barrage capital

January 15 2016

2015 Annual Letter

Barrage Fund

Management Report

For the period of January 1st to December 31st 2015, the S&P/TSX Index provided a negative return of –8.37% (including dividends) while the S&P 500 Index generated a positive return of 21.65% (in Canadian dollars, including dividends). Over the same period, the Barrage Fund's return was 4.69% before fees and 0.79% after fees.

Barrage Capital launched a currency hedging program on August 31, 2015. This hedging was executed at a conversion rate of 75.2 cents, on 70% of the portfolio. Since the Canadian dollar continued its devaluation against the U.S. dollar, we are bearing an opportunity cost of about 4%.

The Fund currently holds 12 securities. Our cash position is currently negligible, as the Fund is fully invested in equity.

Commentary on the markets

The second half of 2015 proved particularly frustrating for investors looking for bargains. They were swarming ad nauseam. However, the majority of our holding stock prices fell, preventing us from seizing new opportunities as they arose. We could draw an analogy with hunting. A hunter kills a deer, and then runs out of ammunition. He is very pleased with his catch. But when a moose comes along, he finds himself unable to take advantage of the situation.

The irony of the predicament was exacerbated by the opposite direction some holdings took. What was expensive became even more expensive, while our bargains' discount grew larger.

The case of Amazon.com (AMZN-Q) speaks for itself. Despite an evaluation we already deemed generous at the beginning of 2015, the stock took off by 120%. Last quarter's results certainly contributed to its stellar performance. However, it seems investors are constantly expecting good results, leaving little room for disappointments.

Netflix (NFLX-Q) also rewarded its shareholders over the same period, with a gain similar to Amazon's, whereas Facebook (FB-Q) provided investors with a 33% return.

During the same period, General Motors' (GM-N) lost a little bit of value, despite largely rising adjusted profits. For the third quarter of 2015, the adjusted earnings per share grew 55%. It appears that investors' focus was on sales growth. The latter reached a respectable 6%, excluding the effect of currency variation, but looked weak in comparison with the 70% growth figure of Amazon.com or the 23% growth generated by Netflix and Facebook.

During any given year, we can witness great volatility, leading to sizeable spreads between market values and estimated values. Warren Buffett's famous quote we published in our last annual letter "Be fearful when others are greedy and greedy when others are fearful" is still valid. We will add that after giving in to our own greed, we will demonstrate patience and discipline. Winds will ultimately change direction. Considering the low valuation of our holdings, we are particularly optimistic.

Showing optimism after a year we can at best described as mediocre follows a logic experienced by bargain hunters like ourselves. If we loved many of our holdings at higher price levels while writing this letter, we love them even more as the margin of safety became larger. We estimate valuations to be more appealing now than they have been since the financial crisis.

We've uncovered a lot of investment ideas over the last few months. Despite abundant opportunities, we did not put the portfolio through dramatic changes. Considering the current attractive valuations of securities, we are becoming even more selective. With no great surprise, our cash level has been low over the last 6 months.

Canada's financial climate

We have been cautious about the prospects of our domestic economy for a long time. Last July, we mentioned Canada could enter into a recession if the fall in the Gross Domestic Product continued. Technically, the country experienced two consecutive quarters of negative growth, but it quickly recovered. However, in people's day to day life, nothing really changed.

However, if oil prices remain under a certain level for long enough, the consequences will be major. Our economy rests to a large extent on the good performance of that sector.

Thanks to a large extent to lower interest rates, the real estate sector remains solid. Household debt did not change. We are maintaining a careful stance with regards to Canada, but acknowledging that the weakness of our currency against its southern neighbor is providing domestic securities with more appeal.

Currency hedging program

As previously mentioned, we have put in place a protection against a possible comeback of the Canadian dollar against the U.S. dollar. As most of our holdings are listed on a US exchange, we deemed it prudent to protect ourselves from this risk.

We must admit we acted to soon, despite the fact the exchange rate had reached a value we thought reasonable. As frequently observed, a trend will continue its run before reversing its course. It is currently the case, as the exchange rate jumped from 0.75 to 0.71 since the program's implementation.

We still remain confident this hedging program will benefit our investors when the reversal occurs. We can continue to benefit from bargains south of the border, without being overly concerned about the exchange rate.

