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FOURTH QUARTER 2012 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the fourth quarter of 2012.

PERFOMANCE REVIEW

During the fourth quarter of 2012, the Tonus Composite increased **4.60%.** Over the same period, the performance S&P/TSX Total Return was **1.72%** and that of the S&P 500 Total Return in Canadian dollars was **0.81%.**

For the calendar year 2012, the Tonus Composite was up **21.46%**, against **7.19%** and **13.43%**, 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 **8.07%**, compared with **-0.20%** for the S&P/TSX TR and **1.56%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The fourth quarter capped a very successful 2012 for the Tonus Composite, which delivered an annual gross return of 21.5%. Had the U.S. dollar not depreciated against the Canadian dollar, the return would have been closer to 24%. At the start of 2013, the portfolio is more than 90% invested, marking a “beginning of year” high for the Composite. It is worth pointing out that the performance this year was achieved in spite of the fact that, on average, 14% of the assets were in cash or short-term banker’s acceptance notes. These yielded a “very high” 1.25% at best! In future, cash balances will vary, of course, and could increase as I weight the risk-adjusted upside of the portfolio’s holdings while I continue to exercise my customary patience in purchasing new securities only when they become attractively priced. Two such opportunities arose in the quarter.

The first was **JTH Holding Inc. (TAX - $13.78).** Its ticker symbol is TAX, which is perfectly befitting as JTH is the parent company of Liberty Tax Services, the third largest national retail tax preparation company in the United States. TAX founder and CEO John Hewitt boasts a great track record. After working 12 years for H&R Block, the largest operator in the industry, he founded today’s #2 operator, Jackson Hewitt, in 1982, which he grew to more than 1,300 offices before leaving that company in 1996. He then founded TAX in 1998, which now counts more than 4,000 offices. He presently owns 2.4M TAX shares worth approximately $33 million.

TAX bears witness to Tonus's opportunistic investment philosophy. JTH had planned an IPO back in the spring of 2012, but as it finalized the process in May, Facebook went public and we know how that unfolded. As the IPO market was subsequently closed to new issuers, TAX took the unorthodox path of listing its existing shares on the over-the-counter (OTC) market in June before taking them to the NASDAQ in July. Unfortunately for the company, the move went largely unnoticed and the share price quickly fell from an initial $15 to $10. It was at this point that I began buying shares.

As the saying goes, there are only two sure things in life: death and taxes. Whether this is true or not, the tax-preparation industry is very steady and non-cyclical, but mature. This notwithstanding, TAX is the company that opened the most new locations in the past 5 years. This has allowed it to gain considerably on its competitors in terms of market share. With the roughly 500 new stores slated to open this year, TAX will reach 4,600 locations and intends to double its count by 2020. In comparison, H&R Block currently has nearly 11,000 locations in the United States. However, TAX operates a model whereby franchisees own and operate its locations. In addition to having the owner in the store during the short, but intense, tax season, it means that the company does not need to raise large amounts of capital to expand. In addition, recent regulatory changes should help national preparers take market shares away from mom-and-pop operations, which still control 75% of the market. Starting next tax season, all tax preparers will be required to pass a national exam and be licensed by the IRS. Finally, the healthcare reform will force many individuals who were not required to file an income-tax return to do so as of fiscal 2014.

An increase in the number of filings prepared, combined with regular price hikes and a higher percentage of financial products processed internally, should result in EPS for TAX of more than $1.50 this year and $1.80 next year, according to my model. There will certainly be a liquidity event in 2013 as two of TAX's initial investors wish to reduce their current ownership. Though this might create some short-term pressure on the share price, it will improve the company's liquidity and might draw coverage from sell-side analysts. The larger but slower growing H&R Block has its stock trading at 11x earnings. The faster growing TAX deserves a similar multiple at the very least. This would translate into a share price of $20.

Leucadia National Corp. (LUK - $23.79) was the other new purchase in the last quarter of 2012. The company operates a conglomerate of businesses, ranging from automobile dealerships to timber processing. Its main investments are National Beef (beef processing), Inmet Mining (copper mining), and Jeffries Group (investment bank). Over the years, Leucadia's two deal-makers, Chairman Ian Cumming and President Joseph Steinberg, have created enormous value for themselves and shareholders by buying or investing in companies that were under-valued, mispriced, in need of financing or in bankruptcy. The two men are now each worth more than $500 million.

Because of their approach of scooping up troubled companies in order to redress and sell them, the company's earnings have been highly volatile on a quarterly and even annual basis, especially as some of its public investments are marked to market. This makes Leucadia hard to value. The best way to analyze its performance is to examine the growth in its book value per share, that is, the value of all assets less all liabilities divided by number of shares. Over their 34 years at the helm of the company beginning in 1978, Cumming and Steinberg have seen book value per share grow at a compound annual rate of 18% (13% over the past 10 years). Investors have historically paid a premium to book value for two reasons: a) some investments were worth more than their accounting value and b) the Cumming/Steinberg duo was expected to continue growing shareholder equity.

