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Semi-annual letter 2014

Barrage Fund

Management report for the first half of 2014

For the January 1 to June 30, 2014 period, the SPX/TSX index posted a 12.34% return (including dividends), while the S&P 500 posted a return of 7.47% (in Canadian dollars and including dividends). For the same period, the Barrage Fund had a 10.05% return before fees, and 7.87% after fees.

All companies held in the portfolios remain US-based. As such, the exchange rate boosted our returns by about 2% in the last six months.

The fund is now comprised of nine securities; we sold four positions and invested in three new companies. We also increased our position in existing stocks. Since we have no problem identifying attractive companies, we continued to maintain a relatively low cash position during the first six months of the year.

Market comments

Despite our negative outlook on the Canadian economy, the latest available data on the gross domestic product (GDP) does not point to a slowdown. As at Q1 of this year, the GDP measured in terms of consumer spending had increased 1.9% over one year. The Canadian stock market had a stellar performance during the first half of the year, rising to 12.3%, (including dividends), on the S&P/TSX.

Our take on the Canadian economy

Despite the good news, our view of the Canadian economy remains unchanged. We are mostly concerned with the real estate market, which we still consider to be pricy. Clearly, housing prices were fueled by low interest rates, and a simple calculation reveals the potential impact of a drop in mortgage rates on the lending rate: a decrease in the interest rate from 9% to 8% translates into an 11% reduction in interest cost. However, the same 1% decrease applied to a lower rate will have a considerably greater effect. For instance, when the mortgage rate drops from 4% to

3%, interest cost is reduced by as much as 25%.

Each time they refinance their mortgage, homeowners gain wiggle room in their monthly budgets. Unfortunately, this financial leeway is rarely put to sensible use, which would be to pay down the capital. Instead, the opposite happens—owners take advantage of a lower interest rate to buy more expensive homes. Let's revisit the earlier example of the rate dropping from 4% to 3%, without counting the down payment or repayment of capital. In theory, a borrower could afford a property that costs 33% more, as opposed to 12.5% if the rate dropped from 9% to 8%. If we apply this logic to everyone who has access to credit, we can easily understand why consumers have been so tempted to rack up debt in recent years.

While we do not expect the Canadian market to be as hard hit as the U.S. market was during the financial crisis, it is easy to underestimate the consequences of a credit market spiralling out of control in our country. When consumers are no longer able to honour their debts, financial institutions tend to get nervous. They suffer losses, and become more conservative in setting provisions against future obligations. To protect their capital, they tighten credit conditions. Fewer loans are granted, which curbs spending and has negative repercussions on businesses that depend directly on consumer spending, such as restaurants, car dealerships and furniture stores. In order to deal with the slowdown, businesses in turn adjust to the lower demand, often by laying off employees. It is the perfect example of a vicious circle—higher unemployment leads to a decrease in consumer spending, which in turn leads to more layoffs.

Once this chain reaction starts, optimism gives way to caution, and people who remain employed begin saving, instead of spending. When faced with a new reality, we adapt by putting money aside for a rainy day. How can our governments fight this trend when they have already exhausted all means at their disposal to stimulate the economy? Interest rates are practically at a historic low, and public deficits are already high!

<u>A choice we are not forced to make</u>

Our take on the future of the Canadian economy may seem a little grim, but it is in no way a prediction. The financial viscous circle described above may never happen or may only last for a short time. The soft landing hoped for by several economists remains a valid possibility.

But thankfully, as your portfolio managers, we are not forced to roll the dice with your assets. What happens if we have doubts? We simply ignore companies that we feel are at risk. When it comes to investing, Warren Buffett once said, "Rule number 1 is 'Never lose money'; rule number 2 is 'Don't forget rule number 1.'" The message could not be clearer—each investment opportunity has two basic and distinct components: risk and return. The most important thing is to minimize the risk, and then consider the return.

Obviously, investors hope to make money while avoiding risk. But they do need to focus on minimizing risk as much as possible, and not allow themselves to be blinded by potential gains. This is why we take a cautious approach to certain Canadian securities, despite their current high profitability.

We are in the privileged position of having a choice, and we prefer securities that offer the best of both worlds: low risk and potentially high returns. The drop in value of Best Buy's stock early this year gave us both.

Best Buy

This retailer, with its 1,400 stores, is currently undergoing a major transformation brought on by the arrival of new CEO Hubert Joly, in August 2012. At the time, Best Buy was taking a hit from online retailers, mainly Amazon, its fiercest competitor. In addition, customers were making a habit of "showrooming," or sampling and trying out merchandise at Best Buy stores and then buying it online, often for less.

Online retailers had a clear advantage over Best Buy since that they did not have to worry about "brick and mortar" locations and their inventory, employee salaries or leasehold expenses. They also took advantage of a legal loophole on the collection of sales tax, making it difficult for Best Buy to compete with their prices. All of these elements combined signaled the beginning of a long and painful decline for a major player in the retail market.

Best Buy's stock price reflected these troubles. From a high of $58 in May 2006, the price fluctuated for several years, finally bottoming out at $11 in December 2012. Investors were buoyed by the arrival of Joly, which led to a four-fold increase in the stock price in less than a year. However, the reorganisation efforts were less than smooth, and investors were left with many unanswered questions.