Oil price's fall

Crude and natural gas prices continued their fall during 2015, giving up 25% of their value. Despite this fall, we did not witness the disappearance of indebted corporations in the sector. Some have resorted to capital restructuring, allowing them to continue production. We are seeing total production cuts in the United States, but this was partly compensated by a rise coming from OPEC.

Our two main holdings in the sector, Chesapeake Energy and WPX Energy, greatly suffered from the situation, losing more than 50% of their value over the last 6 months. But we were able to solidify our position with one of the two by substituting Chesapeake's (CHK.PRD) common shares by one of its preferred shares series (CHK.PRD). It pays a 4.5% annual dividend and trades on the New York Stock Exchange. They were issued in 2005, with a nominal value of $100 per share and a conversion price to common shares equivalent to $40.71.

Given the fears related to the collapse in the price of the commodity and the medium and long-term solvency of the company, those preferred shares fell considerably, from $90 in the spring to $19 today. We purchased the shares at a price between $15 and $20, providing us with a dividend yield of 23%. The dividend is cumulative. In the event of a temporary suspension of payments, everything shall be paid retroactively before reinstating a dividend to common shareholders. In the event of an asset liquidation of the company, preferred shares have priority, right after the creditors and bond holders.

We are not anticipating a liquidation scenario. We think the reserves and assets of the company will help it weather the storm. In the mean time, unless cut, we are enjoying an annual dividend greater than 20%. Since those shares fell in line with the common shares, the potential gain is interesting. If the price returns to $90, we will get 3.5 to 4

times our investment, compensating us for the loss we suffered on the common shares, on top of providing a profit.

Another risk is managed with this change: dilution. If management decides to issue more common shares to bail out the company instead of selling assets, the preferred shares will not be affected. Finally, it should be noted that a rebound of the preferred shares only needs a reasonable confidence about the survival of the company. All we need is for investors and analysts to become more optimistic to ensure the price returns to its nominal value of $100.

Needless to say, we would have preferred to invest in the industry later to benefit from this current turmoil. We nevertheless remain confident our holdings will weather the storm. A large number of corporations in the same sector are much more leveraged, with bodes well for a production cut in the United States, despite the financial restructurings that will arise.

General Motors

We have held this security for more than a year. As mentioned earlier, the stock stagnated during the year, suffering from the contagious fear of China's slowdown. If it wasn't for the good reporting results of the third quarter, the stock would not have rebounded to its current level, after reaching a low of $27 last August.

What about China? Is it an important risk? Without a doubt, investors give a lot of weight to this economy. Its scale and the fact that it is one of the few economies to show real economic growth leads analysts all over the world to rely on it to ensure a healthy world economy. If China is not well, where would our hopes to feed our investment enthusiasm rest?

We do not have a forecast with regards to China's future financial health. Too many variables are in play, preventing us from seeing, even in the short-term, how things will evolve. However, we do not need to improvise as experts in this matter.

The company generates, through its Chinese partnerships, roughly 2 billion dollars of profits annually. Even in the absence of these profits, earnings per share north of $4 is possible, putting the stock's valuation at eight times its profits. We shall note that according to management's commentaries during the reporting of third quarter results, the Chinese market is doing well, and we expect good margins to be cleared on sales considering the two new models that were introduced in the last two years.

We are noticing a disproportionate level of attention in this segment. Ironically, while writing this report, the company reported sales in China for the month of December: a rise of 14% compared to the same period last year, accompanied by growing market

share. It is an all-time record for GM. We also know those sales are retail, and not deliveries made to wholesalers, leaving little room for year-end manipulation.

An important catalyst also currently favours growing profits at GM. Lower prices at the gas pump are having more influence on its results, as the company sells a larger number of SUVs. These generally generate higher margins. As far as general vehicle sales, the trend in the U.S. is for record sales reaching 18 million vehicles for the year.

It is also worth mentioning that the age of vehicles on the road currently stands at 11.5 years, 6 months older than it was 6 months ago. As said a year ago, the average of the last 20 years has grown from 8 to 11 years. Consequently, this catalyst is stronger than ever.

