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FOURTH QUARTER 2013 - NEWSLETTER

Dear Partner,

I am pleased to send you this portfolio review and commentary for the fourth quarter of 2013.

PERFORMANCE REVIEW

During the fourth quarter of 2013, the Tonus Composite increased **11.55%**. Over the same period, the performance of the S&P/TSX Total Return was **7.29%** and that of the S&P 500 Total Return in Canadian dollars was **14.23%**.

For the calendar year 2013, the Tonus Composite is up **39.87%**, against **12.99%** and **41.27%**, 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 **12.68%**, compared with **1.83%** for the S&P/TSX TR and **7.14%** for the S&P 500 TR $CAD.

PORTFOLIO REVIEW

The fourth quarter capped a great year for stocks and, again this quarter, the Tonus Composite outperformed our comparative benchmark. I am particularly satisfied with the fact that the 39.9% rise in the portfolio was accomplished without taking any more risk than prescribed by our investment philosophy. Returns were boosted by the U.S. dollar's appreciation but this was more than offset by the large amount of cash held throughout the year (on average 17.8% of the portfolio). Netting out the two, the outperformance of the portfolio is significantly above the indices. The greenback's ascent and the Canadian market's underperformance prompted me to focus more of my research efforts north of the border. This led to the addition of another Canadian investment in the portfolio during the past quarter.

Uni-Sélect (UNS - $28.73) is a distributor of automobile replacement parts and accessories with 56 distribution centres in North America. I was drawn to Uni-Sélect by some company-specific drivers that I thought could bring about a reversal in its declining share price and by favourable industry dynamics. Aside from being only minimally impacted by economic conditions, the auto parts industry is benefitting from the mounting average age of vehicles (older cars need more maintenance) and their greater complexity (more imbedded technology has translated into a lower ratio of individuals doing their own maintenance repairs). The final positive industry driver is inflation, a friend to distributors that increases each gross dollar of sales (assuming same margins) and pushes up the value of inventory. Over the past few years, the growing influx of

Asian parts imports led to price deflation, but this trend has levelled off recently and inflation is expected to return slowly.

I started looking at Uni-Sélect in early 2013. Its share price had been under pressure during 2012 after the company encountered some difficulties implementing its new ERP system, which disrupted service levels and resulted in negative same-store sales from 2012Q2 to 2013Q1. Management was forced to delay the final cycle of the system's roll-out, which it completed only at the end of 2013. With this issue largely behind it, Uni-Sélect can now focus on turning around its underperforming U.S. operations, whose profitability has not been at desired levels. In our recent meeting, CEO Richard Roy clearly identified this as the priority. The former president of this division was let go in April and his replacement orchestrated the restructuring of the U.S. distribution network with a view to increasing the EBITDA margin from a lowly 2% (my estimate) to a more respectable 6.5%. More costs will also be taken out of the system as the old ERP system is phased out and inventories continue to shrink. My forecast is for EBITDA to grow from $90 million in 2012 to $130 million in 2014 and for the company's financial leverage to drop to more conservative levels. At time of purchase, the stock was trading at a 35% discount to its peer group. The discount has since narrowed but I believe further upside exists once the company confirms its ability to deliver consistent organic growth while also pursuing small acquisitions. We were not the only ones to take advantage of this mispricing as several members of the management team, including Chairman Robert Chevrier and CEO Richard Roy, bought a total of 57,000 shares on the open market during the second half of 2013. We have already made a sizeable return on this investment and I believe there is more to come.

The fourth quarter was marked by the sell of **Carbo Ceramics (CRR - $116.53)**. As was the case with the other four investments that were sold during the year, the move was motivated by valuation. After rising 47% in Q3, Carbo was up another 20% at time of trade. In a way, Carbo is a good reflection of the broader market: its short-term prospects are better than they were six months ago, but its valuation is getting way ahead of itself. I think the same could be said of many stocks that, on the least bit of news, shoot up more than 50% when investors reduce their risk premium. Though I still like Carbo's business model and market positioning, at $120 per share the risk/reward ratio became unattractive. The market is now anticipating and pricing into the stock that: i) they will sell all their capacity next year; ii) new capacity will be added on time and on budget and will sell out rapidly; iii) proppant prices will start to rise; and iv) margins will expand. After meeting with the CEO in December, I believed the first two points were highly likely to occur, but I was no longer willing to bear the risks associated with points iii and iv. When the stock was trading below $90, the risk was worth taking. At $120, the upside is limited while these uncertainties remain. I will continue to monitor Carbo's business developments and stock movement. If the upside/downside ratio returns to favourable territory, I might consider repurchasing the stock.

