

February 20, 2015

Annual Letter 2014

The Barrage Fund

Management Report

Between the 1st of January and the 31st of December 2014 the SPX/TSX index gave returns of 10.55% (including dividends), while the S&P 500 returned 23.81% (in Canadian dollars and including dividends). Returns for the Barrage Fund during the same period were 31.54% before fees and 24.38% after fees.

The majority of companies held in the portfolio are located in the U.S. and exchange rates helped improve our returns by approximately 9% during the year.

Currently, the fund is made up of eleven stocks. There have been fluctuations in our cash level; during the autumn, it reached a level of more than 20%. Shortly afterwards in October, a small market correction took place, followed by the large drop in the oil market. This situation allowed us to deploy our capital fully.

Market Commentary

As we mentioned earlier, October's market corrections created purchase opportunities. To interpret this – we love it when stock markets fall! The French expression “after the rain comes the sunshine” is very apt, however, this is dependent on what you do while it rains. To quote Warren Buffet, “Be fearful when others are greedy and greedy when others are fearful.”

Overall, 2014 was a prosperous year for investors and the US market proved to be particularly lucrative. At the time of writing, the S&P 500 had obtained a price-earnings ratio of 19, while the historical average is 15. The elevated values which we are currently experiencing can easily be explained by interest rates, which are at low levels historically. In general, investors should moderate their expectations and not trust in the performance of the last five years.

As researchers looking for windfalls, we position ourselves to create a portfolio of undervalued stocks. We seek to significantly improve our potential returns, while minimizing the level of risk. As mentioned earlier, the S&P 500 price-earnings ratio has reached 19, while the average ratio of the holdings in our portfolio is only 11.

The Oil Price Plunge

Undoubtedly, the most important event of the year was the fall in oil prices. This fall will continue in 2015. In a short period, the price of oil dropped from \$110, to \$50 at the time of writing. The acceleration of the fall began when Saudi Arabia announced that it would not reduce daily production in order to help prices recover. Saudi Arabia is looking to retain its market share and to suffocate competition, which has intensified in recent years.

The U.S. is producing more and more oil, thanks notably to hydraulic fracking. At the beginning of 2014, the International Energy Agency predicted that the U.S. would overtake Saudi Arabia in 2016, and become one of the most important global producers of oil. The response from the Middle East to the possibility of having to reduce production has been to make defensive moves to protect market share by trying to curb soaring US growth, which has been continuing at breakneck speed.

In Canada, the oil price drop had a particularly significant impact on investments and profits for tar sands producers. Until now, the impact has been mostly felt on our currency. The loonie has lost some of its feathers, which has had a positive impact on our fund, as the majority of our investments are valued in US dollars.

It is still too soon to decide if the price of oil will have negative repercussions for the Canadian economy. On one hand, oil companies are seeing their profits tumble, which could result in layoffs if the trend continues. On the other, consumers are spending less at the pump and the freight transportation sector is able to make considerable savings.

As for our dollar, its weakness improves export opportunities for businesses outside of the oil sector. In summary, it is difficult for us to predict the short and long term impacts. Meanwhile, we are researching opportunities in the natural resources sector, an area that we have avoided for a long period.

We should emphasize that Canadian household debt levels remain high and that the real estate market is not yet showing any signs of weakness. Our negative opinion regarding the Canadian economy has not changed.

Prices at the Gas Pumps help certain Stocks

General Motors

We bought shares in General Motors (GM-N) this autumn. This company underwent a profound transformation during the economic crisis. In the first half of 2009, GM's financial statements mentioned a restructuring profit of \$128 billion. Despite this health cure, the company's tangible net value remained in the red, because the profits created an appearance of significant intangible value on the balance sheet. Despite everything, the company proceeded with its stock exchange flotation in November 2010 at a price of \$33 per share.

Four years later, the same securities were offered to us at the lower price of \$31 per share. During this period, the balance sheet has clearly improved. In September 2010, liabilities linked to the pension fund reached a value of almost \$38 billion. This has now lowered to \$24 billion. Net tangible equity has returned to positive territory, thanks to accumulated profits which can be seen in the significant increase in retained earnings.

General Motors was definitely affected by the late recall scandal, and the bad publicity which was generated probably exerted negative pressure on the stock price. Happily, the new CEO, Mary Barra, has confronted this issue directly. Since her appointment in January 2014, she has made numerous public appearances in which she has stated that she is taking the problem seriously.

GM has established long term profitability targets and anticipates an operating margin of 9-10% by the beginning of the next decade. This figure corresponds to profits of at least \$10 billion after tax, if sales do not improve. We should obtain a price-earnings ratio of 5 times if this objective is achieved.

The prospects seem favourable for a sales increase in both the short and long term. The average age of a vehicle on American roads was 11 years in the summer of 2014. During the last 20 years, this average has increased gradually from 8 to 11 years. This bodes well for the sale of new vehicles, and the North American market makes up more than 80% of the company's operating profit.

