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January 15, 2021

2020 Annual Letter

Barrage Fund

Management Report

For the period of January 1st to December 31st 2020, the S&P/TSX posted a return 5.61% (including dividends) while the S&P 500 returned 16.32% (in Canadian dollars and including dividends). The Barrage Fund's performance for the same period was 31.57% before fees and 25.93% after fees.

The fund is currently made up of 8 holdings and has a modest cash balance. After keeping a generous cash position for much of the year, we have returned to a level more in line with what we have held in the past.

Market Commentary

What a year for investors! The COVID-19 pandemic began to affect the US stock market in February. On March 23, 2020, the S&P 500 closed the day at 2,237, a decline of approximately 30% from the start of the year. At that time, everything led us to believe that the index could continue to fall and reach much lower levels. The government had literally "closed" the economy, instituting a lockdown that could potentially lead to the bankruptcy of several businesses, which would have generated significant defaults on bank loans. The banks would have reacted by tightening their borrowing criteria and would in all probability have sought to accumulate capital to strengthen their balance sheets.

The reactions of different market players, including banks, contribute to the severity of financial shocks. These behaviors are similar to those of individuals at the start of a recession. A person who loses his job will start to reduce his expenses considerably, due to a lack of means. His relatives and friends, hearing the bad news, will fear the same fate.

However, people's sudden fear of their future prospects normally leads to a higher savings rate. If you reduce your spending in order to "prepare" for the worst, businesses face the repercussions, exacerbating the negative consequences. By considering all of these factors, one can understand why our economy goes through boom and bust cycles. In times of expansion, optimism prevails and ultimately leads to excesses. When the recession hits, all that optimism turns into pessimism, reinforcing the downtrend.

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During the expansion phase, companies and individuals take on debt, contributing to increased revenue for businesses. However, debt often reaches unsustainable levels at the top of the cycle, or worse, default when it comes time to pay it off. This is why most of the time, the recession phase does not progress smoothly. It turns out to be brutal and full of unfortunate consequences for the entire population.

As portfolio managers and investors, we are aware of these cycles. For us, they are inherent in human nature. This is why we believe that adopting a non-conformist attitude is a key element in the success of an investor. As the famous quote from Warren Buffett goes: "Be fearful when others are greedy. Be greedy when others are fearful. " Value investing lends itself well to this attitude, since we try to invest in stocks that are shunned, while leaving out those that are highly prized by the market.

After a 30% drop of the S&P 500 index by March 2020, here we are today with a spectacular rebound of 70%! Shouldn't we have been greedy when the markets were clearly fearful last March?

Two important factors, interest rates and government financial intervention, have muddied the waters somewhat. As we explained in our semi-annual letter on July 15, 2020, we have witnessed the biggest and fastest financial rescue in history. This massive injection of money was not only enough to lift the markets, it also contributed to the inflation of asset prices in many ways. It seems we have avoided the worst so far.

Obviously, if we could know in advance and with some precision what the government's intentions were, we would have adjusted the value of securities we follow accordingly. The job of an investor is to weigh all available information and come to a conclusion about future prospects. Does the current price of our securities take risk into account? Does the potential return turn out to be sufficiently attractive to assume this risk? By answering these questions, we come to an informed decision.

Our positioning in March of last year, which included 30% of the portfolio in cash, seemed very conservative in hindsight. We gradually reinvested this cash, however, as we saw how even stronger our companies were than we thought!

Certainly, having displayed a more reckless attitude throughout the year, we would have generated more returns. Return maximization is one of our goals. However, it will always remain second to the key principle of our philosophy: minimizing risk. Between being too reckless or too conservative, we prefer the latter. Our very long-term goal being to enrich our investors, we want to make sure we cross the finish line first! We can confidently say that in March our portfolio was solidly positioned. We had a storm, but we were also prepared for a financial hurricane if the government hadn't stepped in like it did!

