barrage capital

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Semi-Annual Letter 2015

The Barrage Fund

Between the 1st of January and the 30th of June 2015 the SPX/TSX index gave returns of 0.91% (including dividends), while the S&P 500 returned 9.13% (in Canadian dollars and including dividends). Returns for the Barrage Fund during the same period were 14.84% before fees and 11.20% after fees.

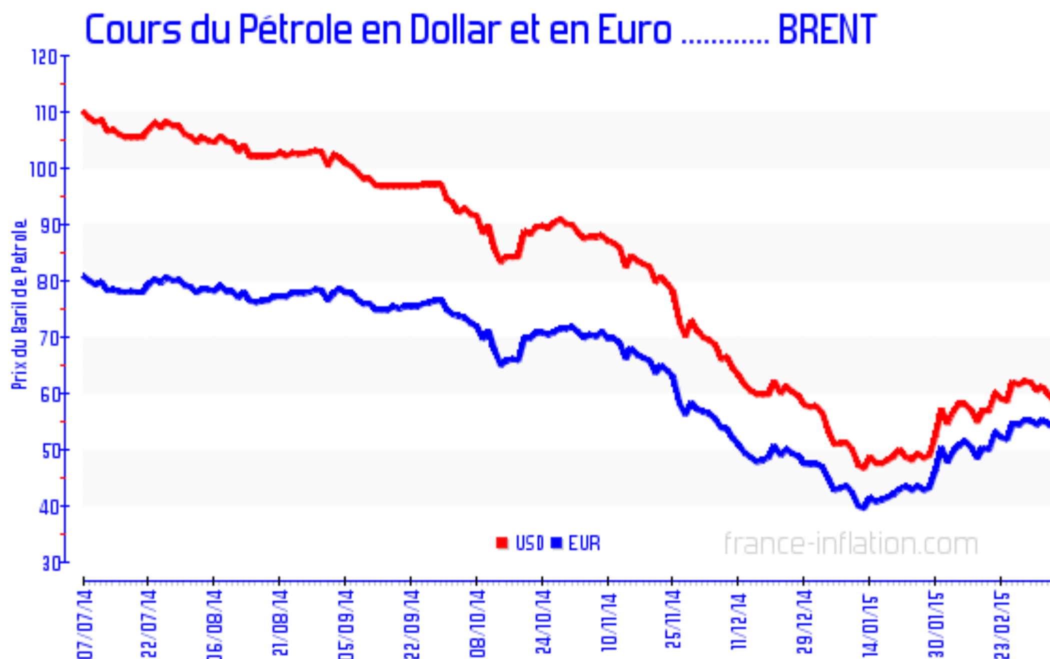
As in 2014, the majority of companies held in the portfolio are located in the U.S. and exchange rates helped to improve our returns by approximately 6.7%. Currently, the fund is made up of fourteen stocks. Our capital is fully invested at the present time.

The Economic Situation in Canada

The main Canadian stock market performed weakly during the first six months of the year, which can probably be explained by the price of oil. Even though the oil market rebounded from its low point of around $40 per barrel, it is still a long way from returning to the price levels it reached in 2014.

Oil Prices in Dollars and Euros – Brent

(Vertical Axis- Price per Barrel of Oil)



The energy sector accounts for a sizeable part of the S&P/TSX index making up 20%, while the financial sector occupies first place with more than a third of the total value of the market. However, because they need large amounts of capital to support their development plans and operations, companies in the energy sector are large consumers of loans. Consequently, energy companies that do not have a solid balance sheet and are not able to make a profit can cause problems for financial institutions, as they magnify the negative impact on the Canadian economy as a whole. Later on, we will discuss our holdings operating in this sector.

The Canadian economy contracted by 0.6% in the first quarter of 2015 and this trend continued in April with a slight fall of 0.1%. It is still probably too early to decide whether or not a recession has begun. Note that two consecutive quarters of negative growth can lead to official talk of a recession.

