barrage investissement privé

August 5, 2013

Letter to Unitholders

Barrage Fund

Semi-annual Management Report

We started the operations of the Barrage Fund on March 1st 2013. As we were ready to deploy the fund's capital, companies that we had been following for several months and had targeted as interesting candidates for the fund saw their stock price rise significantly with the stock market, especially in the United States, where they had their best first quarter since 1987. This somewhat thwarted our original plan and we had to find new investment ideas.

It took about two months for the Barrage Fund to be fully invested. As of June 30, 2013 the portfolio had eight stocks including one Canadian company and seven U.S. companies. The weighting of the Canadian stock was about 20%, the U.S. equities accounted for 80% while the cash position was practically at zero. It is important to note that almost all of the assets of the Canadian company were located in the United States.

For the period from March 1st to June 30th 2013, the SPX/TSX index has returned -3.58% (including dividends) while the S&P 500 returned 8.86% (in Canadian dollars and including dividends). For the same period, the Barrage Fund has returned 14.94% before fees and 12.03% after fees.

We continue to believe that U.S. companies represent better opportunities than those found north of the border. The U.S. market offers strong businesses that are well managed, that possess significant competitive advantages and that are available at prices that do not reflect their value. In addition, with an exchange rate close to parity, we see a great opportunity to acquire such securities without exposing ourselves to significant currency risk. In the event that the Canadian dollar appreciates against the U.S. dollar, we believe the increase in value of the U.S. securities should offset any currency losses in the long term.

Being four partners researching companies allowed us to find several investment ideas in a relatively short period of time. Our list of interesting companies for the Barrage Fund is plenty.

In the event of an expensive market where it would be difficult to find enough investment ideas meeting our criterias, we would not mind keeping a larger cash position than usual. When managing money, it is rarely smart to compromise on the quality of investment ideas for the sake of being fully invested.

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The Barrage Fund's portfolio will be presented to the Unitholders in the year-end financial statements prepared by CIBC Mellon and audited by KPMG LLC. In addition, we will share on an ongoing basis the analysis of certain investments made by the fund to expose our methodology.

Investing versus value investing

We believe that there is a subtle but very important distinction between investing and value investing. We will try to highlight that difference to help the reader better understand how we manage the Barrage Fund.

While an investor benefits from the increasing value of the company over a long period, the value investor tries to profit from the gap between the value of the company and its share price. To understand this distinction, it is important for investors to recognize that the value of a company and its share price are two distinct elements and sometimes a large gap may exist between the two.

From time to time, the shares of a company will trade under their value (undervaluation) or above it (overvaluation). These gaps can be observed over relatively short periods of time. In the long run, the share price usually reflects the value of the company.

When an investor buys a security at a fraction of its value, he can benefit from a reduction in the gap between the price and its value. We refer to this return as the "discount return". On the other hand, when an investor buys a security at a price equal to its value, his return will come from the increase in value of the company over time. We refer to this return as the "business return."

The subtle distinction between the investor and the value investor resides in the price at which each is willing to make the purchase of the same stock.

The concepts discussed above are illustrated in the following graph:

Consider the hypothetical case of a publicly traded company for the period from 2013 to 2021.

The blue line represents the value of one share of this company. In this case, the estimated growth in value is 10% per year. This means that after looking at the fundamentals of the company, we believe the value of its share to be around $40 in early 2013 and we estimate it will grow by 10% per year.

If an investor purchases these shares at a price equivalent to their fair value, he should expect a 10% annual return on its long-term investment.

The black line represents the fluctuations of the share price in the market during the period. One should note that in the long run the share price tends to hover around the value of the company.

Yet in 2017, we can observe that the shares are trading at a price significantly under the estimated value of the company. As the price reaches the "purchase area" (red line), the "value" investor should consider acquiring the stock if the estimated value is still valid at that moment. The investor would be buying a stock worth $60 for the price of $35.

Note that the "purchase area" is a discounted level of the company value. The discount is 33% in that case.

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Here are some observations:

1. An investor who pays the fair value for the stock will get a return equivalent to the increase in the value of the company if held long enough. In our example, the return will be 10% per year.

2. The value investor's return comes from two sources. First, a security purchased under its value gives the investor a "discount return" when its share price comes back to its value. In the previous example, an investor who acquires a securities in 2017 at a price of $35 with a $60 value realizes a "discount return" of 71% ($25/$35).

   In addition, a "business return" is obtained when the value of the business continues to grow while the gap between its share price and its value decreases. In the current example, the value of the business increases from $60 to $80 from 2017 to 2020, providing a "business return" of 33% ($20/$60) .

   The total return of the value investor comes from the "discount return" and the "business return". In the present case, an investor who acquired the shares at $35 in 2017 realized a total return of 128% over a period of 3 years or 31% per year. That compares to an annualized 10% for the investor who acquired the same securities at its fair value.

3. An investor who buys a share at a price higher than its value can still hope to make a positive return when the price paid is not too high relative to its value, when the value increases at a sufficient rate and when the share is held long enough.

   In our example, let's assume a share is purchased in 2014 at a price of $60, with an estimated value of $45. Although the purchase is made at a 33% premium relative to its value ($15/$45), the investor will still realize a positive return if the share is held for several years. However, the return will be smaller than the increase in value of the business.

4. The "discount return" is generally higher than the "business return" but its strength resides in the fact that it comes on top of the "business return". While the "business return" continues over time with the growth in value of the company, the "discount return" disappears when the share price increase to its value. When managing the Barrage Fund, we are constantly searching new investment ideas to replace those whose "discount return" has been fully realized. This approach translates into a higher portfolio turnover but also increases its potential return.

So far, we have only looked at the relation between the price paid for an investment to its potential return. What can we say about its relation to risk?

By purchasing a securities below its value, the investor is protected against any adverse event that may impair the value of his company. The difference between the share price and its value is what we call the "margin of safety". A comprehensive document on the subject is available on our website in the Publications section. We invite the reader to learn more about this important investment concept.

As we have seen, the effect on a portfolio consisting of undervalued securities is twofold.

1. It increases the probability and magnitude of potential gains.

2. It reduces the risk in the portfolio by providing a "margin of safety".

Administrative

When we set up the Barrage Fund, we felt it was important to establish a structure that enabled us to allocate most of our time to research. We believe that managers spending more time doing research perform better in the long run. Administrative tasks should never become a burden affecting returns.

After four months of operations, we are please to report that over 80% of our time is spent on research. Having only one fund to manage along with the minimum investment requirement of $150,000 should help us keep it that way.

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Four months into the operations of the fund, we are very pleased with how CIBC Mellon is performing its administrative and custodial duties. We look forward to grow Barrage investissement privé in partnership with them.

Sincerely,

Barrage investissement privé

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