With regards to technological advances, GM seems to be taking a lead. It recently proceeded with a $500M investment in Lyft, a competitor to Uber. Those two companies operate in the taxi service provided by individuals through the use of mobile applications between users and drivers.

GM is also interested in the electrification of vehicles, and developed the “Bolt”, which should be available in the medium-term. This trend started strong and will be hard to stop. More and more, dominant players in the technology space are jumping in the electric car race—and that will provide clients with numerous advantages.

In the medium to long-term, road vehicles will become true mobile computers allowing users to move from one place to the other while working or entertaining. The electrification of cars is pushing companies like Google and Apple to concentrate their efforts to participate in this significant boom.

With regards to share buy-backs, the company took advantage of its depressed share price while concerns about China were full blown. During the months of August and September 2015, more than $750 million was spent to buy back shares at around $30. Interesting fact: every share repurchased and retired eliminates the obligation to pay a dividend. Therefore, the total amount of paid dividends diminishes going forward, unless management announces a rise in its dividend policy. This situation bodes well for the stock.

In summary, we think GM is driving on a good road to reach its objectives. Let’s remind ourselves management is predicting margins of 9% to 10% from now to the start of the new decade, which translates into earnings before taxes of more than $US10B current sales, against a current equity valuation of $US52B. We must admit that, like a lot of our other holdings, the period of under-valuation is longer than we anticipated. We are armed with patience, and remain aware that stock buy-backs are currently being done at advantageous prices.

Best Buy

After reaching a peak of almost $39 last September, the stock plummeted again to stand at $30 at year-end. We sold a small portion of our position near the top, but preferred to keep the majority of our position. With good results published at the end of August, we were determined to stay shareholders.

For the third quarter, we were pleased with the results, but management felt it was better to issue prudent estimates for the holiday period, considering the numbers published by the "NPD Group". The company's management often refers to this institution. It is a market research company founded in 1966, surveying roughly 12 million consumers each year in 20 countries. It covers more than 165,000 stores, in a universe of diverse merchandise categories.

With regards to the whole electronics sector, the NPD Group published a contraction of sales of 4.3% last quarter. According to Best Buy's management, this comparable corresponds to of its sales. Consequently, the rise of 1.2% of their sales in the United States bodes well. As for the comparable on stores open more than a year, they rose 0.8%.

Due to the numbers published by the NPD Group, management decided it was better to remain careful with fourth quarter estimates. We view this in a good way, knowing their conservative side. However, it disappointed investors as they have neglected the stock ever since. As you can guess, we took advantage of the situation to build up our position.

The company benefits from an excellent balance sheet, with a net cash position of $1.7B. It continues to buy back shares. We reiterate our confidence in this investment.

IBM

We did not expand on this company in previous letters. We will do so in this one, to help our readers grasp our reasoning behind this investment.

We've held this security for over two years, and we have witnessed disappointing results. We particularly like the low stock valuation, and the competitive force of the company. In discussions with individuals with solid industry knowledge, we learned that it is quite difficult to sever links with IBM as a supplier. Its programs and systems—once in place— force customers to incur significant costs in the event of a migration.

This reality was reassuring for the recurrence of IBM's revenues, which stand at 50%. However, the industry is going through an important migration towards the "Cloud". Instead of purchasing software and systems that require an initial installation, the industry is moving toward remote use of the supplier's same software and systems. The

growing efficiency of internet data transfer facilitates this process. Consequently, this was not a temporary phenomenon. We were aware of this.

Luckily, IBM has taken steps to move in the direction of the cloud. When we bought our first shares, the company invested large amounts in what it called the "strategic imperatives", made up of three pillars: data, cloud and engagement (mobile phones and social networks). In 2014, 27% of revenues were coming from these strategic segments, against 13% only 5 years prior.

In its 2013 annual report, IBM mentioned that 85% of new software is developed for the cloud, underlining how these changes will impact the way management continues to build the company.

We should also point to the efforts of the company to improve its profit margins. It sold companies with less interesting margins. For example, in 2014, the Intel x86 server subsidiary was sold to Lenovo. It also got rid of enterprises linked to personal computers, hard disks and retail stores, the last of which were purchased by Toshiba TEC in 2012.

