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SECOND QUARTER 2014 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the second quarter of 2014.

PERFOMANCE REVIEW

During the second quarter of 2014, the Tonus Composite increased **2.70%**. Over the same period, the S&P/TSX Total Return grew **6.41%** and the S&P 500 Total Return in Canadian dollars rose **1.55%**.

Year to date, the Tonus Composite is up **8.99%**, against **12.86%** and **7.40%**, respectively, for the S&P/TSX TR and the S&P 500 TR $CAD.

Since the inception of the Tonus Composite in October 2007, it has achieved a compound rate of return of **13.14%**, compared with **3.55%** for the S&P/TSX TR and **7.74%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

Our return in the second quarter fell in positive territory for the 11th consecutive time. However, this was the first quarter since 2011Q1 in which the markets outshone the Tonus Composite. Although we outpaced the U.S. indices (in Canadian dollars), the Canadian market was on a tear, thanks to exceptionally strong performances from the gold (up 10%), materials (up 6%), and energy (up 10%) sectors. As you know, our exposure to the first two is nil, and we are invested in only one energy producer, which happened to be our worst faring stock in the quarter (more on this later). Also, rising commodities gave the Canadian dollar a strong lift, making it the best performing currency in the second quarter. Needless to say, this had a negative impact on our showing.

Finally, our cash position was once again a drag on results, shaving 2% and 5%, respectively, from our performance year to date and over the past year. This is the “price” for maintaining a disciplined approach and remaining patient for the right entry point. Opportunities have been harder to come by with our benchmark on the rise for 12 consecutive months, something unheard of in the past 15 years (the next longest streak in this period lasted 8 months, from June 2006 to January 2007). Moreover, the last 10%+ correction on the S&P 500 was in 2011Q4. Compounded with the strong performance of some of the investments in the portfolio, almost every time a new stock is purchased another one is sold or trimmed, leaving the cash balance higher than desired. Let’s review the period’s main transactions.

The quarter's first purchase was **Hornbeck Offshore Services (HOS - $46.92)**, a provider of marine transport and logistics services in the Gulf of Mexico. Think of it as the offspring of another of our holdings, **PHI Inc (PHIIK - $44.57)**. The latter transports employees to offshore platforms and rigs by helicopter and the former transports needed supplies (parts, pipes, chemicals) to these same locations by boat. Given that demand for their respective services is influenced by similar drivers, I had been analyzing Hornbeck for the past three years and seized the opportunity of a 35% decline in its stock price to scoop up the shares in April. Like PHI, Hornbeck enjoys a dominant position in the Gulf of Mexico. Timing the market perfectly, Hornbeck management took advantage of the fact that shipyards were desperate for business following the BP well blowout in 2010 to order 23 new high-spec vessels at very favourable rates. Once these are completed, the company will hold a market share north of 35%. In a meeting I had with senior management this past June, they reiterated their belief that the number of deepwater rigs operating in the Gulf will grow from the current 42 to more than 50 next year. As each deepwater rig requires four boats on average to service it, growing demand will drive day rates higher.

Two other factors should contribute to boost profits as well. First, on the Mexican side of the Gulf, demand will increase in the next few years following the reforms being implemented by the government to stimulate production. This coupled with the fact that their largest competitor in that region, Mexican-based Oceanografia, filed for bankruptcy recently, should enable Hornbeck to augment utilization of its smaller vessels. Second, recent tighter enforcement of the Jones Act, which prohibits foreign-flagged vessels from engaging in trade between two U.S. ports, will enable Hornbeck's fleet of U.S.-flagged MPSV vessels to operate at near full utilization over the foreseeable future. Share weakness was the result of a slight disconnect between the delivery of new boats in the first half of 2014 and the delivery of new drilling rigs, which slipped to the second half of 2014. Rates and utilization should improve beginning this quarter. Over the longer term, once the company's new-build program is completed in 2016, free cash flow per share should reach between $6 and $10 and drive the stock price far above the less than $40 we paid per share. Another sign that bodes well is the fact that Hornbeck's CEO increased his position at the same time as we were making our purchase.

The other addition to the portfolio was **DIRTT Environmental Solutions (DRT - $3.54)**, a fine example of how we can be opportunistic. I had been following the company since meeting management at their initial public offering (IPO) in the fall of last year. The company manufactures and markets prefabricated commercial interiors, combining software solutions and innovative construction processes. As it happens, certain company shareholders were restricted from selling shares in the six months following the IPO. When this period expired in May, some 7 million shares were offered in a bought deal at a significant discount to the existing share price. Given that I had already thoroughly researched the company and that I had recently met with the President, the offering gave me the ample discount I was waiting for to buy. Within a month of acquiring the shares at $2.60, they were trading near $4.00. Due to a much smaller margin of safety and the fact that I was never able to fully build the position, I sold the stock for a handsome return.

COMMENTARY

Earlier in the second quarter, I started seeing more stocks down significantly from their peak levels, especially on the U.S. markets. Indeed, the number of stocks whose price had fallen more than 30% had doubled from year's end. When valuations are high, the margin for error shrinks and price drops can be drastic. Under the circumstances, stocks lacking momentum can be overlooked. These become prime candidates for my research list. However, many of the stocks in my sights bounced back quickly in late May and June. As a result, my list of prospects has shrunk considerably. Still, a few of those remaining are very promising and, if stock volatility ever increases (and some day it will), I am confident that they will grow in number. Of particular interest to me are stocks lacking short-term catalysts but offering great long-term potential.

Hornbeck was a good example of this; our holding in **BlackPearl Resources (PXX - $2.26)** is another. As you might recall, we bought into this company after it delayed its financing last year on account of the poor terms being offered at the time. The financing was completed in February and the stock more than doubled in the interval, peaking in April at $3.15. Since then, the investment thesis has not changed materially but the stock has dropped 25%. The main reason for this is a lack of short-term catalysts given that construction of the company's Onion Lake thermal project will take 12 to 15 months to complete. Nevertheless, their existing operations have baseline value and, in the longer term, value will be realized on their growth projects. Current weakness in the share price affords a compelling opportunity to add to our holding. As shares in the portfolio experience short-term weakness and as the prices of stocks shunned by the market decline significantly, I will put more of your dollars to work.

Finally, it was a busy quarter internally at Tonus Capital as we moved to larger premises. Our assets under management have grown and so has our need for space. It should be noted that our telephone number is still the same. Feel free to call should you wish to come and visit our new offices, which, I hope, will be a good incubator for finding new great stocks!

Sincerely,

Philippe Hyn

Philippe Hynes, CFA
July 8, 2014

Tonus Composite Performance Report
As of June 30, 2014

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	2.70%	6.41%	1.55%
6 Month	8.99%	12.86%	7.40%
Year-to-Date	8.99%	12.86%	7.40%
1 Year	27.65%	28.66%	25.81%
2 Years	29.19%	17.79%	25.26%
3 Years	25.59%	7.59%	20.49%
5 Years	19.67%	11.00%	16.75%
Since Inception (Oct. 31, 2007)	13.14%	3.55%	7.74%

Source: Factset Research Systems, Inc.
All returns are gross of fees.
Please note that all returns greater than one year are annualized.

The Tonus Composite was created October 31, 2007. The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of at least 25% of portfolio assets.

Investors should carefully consider the firm's investment objectives, risks, and expenses before investing.

Portfolio composition is subject to change at any time and reference in this letter to specific securities, industries, and sectors should not be construed as a recommendation to purchase or sell any particular security. Current and future portfolio holdings are subject to risk. The Composite return is not guaranteed; its value changes frequently and past performance may not be repeated.