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THIRD QUARTER 2012 - NEWSLETTER

Dear Partner,

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

PERFOMANCE REVIEW

During the third quarter of 2012, the Tonus Composite increased **4.66%**. Over the same period, the performance S&P/TSX Total Return was **7.02**% and that of the S&P 500 Total Return in Canadian dollars was **2.64**%.

Year to date, the Tonus Composite is up **16.13%**, against **5.38%** and **12.51%**, 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 **7.51%**, compared with **-0.56%** for the S&P/TSX TR and **1.47%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

Both the Canadian and the U.S. markets performed very well in the third quarter, as did your portfolio. The returns were particularly satisfactory in light of the currency headwind and the higher cash position that marked the quarter. The Tonus Composite was up 29% over the past 12 months. Let's review the main transactions of the last three months.

With markets climbing to multi-year highs, I was more active on the selling front as some stocks reached their fair value. This meant they afforded limited further upside potential while exposing us to additional downside risk due to a receding margin of safety. Consequently, two investments were liquidated during the quarter. The first is **MTS Systems Corp (MTSC - $53.55)**, which shot up 20% after the company released strong Q2 results driven by high gross margins. Historically, these margins have varied widely from one quarter to the next. When the stock was first purchased, margins had been weak for two consecutive quarters owing to an unfavourable business mix and various one-time charges. I expected these margins to bounce back and that is was they did in the past year. The company's challenge now consists in maintaining high margins and growing their backlog. Few investors have realized that this backlog has been fed by strong orders from China, which today accounts for 25% of the company's business. Any slowdown in China will impact MTS negatively, and certain leading economic indicators in that country have softened recently. Though I still believe MTS is a great business, the fact that the stock reached full valuation and peak margins, combined with mounting exposure to global industrial spending and a new CEO without a strong track record, urged me to take the prudent route of selling the position.

The other holding to be sold, **Valassis Communications Inc (VCI - $24.69)**, fared remarkably well this year. It need be reminded that this investment was motivated by the premise that its valuation did not reflect the quality of its shared-mail operations whereby 70 million packages of coupons and advertisement are distributed through USPS each week. We bought the stock when it was trading below $19 and the company's enterprise value stood at $1.3 billion. The shared-mail business, which enjoys strong competitive advantages and generates ample free cash flow, was (and still is) believed to be worth more than that. In addition, VCI derived $70 million in EBITDA from its national coupon clearinghouse, its in-store advertising, and its newspaper insert activities. When the company's enterprise value rose to $1.7 billion, I sold the shares as they fully reflected the value of the shared-mail operations at that point while giving a fair valuation to the other businesses that had been performing short of expectations until then. Once again it came down to valuation. As the margin of safety had grown significantly narrower since time of purchase, it seemed wise to divest.

On the purchase side, a new position was initiated in **DeVry Inc. (DV - $22.76)**, a leading player in the for-profit education sector. The recent past has been difficult for the industry as governments made regulatory changes to limit aggressive recruitment practices and lower the bad debt on government-financed loans. Contrary to some, DeVry has always placed quality of education front and centre. It enjoys a solid reputation and was not required to make significant changes to its business and educational models. However, as a result of the new rules, competition intensified at a time when fewer students were looking to enrol in new programs. The blow has been particularly hard to DeVry's Business and Management (B&M) schools, where enrolment has declined for the past two years.

This is nothing new for DeVry B&M. The division faced similar challenges following the bursting of the technology bubble some ten years ago. At the time, it was heavily concentrated in technology programs and total enrolment growth at the undergraduate level remained negative for more than three years. Over that period, operating margins shrank from the mid-teens to low single digits. A decade later, though DeVry B&M is now more diversified across several concentrations, enrolment and operating margins are trending in a similar manner on account of macro forces. This time around, however, the turnaround should come about more rapidly given that new-student enrolment is expected to stabilize at current levels before rising again. Moreover, margins were at a much higher point when they began to slide, which suggests they should bottom out at a much higher mark as well. To this end, management has been quicker to enact cost-cutting measures in the past six months to minimize the decline. Finally, there is inherent leverage in the business model and once the segment begins to grow, margins should follow suit.