In our first letter to unit holders, we expressed our concerns regarding the Canadian economy. The reasons behind these concerns remain essentially the same today, with the exception of the price of oil, which adds to current risks. Property prices and household debt are still dangers that we take into account in our valuations. The years pass, but the ground has still not shaken. The big question that should arise for investors is, "How is the economy bearing up, despite these negative elements?"

The Pernicious Effect of Low Interest Rates

We all know that the majority of countries have abused debt during the last few decades and that they maintain deficits that it would be difficult to describe as anything other than "chronic." To give just one example, France has run a budget deficit every year since 1975. How can we sustain so much debt and yet suffer almost no consequences for such a long period?

We have noticed the significant impact of low interest levels on markets over recent years. With a higher rate of interest, an observer would expect a rapid series of defaults or bankruptcies, which would in turn help induce a vigorous rebound in the economy. There is nothing better than a good clean out to help restart on a more solid foundation. Instead, what we are witnessing is a slow agony which seems to last forever, intermixed with false hopes of a return to sustainable growth. The problem is understood, but no one is doing anything to correct it. It seems completely natural to push back the fateful outcome for as long as it is possible to do so.

How can such enormous debts endure for so long? Why are the politicians, creditors and household policy makers, as debtors or creditors, so slow to react?

We believe that there are two main reasons:

1) Low interest rates make repayments affordable. If you pay a 2% rate of interest rather than 10%, it is as if you benefit from 5 years to pay the equivalent of one year's worth of interest at

the higher rate. In the 1980s, the recession of 1982 led to a large number of company and personal bankruptcies. The interest rate for loans at the time was close to 20%. It is difficult to survive very long with such interest rates, if you are submerged in debt.

2) The financial crisis, whose severity and impact leaves a glimpse of better days, is the other reason which explains why various governments, and by implication, the general populace, remains hopeful of a revival. After such a fall, it is difficult to imagine anything other than a rebound! Actually, the whole question depends on a widely perceived error regarding public deficits: we consider them temporal while actually they are structural! To illustrate this phenomenon, we could take the example of a parent who is trying to help their child with gambling debts. The child spends large amounts taking part in an activity, which can only lead to a bad outcome.

The parent, having found out about the problem, makes sure that the child can no longer take part in this self-destructive activity. To help with the transition, the parent provides financial support until the child can reach financial autonomy. However, even though they have become an adult, they don't work or look for employment. Even though the youth has stopped gambling and losing money, they haven't taken the necessary steps to take themselves in hand. Consequently, the parent, who hopes to help facilitate a change in the situation, ends up continually providing financial support. In the long term, the parent risks ruin, until they face up to the evidence: their child needs to work!

Let's take this example further. The parent has an overriding fear that their child will return to their old gambling habits. To make sure that this doesn't happen, they shut the child up in their home, thus preventing them from looking for work. This is equivalent to the effect of overregulation on our society.

Many governments in the developed world have adopted this behaviour. To a large extent, the factors that led to the financial crisis have been exposed. The child is no longer gambling away their money. However, we continue to tighten regulations as if the risks are still current. A good example of this can be found in the financial sector, which has been encumbered by new regulations. This hinders economic revival. Rather than creating employment, financial institutions are preoccupied with exercising tight financial controls over expenditure, and are making layoffs.

For an established economy to flourish, incentives for economic development must be in place. The private sector must take the lead. Like the parent, the government tries to make sure that the crisis will not recur. Like the child, the private sector cannot expand if it is stifled, and if no actions are taken that incentivize it to take itself in hand. Consequently, many governments are falling into greater levels of debt, while hoping for an economic revival that is at risk of never arising. The structural problem is being confused with the temporal problem.

The Situation in Greece

At the time of writing, Greece was in the headlines. The level of Greek debt has become unsustainable and the Greek population has just voted “no” in a referendum to decide whether to accept or reject the austerity measures proposed by the European Union. We are witnessing an arm wrestling match principally between the largest creditor, Germany, and its debtor, Greece.

In relation to the first reason mentioned previously, if interest rates had been higher, we would have already had a decisive conclusion much earlier. The events of 2015 would have taken place five years ago, when the Greek debt crisis arose.

