15.98)**, a leader in e-commerce services. Qurate's main operations include QVC, HSN (Home Shopping Network), and Zulily. The company has been in business for more than 30 years, led by media mogul and billionaire businessman John Malone. He far exceeds our hurdle for being an excellent steward of shareholder capital and for eliciting value for shareholders. With 60% of its revenues stemming from e-commerce, it ranks among the top 10 online retailers in the United States. Its primary differentiator is the fact that, unlike many of its peers, it actually makes money, and lots of it. In 2018, it reported a pre-tax profit of more than $2 billion. If it has one relative shortcoming, it is growth. Indeed, it might not grow as fast as some other online platforms, but it has nonetheless grown steadily over the years. When investors shift their focus from growth to value, Qurate will stand out. With such a structure, our gains will derive from three main factors: a) sustainability of profits; b) capital allocation decisions; and c) valuation of the stock.

As long-term holders, we painfully watched the stock drop 20% since the beginning of the year after margins came in slightly off target in the fourth quarter of 2018. To our eyes, this is an extreme reaction to the fact that profits ended up notching in only 5% shy of our expectations. Moreover, we expect any potential further pressure on margins to be offset by announced cost synergies flowing from the HSN acquisition completed a year ago. Investors have completely ignored this and have been quick instead to turn to trendier ideas. It is not our practice to determine the long-term value of a business on its performance over a single three-month period. However, the market is a short-term voting machine that shows no mercy to companies that miss their estimates. Qurate is not new to such developments, it has been there before. In the second half of 2016, a similar profit pinch led to a 30% drop in share price, which was followed by a 50% gain the next year. Management took advantage of the situation to buy back almost 10% of the shares outstanding on that occasion. We expect them to do the same this time around.

Where capital allocation is concerned, it is reassuring to know that Qurate's Board of Directors is chaired by John Malone, one of the sharpest minds in the media sector. The company's strong suit lies in the free cash flow it generates. Over the past 12 years, it has used it to repurchase half of its shares outstanding. Last year alone, $1 billion was used to retire 9% of these. Consequently, while operating profits have grown from $1.8 billion in 2011 to $2.1 billion in 2018 (slow growth), they have almost **doubled** from $1.20 to $2.00 on a per share basis.

Finally, regarding valuation, the stock closed the first quarter trading at 8x free cash flow. The last time it traded at such a level, the share price subsequently doubled. Though we cannot predict how soon the market will come to its senses and reprice the stock, we believe that any further downside is extremely limited. As with many of our value investments, we believe the current share price offers a favorable asymmetrical return potential.

Our opportunity set remains robust and, as always, our entire team remains active seeking out new, promising investment ideas. We are currently looking at a slew of quality companies with attractive valuations, much like those presented by the two stocks described above. We look forward to adding new long-term holdings to our fund in good time.

Sincerely,

Philippe Hynes, CFA
April 16, 2019

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

Tonus Composite Performance – As of 3/31/2019

	Tonus Composite (Gross Returns)	*Index*
3 months	-0.32%	12.22%
6 months	-11.10%	1.68%
YTD	-0.32%	12.22%
1 year	-7.16%	10.68%
2 years	-5.53%	8.23%
3 years	2.63%	11.92%
5 years	3.34%	10.21%
Since Inception	**8.96%**	**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.