Panic broke out when the company announced its financial results in January 2014. Same-store sales were down slightly, with the Holiday period having been mostly a bust for retailers in general. Management revised profits downward for the rest of the year, causing the stock price to plummet by about 40%.

In an interview, Hubert Joly indicated that he had no intention of altering his strategy. He urged his executives to ignore the stock price fluctuations and to focus on aspects they could control. The strategy would take some time to pay off, as progress is not always linear, as many investors would like it to be. The projections announced in January worried investors, whose reaction was quick to be felt on the stock price. In just a short period of time, we were faced with a company whose medium- and long-term potential had not changed, but whose stock was now available for 40% less.

This type of contraction gives us the margin of safety we need. A lower price of entry allows us to benefit from every bit of good news, generating value, while protecting our investment from potential losses in the event investors get skittish about some new issue. As for long-term value, a quick calculation reveals that a 40% drop would equal a 67% increase if the stock were to simply return to its original price.

We were more than pleased with the company's latest quarterly results. The reorganisation is on its course, despite an especially difficult market for retailers in general during this period.

<u>A margin of safety requires a high level of certainty</u>

Given the fact that Best Buy stock was trading well below $25 in early 2013, we might have thought it was too late to invest. Our average cost was more than double the bottom price at the time. So, in just one year, the stock price had gained more than 100%.

A simple probability calculation can adequately illustrate what we mean by "margin of safety." In most cases, all things being equal, we will opt for an opportunity with an 80% chance of yielding a 150% return, rather than a 10% chance of a 500% return. From a mathematical viewpoint, if we simply multiply the probabilities by the expected returns, 120% is obviously a better outcome than 50%.

And how do we determine the probability rate? It is not a precise scientific measurement, but it is rather determined by our level of understanding and confidence in the stock. When a company is undergoing fundamental changes, the evolution and completion of these changes provide us with valuable clues on the efficiency of the plan implemented by management. When we can see clear results, it becomes easier to assess the risk and the value potential of that stock.

The stock market is fraught with companies struggling and undergoing major transformations. The idea is to identify the ones that will land on their feet and to pay a reasonable price for their stock. Our confidence in Best Buy was boosted by the steps taken toward recovery since the arrival of the new CEO, by our in-depth knowledge of the company's operations, and by a study of the various forces at play in the industry. This is why we will sometimes prefer to invest in a stock at a given point in time, even following a significant price increase over the short or long term.

A situation to avoid

Investors often make the mistake of systematically compensating for a lack of confidence in a security by investing less in it. When an investor hears about a potentially interesting company, but remains somewhat sceptical about its business model or profit level, he will try—more or less successfully—to get the best of both worlds: seize the opportunity while mitigating the risk by purchasing fewer shares.

We try to avoid making this type of compromise, unless the probabilities are clearly in our favour. In general, if we have any doubts about a company, we often prefer not to include it in the portfolio at all, rather than decide, for example, to allocate 5% of the portfolio to it instead of the initial 10%. If we seized every interesting opportunity that came along, we would constantly be making that very compromise. And to what end? We would quickly find ourselves with a highly diversified portfolio and barely enough time to properly track and analyze each individual security. This approach largely explains why we recently sold our position in Western Union.

Western Union

This money transfer company deals with over 500,000 agents in approximately 200 countries worldwide. The major strength of their business model is that it allows people without a bank account to receive money, in cash, from a third party. For instance, someone who works in the United States and who has relatives in a third-world country can assist them by sending money through one of the agents located in the country in question.

Recently, however, we noticed a new trend that could basically neutralize this sizeable competitive advantage. In nine African countries, people with bank accounts are now outnumbered by people who use mobile phone-based money transfer services. What could this mean for Western Union?

Our interest in the company did not reside mainly in its capacity to offer online transfers, but rather in its ability to transfer cash anywhere in the world. This transfer system relies on a network that is difficult to replicate—it would be rather burdensome for a competitor to conclude agreements with half a million agents in several countries. If it were really that easy for an American to transfer $400 to someone in Tanzania who did not have a bank account, Western Union's competitive advantage would definitely diminish.

We know that many companies, including Apple, are trying to gain a foothold in the payment industry. Their success will no doubt encourage other companies to jump on the bandwagon. We don't know how this new trend will play out, but why take the risk? The stock market gives us the unique ability to buy or sell shares at little cost. We therefore opted to liquidate our position. While we made money on the sale, it is important to emphasize that this decision was not motivated by financial gain.

<u>Administrative</u>

We were pleased to meet with the unitholders on May 8 at the Barrage Fund annual general meeting, where we updated them on the past year, and discussed Barrage's investment philosophy. As you noticed during the presentation of each of the securities in our portfolio, we place a great deal of importance on their discount compared to company value, since it represents our margin of safety.

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We moved our offices recently and we are planning to invite you to a cocktail party this fall in our new, more spacious location. For those of you familiar with our old offices, rest assured: our new door is located just 2 metres down from our previous one, and we have even kept the same address!

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The Barrage Capital website is scheduled for a major upgrade. Feel free to check in over the next few months.

Cordially,

Patrick Thénière　　　　Rémy Morel

Mathieu Beaudry　　　　Maxime Lauziere