The market is focused on DeVry B&M because of the declines it is experiencing. Meanwhile, it is overlooking the company's other divisions. This is particularly true of its Medical and Nursing schools, which were much less affected by the industry's woes, as evidenced by the fact that demand for enrolment far exceeds supply. I estimate that, together, Medical and Nursing represent 40% of DeVry's profits, that is, $120 million. On top of that, in the past three years, the company has spent $90 million to acquire universities in Brazil where DeVry has more than 25,000 students currently enrolled. This is a very promising growth market and the business is profitable. What's more, DeVry has a clean balance sheet with $175 million in cash and it is presently buying back shares.

If we sum the value of the Medical and Nursing schools and the Brazilian segment and consider the inherent value of DeVry B&M, this stock is a genuine bargain. My purchase price was less than $20 a share, the same level the company was trading at in 2002 when DeVry B&M was half its current size and accounted for almost 95% of the company (compared with 60% today). Clearly the industry is navigating tumultuous waters stirred up by recent regulatory changes. However, education will continue to be a priority for Americans and with funding for public institutions being pared back, the for-profit sector should enjoy healthy demand.

Another position was initiated at the very end of the quarter and I am currently buying more of the stock. I will have further to say about this investment in the next letter.

Finally, during the quarter, two of the holdings in the portfolio experienced similar "corporate events" that had a very positive impact on share price. Both **Shawcor Ltd (SCLa - $42.68)** (see the 2011Q4 letter for the investment thesis) and **Learning Tree International Inc (LTRE - $5.09)** announced their controlling shareholder's intention to privatize the company through an outright sale or a minority shareholder buyout. I will continue to monitor developments and share price fluctuations closely in order to maximize the return on a potential takeout while assessing the downside risk should the deals fall through.

COMMENTARY

The biggest macro event in the quarter was without a doubt the commitment expressed by the U.S. Federal Reserve, the European Central Bank and the Bank of Japan to continue lowering interest rates through various forms of quantitative easing. The objective is clear: to increase consumer spending and business investment. Governments have elected to take this course of action after bellwether companies such as Fedex, Caterpillar, and Intel reported anemic growth and poor prospects for a strong rebound anytime soon. Though I am not convinced that these monetary policy measures will succeed in boosting private spending much higher, at least it is now clear that the central banks will go on stimulating the economy for as long as it is necessary.

Though such announcements have little impact on the real economy in the short term, they contribute to lower the risk of a deep global recession going forward. This explains the performance of the stock markets over the quarter. Indeed, indices rose slowly but steadily to multi-year highs (the S&P500's worst negative one-day showing in the quarter was a mere -1.05%). I took advantage of the situation to sell some positions that had reached full valuation but, in such an environment, it is often more difficult to uncover mispriced securities. As mentioned in the past, I believe volatility can be an ally, provided you know how to use it to your advantage. It is just a matter of time before the right conditions present themselves anew. When this happens, the portfolio is well positioned to seize the opportunities that will arise.

Sincerely,

Philippe Hyn

Philippe Hynes, CFA
October 11, 2012

Tonus Composite Performance Report

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
1 Month	3.84%	3.43%	2.29%
3 Month	4.66%	7.02%	2.64%
6 Month	5.53%	0.95%	1.82%
Year-to-Date	16.13%	5.38%	12.51%
1 Year	29.18%	9.17%	23.30%
2 Years	13.13%	2.61%	12.22%
3 Years	12.00%	5.53%	9.98%
4 Years	7.40%	4.25%	5.83%
Since Inception (Oct. 31, 2007)	7.51%	-0.56%	1.47%

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.