Their stock buy-backs were impressive, which lead Warren Buffett, an important shareholder, to acknowledge it publicly. In ten years, the number of shares in circulation was reduced by 40%. In 2013, we noticed the great stability of their earnings' growth. With the share buy-backs, shareholders have benefitted from a very nice earnings growth.

The main negative element of the company's performance was driven by the stagnation of sales. In ten years, sales have not moved. Profits' rise was possible because of a progressive improvement in margins.

Despite the important initiatives launched by the company, we are witnessing an absence of progress in the results, at least in the short to medium term. For example, the cloud segment has had excellent growth, but started off as a tiny base as a percentage of the firm's total revenues. In 2012, cloud revenues reached $2.6B. As of the third quarter of 2015, the last available financial statements, we had annualized revenues of $9.4B. We could applaud this great growth, but it is difficult to evaluate the necessary time it will take for this segment to become significant to compensate for revenue weakness in more traditional segments.

We have, in IBM, a company going through transformation that needs to migrate to new technologies to ensure some sort of growth going forward. With a fairly aggressive share buy-back program, an investor could hope for satisfactory revenue per share growth. As the stock valuation appeared low, we were benefitting from an attractive discount compared to our estimated value. In addition, management was expecting a

profit per share of $20 in 2015. We could therefore apply a reasonable multiple, and know the extent of our margin of safety.

But in October 2014—following disappointing results—management announced it is dropping this objective. Add to this the currency variation, which greatly impacted 2015 results, as the U.S. dollar rose against most global currencies. For the last available quarter alone, revenues gave up an additional 8% solely due to the currency impact. Finally, during the October 19 conference call, CFO Martin Schroeter acknowledged the company's migration towards its "strategic imperatives" was not happening at the desired speed.

Where does Warren Buffett, IBM's largest shareholder through its Berkshire Hathaway Corporation, stand? Mr. Buffett reiterated his confidence, stating the stock would ultimately rebound. However, we would like to clarify how the presence of this famous investor influenced our decision to invest in the stock.

IBM operates in a sector we do not completely master. We are not experts in IT nor in complex networks of operating systems. We do not think it is the case for Warren Buffett. Nevertheless, this man was acting from an advantageous position to take an enlightened decision. His company, Berkshire Hathaway, holds subsidiaries in all sorts of industries, like retailing, real estate, insurance and power generation, to name a few. Since he receives a monthly report from all his subsidiaries, and has unlimited access to all their management, we could easily imagine the information he is getting regarding systems used by each of them.

Consequently, our main interest in Mr. Buffett's choice for IBM did not come from his direct investment, but rather from the assumption he benefitted from an extended survey from his subsidiaries, allowing him to acquire a certain confidence that would have been harder to obtain otherwise. This gave more weight to our own observations. The individuals with whom we discussed the company confirmed what we were thinking. IBM proves to be a difficult supplier to break off from. The high barrier to entry largely influenced our opinion on the stock.

The last two years have been very difficult for IBM, as results came to disappoint us. We always find it difficult to sell a stock under this type of scenario, when its important fall makes us hesitate.

However, the recent variation of many securities on the market facilitated our decision. While IBM was plummeting in the market, other securities, interestingly, dropped even further. We took this opportunity to reduce our position in IBM, to seize an opportunity elsewhere. This opportunity is a firm in our own industry, with a particularly solid balance sheet.

We have not turned the page on IBM, but our disappointment as well as other opportunities lead us to revise our weighting lower. At current price, taken in isolation, IBM constitutes a very attractive proposition.

AIG: follow-up of events

We sold our shares of insurer American International Group in 2014, in large part because of the risk that Mr. Greenberg's lawsuit against the company represented. We brought this issue out in our 2014 annual letter. But this trial came without any big surprises. Certain arguments from the plaintiff were acknowledged, but the judge clarified that without the government's intervention, the ex-CEO would have lost the totality of his investment in AIG anyway. It is a conclusion that confirmed our opinion: this trial served no purpose. However, the sole fact that a judge was willing to let it stand made us fear the possibility that a senseless decision could come out.

New events occurred in AIG's case. It is now the target of activist Carl Icahn. He is calling for the split of the company into 3 distinct public entities. He is referring to casualty insurance, life insurance and mortgage insurance.