In relation to the second reason, austerity will only harm an already precarious economy. Of course, Greece must cut its levels of spending, but it also needs to take measures that will encourage new enterprises and investments. These are the measures that will lead to people being hired and general wealth creation throughout the population. Of course it is necessary to cut public services to control the deficit, but it is also necessary to encourage the private sector. The private sector is the real wealth generator of an economy. Unfortunately, this problem seems to be poorly understood. The austerity measures that accompany the financial rescue plans will do nothing except to delay the outcome. We expect to to hear about setbacks in Europe for a long time into the future.

The problems which are ravaging Europe do not really concern us with regards to the holdings in our portfolio. Market anxiety leads to price falls, which actually makes valuations more attractive. We keep an eye on the economy, but make sure that we are investing in stocks that have a sufficient margin of security to compensate for any economic risks.

Canada and Interest Levels

In Canada, interest rates have continued to be low, and could drop further. With mortgage rates at less than 3%, buying property at high prices becomes realistic. In such a context, problems of over-indebtedness are being pushed out to a point in time that is difficult to determine. As with Greece and other countries within the European Union, low levels of interest rates are creating a situation where the status quo is becoming the norm. It is for this reason that we are reticent about our economy and are not taking a position to profit from a crash that is impossible to predict. Happily, we do not have to attempt to guess the short or medium term outcome for our country. We are still finding excellent opportunities in the United States.

Our Oil Holdings

Our interest in the natural resource sector arises from the notorious event which has shaken many of the countries that participate in it. We are, of course, referring to the fall in oil prices. Our investment theory can be summarized like this: the fall in the prices of oil and natural gas is causing and will cause, sooner or later, a reduction in production, and in turn a fall in production will lead to rising prices. In our opinion, the key to making a profit in this situation is to select companies with a solid balance sheet, lower production costs and, of course, an attractive stock price.

If the oil market recovers rapidly, a return to profits will occur and the valuation of the stocks will follow. On the other hand, if the price of crude oil is slow to regain, at least partially, some of the ground lost last autumn, then the most indebted and least efficient of these companies will have no choice except to default, restructure their debt and to reduce their production.

To obtain the largest possible margin of safety, we have chosen companies that are available at a price lower than our estimates of their reserves of oil and/or gas. This is the case with WPX Energy and Chesapeake Energy. To evaluate their reserves, we have used a relatively simple yet conservative hypothesis. We estimate the expected profit per barrel of oil or per billion cubic feet of natural gas. When there is a significant difference between our estimate and the value of the company, we consider this to be a good margin of safety. Additionally, large reserves reinforce the company's solidity and financial flexibility, because they enable it to borrow more easily ~~to~~ for development and operations.

We should note that the value of a company corresponds to its stock market price with adjustment according to its cash reserves and debts. For comparison, when we applied this calculation to Exxon Mobil's reserves, it resulted in a value that was lower than its market capitalization. This will not necessarily tell us whether or not the stock is on an attractive path. An oil producer can be sufficiently profitable and stable in its activities to justify an investment without the support of reserves. In any case, we have opted for stocks that offer both a substantial potential for gain, as well as a price below their reserves.

Subsequent to the fall in oil prices, the shares of WPX and Chesapeake both lost more than 50% of their value in comparison to their highest points during the last 12 months. We think that both of these companies are managed by leaders who are exceptional in this industry. At WPX, Richard Muncrief took charge of the company in May 2014. He is notable for his ability to allocate capital. This characteristic is remarkably rare in the natural resources industry, where too often the emphasis is on expansion rather than maximising capital.

At Chesapeake, Robert Lawler replaced Aubrey McClendon, who has a reputation for recklessness, particularly his propensity towards indebtedness. We recall that McClendon was obliged to sell 90% of his shares in Chesapeake in 2008, in order to meet the margin call requirements of his broker! The hiring of his successor, Lawler, was influenced by Carl Icahn,

who holds an 11% stake in the company. Icahn is an accomplished billionaire. This is the same individual who was able to exert enough pressure on Apple to lead that company to engage in a massive buyback of its shares. In a letter to Apple's leadership, Icahn indicated that he valued Apple shares at $240, compared to a market price at that time of $130.Cheapeake will benefit from what people in the industry call the "Icahn lift."

