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THIRD QUARTER 2021 - NEWSLETTER

Dear Partner,

We are pleased to send you this portfolio review and commentary for the third quarter of 2021.

Performance Review

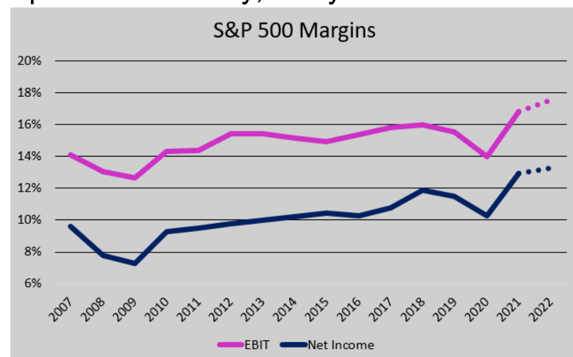
During the third quarter of 2021, the gross return for the TONUS PARTNERS FUND was **-2.6%.** Year-to-date, the Fund achieved a gross return of **16.5%.**

Since the inception of the Tonus Composite[1] in October 2007, it has achieved a compound gross rate of return of **10.2%**, compared with **8.2%** for the benchmark[2].

Quarterly Review

Our returns this year are staying strong, north of 15%, while our third quarter was quieter than the second in terms of both trading and gains. For the 12-month ended September 30, our fund had a gross return of 41.2%. Like the broader market, we saw our returns for the period veer slightly negative in the last week of September. We explained in our previous letter our cautiousness regarding inflation and supply chain tightness. While these continue to be hot topics in the discussions we have with management teams, they have also emerged as focal points for many other investors, the upshot being higher volatility and near-term price declines. That said, these factors have not been an impediment to growth in corporate earnings, at least not yet, and this explains the market's continued strong return year to date.

Aside from dividend yield, two factors lead to profitable investments: earnings growth and multiple expansion. For the longest time, the latter was the locomotive for gains. However, with the economy bouncing back strongly post COVID, the former has turned into the primary engine pulling shares higher. Since January, the estimated 2021 earnings per share of S&P 500 constituents have increased from $165 to $199, a leap of 20%. Clearly, this year's returns have been driven by better-than-expected earnings. Can this continue? Forecast 2022 profits are currently saying "yes". Estimates point to earnings swelling another 13%, 30% for small caps. What is more surprising to us is the fact that earnings are expected to grow faster than revenues (estimated at 6%). In other words, margins should in fact outstrip the record-high levels of 2021. Secular factors no doubt spurred margins to expand over the past 15 years (see Graph 1). However, in light



[1] Please see page 4 for a description of the Composite.
[2] Please see page 3 for a full description of the benchmark along with its historical returns

of the current state of the labour market, elevated transportation costs, global supply chain tightness, and raw materials cost inflation, it is hard to envision a scenario where margins keep rising. Therefore, we believe that margin expectations need to be reset. This is also why we believe that, barring much better top-line growth, market returns will prove dismal at best.

Our Approach to Elevated Estimates

Turning to our portfolio, we analyze each of our investments independently, each with its own unique investment thesis. While the general market expectations for 2022 seem lofty, they vary widely on a stock-by-stock basis and we can act accordingly. Our biggest gainers this year, too, benefited from much better profitability. Generally, when expectations are high and stocks have gone up a lot, under a general/macro approach, these winners would be sold. However, this is not our approach; we base our decisions on our own proprietary, bottom-up research and models. If there is further upside and earnings growth, we will hang on to our shares. If they reach our target price, we will sell.

Nutrien (NTR - $82.21) is a good case in point. The company is both the world's largest potash producer and the operator of a network of 2000 retail locations providing agricultural solutions to farmers. While potash profits can swing from period to period, the retail segment tends to be a slow growth business earning a nice return on capital. At time of purchase a year ago, potash prices had dropped below their five-year average and the share price had declined more than 35%. At that level, we essentially paid an attractive price for the retail operations and got their world-class potash assets for a song.

A year later, the retail segment continued to perform well but potash prices were above $500/tn. Our 2021 profit estimate was bumped up 45% to $6.3B and the stock price followed, almost doubling. Although NTR could benefit from the inflationary environment in the short term, we sold our position given that current expectations surpass our estimates for future profits and the share price reflects most of the long-term gains that we anticipated. The risk-reward ratio having grown less favourable, the stock was put back on our wish list until the time is right to buy again.

Although our portfolio is up significantly year to date, following recent transactions, we currently hold eight stocks that are down in 2021. Comparing our prior-year and current profit estimates shows that for all but one of these our financial expectations have not changed. The declines have been driven by investors temporarily losing interest in some of these businesses now trading at lower valuations. As our long-term view of these remains intact, we acquired more shares, lowering our cost base and increasing our expected returns.

One of the eight is **Haivision (HAI - $7.71)**, a provider of infrastructure solutions for the video streaming market. We bought the stock at the launch of its IPO back in December 2020. At the time, our model pointed to EBITDA reaching $13.9M/$21.4M for 2021/2022. The stock shot up quickly, doubling from our purchase price, and we took some profit. Nine months later, our expectations for 2021 have barely changed but a larger-than-anticipated acquisition by the company has spurred our 2022 estimates upward. Meanwhile, the stock is down 25% this year. At this price, we were delighted to buy more.

A word on portfolio construction

We have always favoured small-cap stocks partly because of the information asymmetry that comes with them. Spending time analyzing smaller stocks like Haivision can give us an edge. On occasion, larger caps enter value territory following negative short-term news or comments from

sell-side analysts. Also, owing to their often more complex business models, they can be prone to conglomerate discounts, that is, to having their assets valued at less than the sum of their parts, as was we saw with Nutrien. We anticipate that our portfolio will continue to be heavily weighted towards small caps, but we also like the stability and liquidity provided by a few more largely capitalized anchor stocks.

In closing, markets have been moving up and down of late, also referred to as sideways, while current 2022 expectations seem lofty to us. It has been a long time since companies and consumers have faced inflation of the magnitude experienced of late. While it might not last, our focus remains on analyzing such risks on a company-specific basis and determining whether current valuations can deliver strong returns for patient investors over the long term. For the first time in years, **we were unable to find stocks attractive enough** to buy during the quarter. Consequently, while our team looks at a variety of interesting new stocks, our cash position will remain higher than usual until we find investments offering limited downside risk and plenty of upside.

Sincerely,

Philippe Hynes, CFA
October 8, 2021

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

Tonus Composite Performance – As of 09/30/2021

	Tonus Composite (Gross Returns)	*Index*
3 months	-2.57%	-0.39%
6 months	5.14%	6.46%
YTD	16.45%	15.48%
1 year	41.27%	33.94%
5 years	6.68%	11.23%
10 years	13.14%	12.65%
Since Inception	**10.20%**	**8.10%**

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.