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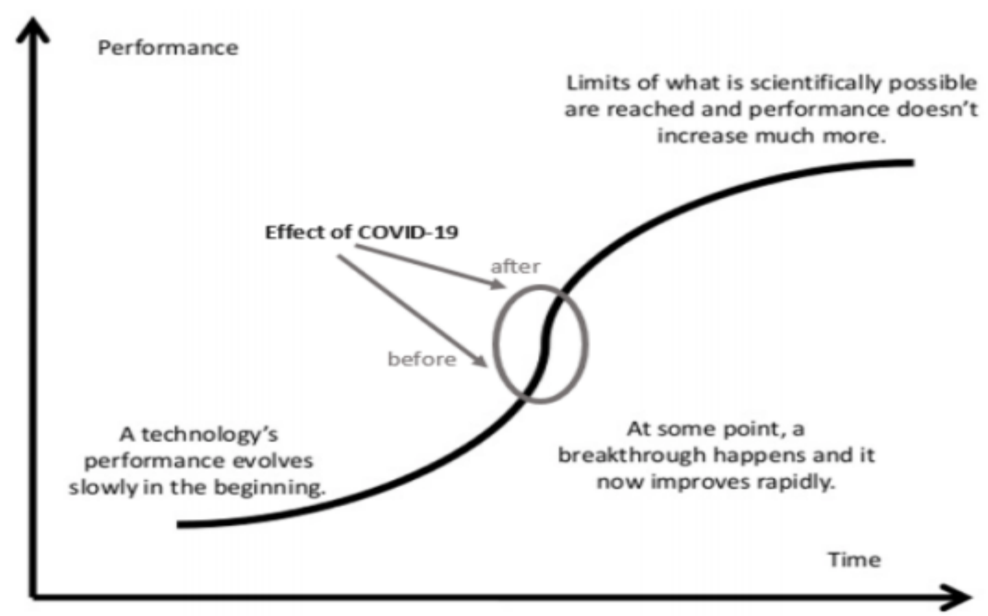
A more optimistic Warren Buffett?

In our semi-annual letter, we mentioned how pessimistic Mr. Buffett seemed to us at his annual meeting in May, considering his usual disposition is one of encouragement. Mr. Buffett had explained his inaction during the lows of March by saying: "We did nothing because we saw nothing attractive to do". That's why, among other things, Berkshire Hathaway didn't even buy back its own shares at $160 (class B), having repurchased stock between $214 and $226 just a month earlier.

When the 3rd quarter results were released, we learned that the company had repurchased $9.3 billion worth of its own shares at a price of approximately $215. That's quite a turnaround, which is unusual in the case of Mr. Buffett. We believe, however, that given the uncertainties he was facing at the time, he was acting rationally. Knowing how to adjust to the information we have at any given time, regardless of the past, is a key success factor in our opinion.

The ongoing digital transition

In 2020, we took advantage of the accelerating movement towards digital technology with our stocks. As the following graph shows (it also appears in our previous letter), this transition has accelerated, but is still not over.



Our companies are not the only ones to benefit from this revolution. 2020 has been rich in initial public offerings (IPOs), with the arrival of Doordash and AirBnB in particular. According to a report from the site "Stock Analysis", there were 480 IPOs in the U.S.

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during the year, an all-time record. This is twice as much as 2019, as well as 20% higher than the previous record which was reached in 2000, just before the burst of the tech bubble.

Our portfolio companies are also benefiting from the online transition and the development of the cloud, but they do not appear to have benefited from the generosity of investors expressed in the valuations of certain companies. We find glaring examples among enterprises that operate in the software as a service (SaaS) sector. Here are a few stocks in this sector, which are displayed according to their price to sales (P/S) multiples:

Company	Symbol	Current P/S	Previous P/S
Snowflake	SNOW	173	N / A
Crowdstrike	CRWD	63	25 (2019)
Cloudflare	NET	61	20 (2019)
Datadog	DDOG	55	36 (2019)
Zscaler	ZS	54	17 (2019)
Coupa Software	COUP	47	9 (2017)
Palantir Technologies	PLTR	44	N/A
Okta	OKTA	41	17 (2019)
Fastly	FSLY	35	10 (2019)
Atlassian	TEAM	34	11 (2016)
Twilio	TWLO	33	6 (2017)

The price to sales ratio is often used for this industry, in order to be able to assess companies that are not yet profitable. The success of the players in the SaaS industry relies in large part on the efficiency of the internet to allow their customers to access their services more easily. These customers no longer need to install software on their premises. These are products that can be distributed all over the world at low cost, like the streaming service from Netflix. In such a context, some of these companies reinvest massively and target volume, creating accounting losses for which it is difficult to apply a price/earnings ratio.