Finally, during the first quarter of 2015, our oil holdings have made a positive contribution to returns, while we noticed the opposite during the second quarter. However, we remain enthusiastic as to their future prospects.

General Motors

Having reach a high point of $39 last March, General Motors' stock price has dropped lower than its value at the initial public offering in 2010. Despite this, our original hypothesis remains intact and the company's relaunch plan is continuing. At the time of writing our largest doubt concerning this holding relates to a probable slowdown in China. As China is a growth market for American manufacturers, investors are fearful of stagnation in sales.

In the first quarter of 2015, two one-off events affected GM's profits. The first was the closure of its factory in Saint Petersburg, Russia. The second was costs related to defective starters.

In the second quarter, an exceptional charge of $600 million hit GM's results, the company having re-evaluated its assets in Venezuela at an exchange rate which reflected a large decline in the value of the Bolivar. GM's profits are often affected by charges of various types, such as recalls and the problems related to its starters. Nevertheless, earnings will grow significantly when these recurrent elements are finally in the past.

The substantial investments that took place during the re-launch of GM's brands, notably Cadillac, have contributed to an improvement in margins, as was predicted by its management in the medium term. A share buyback is in process. On the 21st of April, at the time of the announcement of their results, the company acquired 19.4 million shares. Of their objective to buyback $5 billion of shares, there still remains around $4.3 billion for future buybacks. At current prices, this will greatly benefit patient shareholders.

Weak oil prices already appear to be bearing fruit. The Vice President of Sales Operations for the US, Kurt McNeil, stated recently that the US automobile market had just experienced its best six month period in the last decade. Demand was stimulated by the attraction of SUVs and pick-ups, as predicted. When the cost of petrol is lower, consumers will tend to more readily choose energy intensive vehicles.

Our main reason for interest in General Motors is because of its weak valuation. Sales still have not risen substantially enough to benefit shareholders. We like to invest when the hurdles are

low. The management still has ambitious objectives, one of which is a large medium to long term increase in its operating margins, with a target of between 9 and 10%. Last quarter, after adjustments, operating margins were almost 6%, whereas for 2014 they managed only a feeble 3.6%

The financial division of the company (GMF) continues its growth. In North America, 21% of sales were linked to GMF financing in the first quarter, as compared with 7% in 2014. Interestingly, compared to its competitor Ford, GM is able to increase the number of sales supported by its financial division. Although Ford sales are lower than those of GM, its financing assets are 2.5 times higher.

The balance sheet of the company still has appreciable net cash reserves, considerably reducing its financial risk.

AutoNation

Due to valuation reasons, we have sold our shares in this company. We will usually sell in the following circumstances:

1. The holding no longer offers sufficient levels of returns
2. We prefer the potential of an alternative stock.

The first example consists of two components. We sell when the stock reaches its estimated value, thus wiping out the security margin that we envisaged initially. In other cases, the estimated value may be downgraded thus removing partly or wholly our famous margin of safety. In the case of AutoNation, the stock simply appreciated, reaching its estimated valuation.

Best Buy: Never two without three

We have already mentioned that this holding had been the object of both purchases and sales. In our annual letter of 2014, we explained how we first bought at a price of $25 during the first half of the year, and then sold at $39 a few months later. Later, the stock corrected to $34. With a new discount in relation to our estimates, we became shareholders again for a short period of time. Then the stock became popular in the market suddenly, which led us to invest our capital in other, more attractive prospects. Eventually the market resumed its lack of interest, and the share price dropped below $34, so we repurchased.

The frequency of our transactions could lead an observer to believe that we are looking for short term profits. Actually, we are simply reacting inversely to the market. When the market is prepared to pay a better price, we accommodate it. When the market is more reticent to hold a

stock, we are willing to serve as a counterpart again. The more that the market behaves in a manic depressive fashion, the more likely we are to behave opportunistically. We are not able to explain the irrational behaviour that we sometimes see among general investors. Instead, we always strive to concentrate on the operations of the companies that we evaluate, and not on market fluctuations. This allows us to make clearer decisions and to profit from a situation which seems absurd.