As one might expect, the drop in oil prices is another positive element for automobile manufacturers. At the time of our first purchase of shares, we did not doubt that "black gold" would make headlines so spectacularly. The attraction of this stock comes from its evaluation, from the positive energy created by the objectives of its leader and the solidity of its balance sheet. Low prices at the pumps are an additional attraction for these shares.

We believe that we are already witnessing the effects. Last December, GM announced record sales for the month with a 19% increase in the number of vehicles sold. The company was able to close its best year since 2006.

AutoNation

Headquartered in Florida, AutoNation has the largest network of car dealerships in the United States. Last September, the stock's price adjusted and offered an attractive entry point at \$48. We really like the CEO, Michael Jackson, and believe that the company has the wind in its sails thanks to the continual growth of new vehicle sales in the U.S. since the financial crisis.

Gas prices increase sales even more, and we had already noticed an effect when the company announced particularly good results. Sales in the fourth quarter of 2014 grew by 24% and those in January of this year by 20%.

Note that our acquisitions of AutoNation preceded shortly the purchase of the Van Tuyl Group by Berkshire Hathaway in October. Mr. Buffett showed his interest in the sector and is looking to become a major player.

Best Buy

This is another of our stocks which profited from the low price of oil. When consumers have more disposable income, sooner or later they spend more. This is excellent news for retail sector businesses such as Best Buy (BBY-N).

In our previous letter, we discussed the multi-year restructuring plan that was put in place by Best Buy's CEO, Hubert Joly, when he was appointed in 2012. As predicted, we saw an improvement in profitability and the shares saw a nice rise since our first purchases at around \$25. Despite a decline in sales across the electronics sector during the holiday season, Best Buy showed a comparable rise in its own sales.

However, investors were showing signs of impatience at the time of this announcement. On the 15th of January, the stock price plunged from near \$40 to \$34. A management profit warning predicted slightly negative results at the official announcement in March. Knowing the conservative attitude of the management, we have taken this opportunity to buy more stock at a price which we believe is attractive, given the evolution of the company's value.

A Buyback in the True Sense of the Term

We omitted to mention a detail in the preceding paragraph; we had already reduced our position in Best Buy. Therefore we purchased shares which we had previously divested. We will discuss this type of transaction, which happens occasionally, so that you can better understand how we apply our investment philosophy.

We look to buy shares which are at a discount in relation to the value of the company. For example, following a sharp fall in the stock price in January, we had the opportunity

to swipe shares in Best Buy (BBY-N) at \$25 in the first half of 2014. We estimated that the shares had a real value of \$46, thus giving us a potential gain of 84%.

Several months later, the shares had reached a value of more than \$39. At this point, our potential returns had considerably diminished. For example at \$39, the expected return is only \$7, thus leaving potential growth of only 18%. Therefore, we reduced our position several times to reinvest in stocks with greater potential.

On the 15th of January, investors reacted negatively to management's announcement and the stock price dropped to \$34. We were still confident in our estimate of the company's true value. Best Buy's restructuring plan is continuing as predicted and the fall in stock price changed the potential profits to 41%. Therefore we bought back the shares that we had sold before.

It is vital to grasp the importance of a company's evolution in such a scenario. The stock price tumbled, while our estimate of the company's value remained unchanged, and perhaps had become even more certain. As we had been following the development of the company for an extended period, we understood the issues it was facing.

A typical investor error is to purchase a company's shares only in relation to stock market behaviour. To get a discount and a potential return upon which to base our decisions, a new estimate of the value of the shares is unavoidable.

The share price could have fallen to \$34 for valid reasons if our evaluation had been affected by the newly published information. We would then have considered further sales of our shareholding rather than repurchasing.

Our primary goal is not to buy and sell the same shares repeatedly. In our opinion, that would be pure speculation. However, if the irrational behaviour of investors gives us an opportunity to exploit their bad decisions, we will always look to be among the beneficiaries.

Partial Sale of AIG

We have reduced our position in AIG considerably. The development in results has been a lot slower than we would have liked. In addition, another large element cooled our enthusiasm this autumn. A major trial without jury was contested between Starr International and the U.S. Government. The trial has now finished but the presiding judge, the honourable Thomas Wheeler, will return his verdict within the next few months.

According to the different facts laid out by Starr International's lawyers, the government acted illegally when it became a majority shareholder in AIG. It also forced the company to accept less advantageous terms for several aspects of the rescue package, such as the interest rates on borrowings.

We think that Starr International's motives are not valid given the imminent collapse of the company at the time. The plaintiff is demanding a sum of \$40 billion dollars, while the market capitalization of AIG is currently \$75 billion! This sum would serve to compensate shareholders for the more than 90% drop in value that they suffered at the time of the restructuring in the autumn of 2008.

Starr International held approximately 11% of the shares, and it was founded by Maurice Hank Greenberg. Mr. Greenberg managed AIG for a long period before he was fired in 2005 after accusations of accounting irregularities were made by the then Attorney General of New York, Eliot Spitzer. Mr. Greenberg was, indirectly, the largest shareholder in AIG. Even though we believe that this action is without merit, the simple fact that Judge Wheeler agreed to hear it in court, leads us to believe that any result is possible.