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Here is the same ratio of price to sales for our companies (only one stock is not in the table, given its sector):

Barrage's stocks	Symbol	P/S
Spotify	SPOT	7
Netflix	NFLX	10
Facebook	FB	10
Alphabet	GOOG	7
Amazon	AMZN	5*
Microsoft	MSFT	11
Activision Blizzard	ATVI	9

**Given the nature of the company's operations, particularly retail sales, the price-to-sales ratio is not comparable to the other stocks. We believe, however, that the cloud division as well as the third party platform would reflect comparable multiples if isolated.*

It should be noted that although our companies are investing in their growth, they all generate profits. Several of them are not showing growth rates as spectacular as what we can see in the SaaS industry. However, given the current profitability as well as their dominant positions in their respective industries, we believe their stocks deserve higher P/S multiples.

Note that the US stock market posted excellent performance in 2020, despite the recession, leading some stocks into overvalued territory in our opinion. We therefore remain cautious, and also do not attempt to benefit from the elevated valuations through short selling.

In this regard, we are closely following a manager who has been betting on the fall in Tesla's stock for several years already, but has only accumulated losses so far. The most surprising thing about this stock is Elon Musk's statement at the very beginning of last May. He had said on Twitter that he believed Tesla's shares were overvalued. Here is the price and context to his statement:

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**Chart taken from Market Insider*

Reflexivity, a concept whose application in the stock market was once explained by the famous hedge fund manager, George Soros, can often work against short sellers. Reflexivity ensures that investors' very positive perception of a company, Tesla in this case, influences the company itself. The meteoric rise of the stock has enabled the electric vehicle maker to tap capital markets at a very low cost! Tesla has taken steps to issue up to US $5 billion of stock twice since last September. At the current share price, these sales are much better than taking on additional debt, since it causes a negligible amount of dilution for shareholders. Tesla will end up with an additional US $10 billion, for which no interest will be payable!

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Our companies' Results

Netflix

With the economy shutting down and the lockdown, we expected cash flow to improve. This is indeed what happened. The slowdown in production expenses due to COVID increased these flows from -502 million $ to $1.26 billion (in US dollars). Content spending fell from $3.65 billion to $2.65 billion. This decrease was necessary in the context of a pandemic, but it does indicate that the negative cash flow was caused mainly by the company's deliberate choice to invest heavily in content in order to strengthen its position as a dominant player. If Reed Hasting suffered from financial myopia, he wouldn't have waited for the pandemic to make the short-term results look good. Netflix's strategy of focusing on the production of original content requires significant investments upfront, but will ensure the sustainability of the company.

When the latest results were released, management said it expected a gradual return to production, expecting cash flow for 2021 of between 0 to $ -1 billion. With a cash position of $8.4B as of September 30, 2020, the company did not foresee the need for external financing in the short term, and will therefore be able to resume its emphasis on the creation of original content. This will allow it to host more and more exclusive content, of which it will enjoy full control.

Alphabet and Facebook

Not surprisingly, Alphabet's sales did not grow in the second quarter. The travel sector accounts for between 10% and 15% of its sales. However, as the pandemic continued, we were somewhat surprised by developments of the following quarter, when sales jumped by 15%! The sale of advertising on YouTube was particularly strong, an increase of 32% for the quarter, reaching US $20 billion on an annualized basis.

Despite the economic slowdown, Alphabet is still benefiting from the online transition. With net cash of US $120 billion and annual research and development expenses of US $28 billion, we believe the company will continue to perform well.

At Facebook, we expected a decrease in users in Q3 compared to Q2. Engagement on their platforms expanded significantly during the pandemic, setting the bar high for the future. However, the number of users fell slightly in the United States and Canada, but continued to increase for the rest of the world, contributing to a net increase of 1.4% globally (monthly active users).

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ARPU (average revenue per user) climbed 6.8% compared to the same quarter last year. Considering the economic slowdown caused by the pandemic as well as the boycott against the company, this is quite the success! Facebook explains these results by the increased demand for online advertising compared to traditional advertising. The pandemic has accelerated this transition. These positive factors were reflected in revenue generated, an increase of 22%!

What repercussions have we observed in relation to the boycott? In June 2020, several companies announced their intention to cease advertising their products and services through Facebook, in order to protest against hate speech that had circulated on social networks (including comments from Donald Trump). Coca-Cola, Ford, Honda, Hershey's, Best Buy, Microsoft, Starbucks and Adidas were some of the companies who joined the boycott. These are big names, and therefore important clients. However, Facebook had 10 million advertisers in October 2020, compared to 9 million in July. This number continues to grow. So we have to ask ourselves the question: what really happens in the event of a boycott?