We like this initiative from Mr. Icahn, because it acts as a catalyst we would have liked to benefit from when we held the security. We think the poor return on equity reflects a lack of significant action from management. The status quo seemed to have been adopted.

A lot of analysts and investors discussed AIG's book value, arguing it surpassed by a large margin its market value. But a large part of the assets are made up of deferred taxes on the balance sheet of the company. In its objectives settings, management often uses the book value adjusted for deferred taxes. A plausible explanation for using such a reference could reside in their desire to lower the bar for reaching their objectives. It's easier to reach a 10% return or any other target on a value if the latter stands at $61.91 rather than $79.40.

So on one hand, investors would like to believe the stock trades at a price significantly below its book value. On the other hand, management prefers to use a lower reference book value. We do not think this is a conservatism concern.

Many actions have already been taken—for example a share buy-back and the sale of numerous assets—but we think under Mr. Icahn's influence, the improvement in profitability will become a priority, rather than simply managing the size of the company. We did not buy back any AIG shares recently, but this stock remains a focus of ours.

Apple

This stock still represents a sizeable weight in our Fund. Another perception change is happening with Apple: the market is sceptical once again. Since the stock was already under-valued according to our calculations, the discount has widened. Analysts' concerns are mostly resting on the company's suppliers' results.

This is not the first time we are reading and hearing negative comments on Apple. However, the stock fell considerably since its peak, moving from $130 to $97 over a 6-month period.

Apple still dominates the markets in which it is active, which challenges other competitors. For example, the company collects more than 90% of the profits of the smartphone industry, according to brokerage firm Canaccord Genuity. The PC industry on the other hand has been in decline for several quarters, which did not stop Apple from growing its sales as well as its market share. Its growth prospects remain good, despite its current gigantic scale.

Apple's balance sheet is still attractive to us, and the company continues to buy back shares. During the last quarter only, the buy backs reached $US13B. At current price, we think shareholders will benefit greatly from this program.

Distribution

On December 31, 2015, the Barrage Fund made a capital gain distribution of $11.66 per unit. This distribution corresponds to capital gains, dividends and interests realized and earned during the course of the year, net of management fees.

We can explain the rise of distribution compared to last year's by the fact that many of securities reached their full potential in 2015 and we realized gains when we sold them. The stock prices of our recent purchases has not yet risen.

As far as the difference between the estimated $20 distribution announced in December and the true distribution of December 31st, an opportunity came along at year-end and we decided to realize a loss on a security in order to take advantage of it.

Each year, unit holders that hold units in non-registered accounts pay taxes on the value of the distribution. The units' value is reduced by this amount, which leads to a lower capital gain when the units are redeemed. The tax bill comes yearly as opposed to at the end of the investment period. This inconvenience is inherent to the fiscal structure of all investment funds.

We understand receiving a tax bill is unpleasant while a decline in the Fund's return is taking place!

Management fees

Many unit holders asked themselves how the Fund could deliver a 4.69% return before fees and 0.79% after fees in 2015, when the performance fees are only levied when a performance threshold of 5% is reached.

This difference can be explained by the fact that performance fees were charged during the first quarter when the returns reached 14.9%. Only the base fee of 1% was charged during the last 3 quarters. So it was the results of the first quarter that created the spread between the before and after fees for the full year.

In March 2015, the unit value was $176.20 (the equivalent of $164.54 after the year-end distribution). Since performance fees are subject to a high water mark, no performance fees will be levied if the unit value is below a level where fees were charged. This level is increased by 5% annually (applied monthly) which translates into a performance threshold of $171.80 today. The 5% minimum return to generate performance fees is cumulative from one year to the other.

We have added to our website data on the performance threshold with the realized and unrealized gains so unit holders can access this up-to-date information at all times.

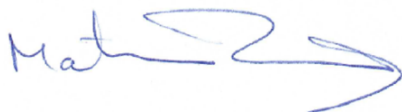
We want to stress that we are managing the Fund with a long-term perspective and this is to be kept in mind when returns, distribution and fees are concerned.

In closing, here is a quote from Warren Buffett with regards to patience in the stock market: "If a business does well, the stock eventually follows".

Regards,

Patrick Thénière

Rémy Morel



Mathieu Beaudry

Maxime Lauzière