The rescue package offered by the U.S. government in 2008 included one condition: if there was a legal action related to the rescue, AIG could potentially have to compensate the government. Following the results of the legal action, the losing party will undoubtedly initiate an appeals process. Therefore we foresee a period of uncertainty for investors, and consequently, continual pressure on the stock price.

Here is an interesting anecdote concerning Mr. Greenberg. According to the writer John Rothchild, Mr. Greenberg has already participated in a meeting to propose a bailout involving Warren Buffett. He was prepared to provide a cash injection into the insurance firm GEICO, which risked bankruptcy in 1979 (note that today GEICO is wholly owned by Berkshire Hathaway). Ironically, Mr. Greenberg did not bring into question the dilution for GEICO shareholders at the time. While some shareholders complained about the dilution that they were obliged to accept, Mr. Greenberg claimed that in his opinion it was futile to pay attention to the details of a bailout, when the whole company was at risk of failure. Today, Mr. Greenberg is fighting tooth and nail to outline the importance of these details for the shareholders of AIG to which he belongs.

In spite of the court case, AIG remains one of the most attractive insurers evaluation-wise. We will follow the situation closely and could make AIG a significant investment in our portfolio again.

A Stock and its Catalyst

Towards October, we bought several shares in Nicholas Financial (NICK-Q) at around \$12. This company offers auto loans to people with damaged credit ratings. We refer to this type of loan as "subprime."

Nicholas Financial should have been bought by Prospect Financial during 2014 at the price of \$16 per share. However, the company was grappling with the Securities and Exchange Commission and could not meet their demands regarding the accounting

methods used for corporate purchases. Nicholas abandoned the acquisition project, which caused a drop in its share price.

The company had clearly shown its intention to improve its value to shareholders. The acquisition by Prospect Financial, even if it failed, was proof in and of itself. On the 21st of October, the management communicated its desire to realise its plans again. It announced that it was considering various financial strategies including a share buyback, a special dividend payment or a loan to facilitate an acquisition (or expansion) of the company. We knew that a catalyst was about to appear and that the stock price would benefit.

We noticed that the returns on equity of the company have been eroded during the last fifteen years, following a gradual reduction in leverage. We calculate this ratio by dividing loans held on the balance sheet by the tangible net worth. This has declined gradually, from more than 5 in 1999 to less than 2 today. In other words, the growth in loans has not kept pace with the growth in equity. Consequently, the management should have been feeling a growing urgency to put in place a plan to improve the company's profitability.

On the 22nd of December 2014, the anticipated catalyst arrived. Nicholas announced that it would hold a Dutch auction. It anticipated devoting \$70 million to buy back shares, or almost 40% of its value on the stock exchange! The proposed range was between \$14.60 - \$15.60. Supposing a sum of \$70 million for the purchases at a price of \$15 per share, the reduction in equity would adjust the ratio of loans to 3.7. This would thus return the loans ratio to a 2004 level and considerably improve the return on equity. The profit per share would increase to more than \$2, improving the price-earnings ratio to 7 times.

This news caused the stock price to jump to around \$15. Despite the low valuation which will follow the auction if it is successful, we preferred to liquidate our holdings, making a return of 17%. We have opted for other opportunities.

We would also like to underline that the subprime auto loans market has become extremely competitive and represents a higher level of risk in the medium term. This sector was not affected greatly during the crisis and the good results were not unnoticed by financial firms. The competition has lead many players to acquire, or to maintain loans of a mediocre quality. We see this notably in the increase in provisions for losses, which for Nicholas were fairly significant in the last quarter. The catalyst could be interesting in the short term, but the longer term prospects for this company left us less enthusiastic.

Apple

We are happy with the outcome regarding this stock. At one time, analysts were sceptical about the company and the share price fell to \$62. At the time of writing, the price has doubled and analysts are becoming more excited. This is a good example of how to exploit stock market pessimism. You will regularly see this type of scenario in the choice of our stocks, because opportunities are often created by a change of mood, either by investors or by industry professionals such as financial analysts.

Administrative

On the 31st of December 2014, The Barrage Fund made a distribution of \$2.62 per unit. This payment corresponds to gains in capital, dividends and interest generated and earned through the year, from which we have subtracted management fees. For those of you who hold your units of the Barrage Fund in a non-registered account, you will receive your T3 tax form within the next few weeks.

The Barrage Fund is now available on the FundSERV platform. This allows all licensed financial advisors to have access to our fund. An investor can request their advisor to include The Barrage Fund in their investment plan, while keeping their assets with their current financial institution.

KPMG is currently auditing the financial status of The Barrage Fund for the period until the 31st December 2014. You will be sent a copy of the audit towards the end of March.

We will be holding our Annual General Meeting on the 14th of May at the Tour de la Bourse. You will receive an invitation in the near future.

With kind regards,



Patrick Thénier



Rémy Morel



Mathieu Beaudry



Maxime Lauziere