Normally, if you used to spend $100 per month at any retailer, that retailer will have $1,200 less in sales after a year. At Facebook, the advertising platform works like an auction. The price of advertising varies depending on supply and demand. So if you stop contributing, which lowers demand, the price of $100 for ad X will simply decrease to the price needed to interest another advertiser. Therefore, in many cases, Facebook would not lose the sale, but the auction for that ad will clear at a lower price.

However, the law of supply and demand works in its favour. Indeed, if an ad that normally costs $100 becomes available for $50, what will most advertisers who do not boycott the business do? They will just buy more advertising.

If you have a budget of $1000 for this type of expense, are you going to cut it down to $500 or just feel very happy to get twice as much for the same price? Would you go so far as to spend more, knowing that your sales will benefit greatly?

We observed that the costs per click and per impression did not drop until March 2020 for Facebook, and quickly recovered in the following months. The boycott that began in June seems to have had no impact on its results. As a result, not only was the effort wasted, even if it had worked, Facebook would still probably have ended up with more advertisers in the end.

However, was this really the aim of this boycott? We suspect that several of these large companies are familiar with the mechanism behind the Facebook platform. By publicly supporting the boycott, they benefited from some free publicity (social networks, television, etc.), demonstrating that they were behind the opinions of their customers.

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As of this writing, several of these companies, including Adidas and Unilever, are already back to advertising on Facebook. Obviously, these returns are not making the headlines!

As for regulation, is it a high risk for Facebook and Alphabet? Recent events at the Capitol in Washington have once again drawn the spotlight on Facebook. We hear criticism from all sides. On the one hand, there is a desire for the company to have more control over what circulates on its networks. On the other hand, there is anger when it intervenes, with reference to freedom of expression and the "abusive power" of the company when it decides to close or restrict an account.

At Alphabet, the accusations follow, one after the other. Google's dominant position in online research is strongly criticized. Will we eventually see an end to these attacks?

We believe that if it weren't for all of the criticism these two companies faced, their valuation would be pricier. Meanwhile, they continue to innovate and generate profits. We are closely monitoring the evolution and impact of regulations, and remain confident about their future.

Amazon, Spotify and Microsoft

Amazon has clearly benefited from the pandemic. More than ever, shoppers have turned to online shopping, contributing to an increase in sales of 37% for the quarter ended September 30, 2020. Profits increased 200% despite the significant Covid-19 related expenses.

On the Spotify side, sales grew 14%, with users growing 29%. The increase has been particularly strong in India. The company closed the September 30th quarter with US $1.18 billion in cash and no debt.

For Microsoft, we highlight an interesting comment from its CEO, Satya Nadella, when unveiling the latest results: "The next decade of economic performance for all businesses will be defined by the speed of their digital transformation."

This comment provides 3 insights. First, it highlights Microsoft's involvement in the digital movement. Otherwise, Mr. Nadella would have refrained from making this statement. Second, he specifies that transformation must happen quickly, otherwise companies are putting themselves at risk. Finally, by saying "decade", we understand that this transition will continue for several years!

The company saw its earnings per share grow 32% in the last quarter. Revenue from Azure, their cloud subsidiary that we follow with great interest, jumped 48%.

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Activision Blizzard and Kinder Morgan

A new company has been added to the portfolio. Being one of the biggest players in its industry in North America, Activision Blizzard is very successful with its games such as Call of Duty, World of Warcraft, Overwatch and Candy Crush. We are taking a keen interest in this sector which is experiencing significant expansion with the online transition. Before, players bought their games in stores. They paid a price of around $60 and could play at will.

Increasingly, the industry is adopting a Spotify-like model: subscriptions (monthly payments) and in-game purchases and/or advertising. In this case, these games are often distributed for free to attract as many players as possible. Note that we also participate in this sector through Microsoft (Xbox), as well as Facebook to a lesser extent.

As for Kinder Morgan, this is a stock that we sold in November 2018, in the $17 range. The pandemic caused a sharp correction in the stock, and despite debt reduction and a dividend increase, the stock has barely rebounded from its March lows. Its executive chairman, Richard Kinder, owns 11% of the shares (worth around US $3.8 billion), which encourages prudence in the management of the company's growth and its balance sheet. We believe that between $12 and $13 a share, we benefit from an attractive entry price.

We wish all our clients a happy new year.

Sincerely,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière

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