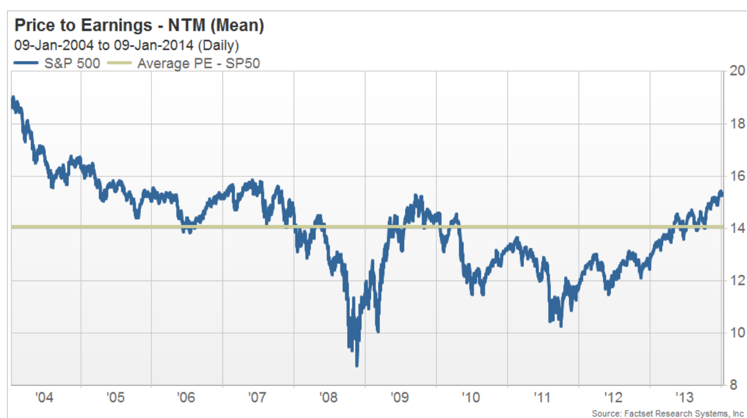
The third stock with interesting developments in the quarter was **Shawcor Limited (SCL – $42.48)**, which I find to be a prime example of the market's bad habit of focusing on the short term instead of looking at a company's value over the long term. Shawcor was down almost 10% following its 2013Q3 earnings release on what were exceptionally strong results. The company executed so well on the two large Asian coating projects that it pulled revenues from future quarters. Looking back at my model a year ago, I expected Shawcor to generate $508 million in revenues from Asia in 2013. Instead, the company will end up making closer to $650 million. This will create a short-term "hole" in 2014, when earnings will decline 17%, according to my forecast (it need be reminded, however, that EPS doubled in both 2012 and 2013). Below $40 per share, the stock was very attractive, trading at 10x 2014 depressed levels. This for a company that boasts a clean balance sheet, generates strong returns on invested capital, and

expects earnings to grow materially in 2015. By then, earnings should reach peak levels propelled by continued growth in North America owing to a glut of pipeline capacity, by large transmission line projects in Europe, and by the expansion of Shawcor's Flexpipe composite pipe division. I took advantage of investors dumping their shares to buy more at a bargain compared with my discounted cash flow value in the high $50s. It is my firm belief that we will be handsomely rewarded over the next two years.

COMMENTARY

The spectacular showing by the U.S. stock market over the past two years has come as a surprise to many. After climbing 13% in 2012, it sprang 29% in 2013 (excluding dividends). What I find astonishing is that such a rise happened while the economy performed at sub-par levels and, for the most part, corporate earnings came in below original forecasts. Returns were driven almost entirely by multiple expansion, which, as mentioned in previous letters, derives from low interest rates. There is no denying that the economy is in better shape than it was six or twelve months ago and that leading indicators point to favourable developments in 2014. However, how much of this is already priced in stock?

From a simple point of view, stock price movements are driven by earnings growth and what investors are willing to pay for such earnings (P/E multiple). Stock will rise either if earnings grow faster than expected or if the multiple assigned to these earnings expands. Let us look at what fuelled the market's advance in the past two years. At the beginning of 2012, estimated profit per share for the S&P 500 was $106. It pegged in at $103 or 3% below forecast. The index's 13% return was driven entirely by the fact that the P/E multiple went from 11.9x to 13.8x, a 17% increase. In 2013, the original earnings estimate of $110 per share will likely prove slightly optimistic, yet the P/E ratio has vaulted from 13x to 17x, a 31% increase! The trend on the Canadian market has been similar, albeit less steep, with the multiple increasing 12% in 2013.



As shown on the graph, at the start of both 2012 and 2013, market multiples were below their historical average and market gains then came from multiple expansion. We are starting 2014 with a multiple of 15.4x expected earnings, which is at the high end of where it has been over the past 10 years. Can it go any higher? Of course, but this would take it back to levels seen during past bubbles. Alternatively, stock prices could rise if earnings surprise on the upside. Current forecasts call for S&P 500 earnings to grow 10% in 2014. With margins already at record levels, companies will likely need to post revenue growth in the mid-teens to surpass this target. Over the past 15 years, only once have S&P 500 revenues grown at such a level. Consequently, we are unlikely to see spectacular returns given that market multiples are already high and that above-average growth levels have already been anticipated. In such an environment, it is extremely difficult for a value investor like me to find many bargains. However, the flexibility offered by Tonus's investment policy can nonetheless allow us to benefit from the situation. Fully priced stocks in the portfolio have and will be sold. Moreover,

thanks to our concentrated portfolio, a handful of new investments are all that is needed to make a sizeable impact on performance. And I am confident that there will be mispriced securities to be had in the year to come.

In closing, Tonus Capital saw its assets under management rise significantly in 2013. We are beginning 2014 on strong footing and you can count on me to continue looking for potential stock winners that will buoy portfolio returns this year and in those to come.

Sincerely,

Philippe Hynes, CFA
January 13, 2014

Tonus Composite Performance Report
As of December 31, 2013

Date	Tonus Composite Gross Return	S&P/TSX Total Return	S&P 500 Total Return ($CAD)
3 Month	11.55%	7.29%	14.23%
6 Month	17.10%	14.00%	17.14%
Year-to-Date	39.87%	12.99%	41.27%
1 Year	39.87%	12.99%	41.27%
2 Years	30.29%	10.02%	26.50%
3 Years	20.73%	3.40%	18.77%
5 Years	16.36%	11.91%	14.52%
Since Inception (Oct. 31, 2007)	12.68%	1.83%	7.14%

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.