Recently, the company's stock has been trading at a discount to book value. I purchased our shares at less than $22 on average while book value is presently closer to $25. The market was wary of Leucadia on account of three issues that I believe have now been laid to rest. First, profitability in the mining sector has been under pressure during 2012 and this negatively impacted the value investors were willing to put on the company's sizeable investments in the sector, namely in Fortescue and Inmet Mining. In this regard, the Fortescue investment was liquidated in October for $715 million and a pre-tax gain of $526 million and Inmet received an acquisition offer in December that propelled its share price from $55 to $70.

The other two areas of concern were the value to assign to the company's large deferred tax asset of $1.4 billion and the company's succession planning in light of the fact that its two principal managers were drawing closer to retirement. Both issues were addressed in November when Leucadia announced the acquisition of Jeffries Group, in which Leucadia already held a 28% stake. Jeffries is led by Richard Handler, who has done a fabulous job in a difficult environment over the past 10 years. He will now be CEO of Leucadia, which takes care of the succession problem. Moreover, as Jeffries is highly profitable, Leucadia will be able to take advantage of its deferred taxes more quickly. Both Jeffries and Leucadia have a track record of growing shareholder equity. I expect this trend to continue, which should lead investors to price Leucadia shares at a premium to book value.

On the sell side, our position in **The Madison Square Garden Company (MSG - $44.35)** was liquidated during the quarter at $44. The stock proved a great performer as shares were purchased in March 2010 at $18. Since then the company managed to increase pricing and revenue as it completed phase one of the Garden's renovations. Moreover, there has been a high demand for its media assets, specifically the MSG cable channel. Like other specialty sports channels, it has been able to impose much higher affiliation rates on cable distributors. However, I believe most of the stock's value had been realized at time of sale.

COMMENTARY

I feel it is important to discuss performance attribution as 2012 was indubitably an excellent year. In theory, the solid return could have been generated by a single stock (for example, a 2% position going up 10x during the year would generate a 20% return for the portfolio). If so, you would be justified in wondering whether I was capable of hitting such a homerun two years in a row. Given that the portfolio is concentrated in a small number of large holdings, most of the performance is expected to be driven by just a few stocks. Looking back, however, its return in excess of 20% is not attributable to just one "super performer". Five stocks contributed more than two percentage points and four more added more than one percentage point to the overall return. In other words, nine stocks made a large impact on the performance. Some we are still holding and I believe they will continue to perform well over the long term.

One such stock is the year's largest contributor, **Comcast Corporation (CMCSK - $35.92).** The cable company became the largest holding of the portfolio in October 2009 after news leaked that it was looking to buy NBC Universal. The market wasn't fond of the deal, but I liked it, as it enabled Comcast to increase its cable portfolio and accelerate its transition to digital media. As Comcast's share price underperformed during 2010, my patience and investment thesis were tested, but I took advantage of this mispricing to buy more shares. It was finally this year that the market gave credit to CEO Brian Roberts and drove the stock up 52%. The EV/EBITDA multiple has gone from 5x in 2009 to 6.5x today, profitability grew by 20%, and $9.5B has been returned to shareholders in the form of dividends ($4.0B) and share buybacks ($5.5B). The timing of my purchases will rarely be perfect, but by conducting my own research and forming my own opinions, I believe, in most cases, my patience will eventually be rewarded (acknowledging that sometimes it will take longer than I would prefer...).

I like our current portfolio but I will not hesitate to sell some shares when they hit my target price or begin to present a less favourable upside/downside ratio. The market has done well recently and new ideas have become harder to come by. In such an environment, our investment philosophy affords me the leeway to hold liquidities and wait patiently to take sizeable positions in promising stocks when opportunities arise. Rest assured that I will continue to work hard in 2013 to identify such investments in the hopes of another year of strong returns.

Sincerely,

Philippe Hynes, CFA
January 11, 2013

Tonus Composite Performance Report
As of December 31, 2012

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	4.60%	1.72%	0.81%
6 Month	9.46%	8.86%	3.48%
Year-to-Date	21.46%	7.19%	13.43%
1 Year	21.46%	7.19%	13.43%
2 Years	12.17%	-1.08%	8.91%
3 Years	12.89%	4.79%	9.01%
4 Years	11.13%	11.65%	8.67%
5 Years	7.92%	0.81%	1.81%
Since Inception (Oct. 31, 2007)	8.07%	-0.20%	1.56%

Source: Bloomberg Finance L.P.
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.