Without any surprise, the morose attitude of the market towards this stock has only increased our enthusiasm. The setback in Greece has dragged most stocks lower, even those without any operations in Europe! Best Buy now holds an important position in our portfolio. Its CEO, Hubert Joly, continues to do an excellent job. Despite this, we often hear negative comments about this company from investors. Electronic goods retailers are certainly in decline, losing market share to large competitors such as Amazon, which profit from online sales networks that demands little capital expenditure. Therefore, we will explain several important reasons that allow us to hold on to our confidence in Best Buy.

- Its 1000 large stores operate as mini-warehouses, serving as delivery points for online sales. Customers are guaranteed to receive their purchases quickly. The store also serves as a good location to come and find goods and to return them, where appropriate.
- The company has to align its prices with those of the competition. Thus, customers are assured that they will pay a good price. Despite weaker sales margins that result from such a strategy, Best Buy continues to show profitability and to cope with its competition.
- The company has put in place the concept of "stores within a store."A customer can try different products from different brands and benefit from sales advisors who are trained specifically in one particular brand, such as Apple or Samsung. An online competitor cannot offer this service.
- The company has an excellent balance sheet, with $2.1 billion USD in net cash reserves

We will not hesitate to increase or reduce our position as the situation develops at Best Buy. Our goal, as always, is to obtain a good margin of safety, that is to say, an appreciable discount in relation to our valuation. When this discount diminishes, we will adjust our portfolio as a consequence. We constantly keep in mind all the opportunities that are available to us on the market. Our work is to make sure that the Fund's capital is maximized at all times.

<u>Citigroup and Bank of America</u>

Our two banks are trading at a discount compared to their competitors. The reason is in large part due to the amount of litigation that they are facing. These costs rose from $6 billion USD to $16 billion USD for the year 2014 respectively. Once these one-off payments are behind them,

profitability will improve. We should add that we expect a level of profitability that is much less than that which prevailed before the crisis.

The regulatory climate has been tightened, which reduces considerably the returns that a bank can make on its capital. Moreover, at the current share prices of Citigroup and Bank of America, a moderate increase in profits could act as a catalyst to command a much better market valuation. Interest levels are set to rise in the US, and these two banks, in particular the Bank of America, will profit from an expansion in the net interest margin.

IBM, Apple and others

Our estimate for IBM shares remains unchanged. IBM is currently the second largest position in our portfolio. The transformation and orientation of its business model towards the cloud and data analysis continues to progress. This segment made up 27% of the company's revenue last quarter.

While our estimation of Apple shares is not quite as elevated as Mr Icahn's, we are satisfied with the results, as well as with the management of excess liquidities by the company's management. Compared to the market as a whole, this stock continues to be undervalued.

We are holding shares in a small player in the home construction industry, whose headquarters are located in Texas. Its valuation seemed attractive to us because of its high growth in sales, as well as its position in a niche market. As the U.S. economy continues to improve, this cyclical industry has the wind in its sails. Before the crisis, the home construction industry was creating more homes than households. After the crisis, unsurprisingly, we see the reverse.

Administration

During the preparation of our 2014 tax reports for the Barrage Fund, it was brought to our attention that the Fund was subject to the alternative minimum tax for trusts.

This tax was applicable because the Fund had less than 150 unitholders on December 31, 2014. Canadian tax makes a distinction between trusts with less than 150 unitholders (Unit trust) and trusts with more than 150 unitholders (Mutual fund trust).

A total tax bill of $85,551.40 was thus payable by the Fund to the provincial and federal governments for the 2014 fiscal year.

It was decided by the management of the Barrage Fund, Barrage Capital, that they would take on this tax. Thus the management fees, payable by the Fund on March 31, 2015, have been reduced by an equivalent amount. Overall, the financial impact to unitholders is nil.

Fortunately, the Barrage Fund now has more than 150 unitholders, and therefore will not be subject to this tax in future years.

We have welcomed a new member into the Barrage Capital team, Marianne Handfield, Accounting and Administration Technician. She will assist our Office Manager.

Warm regards,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière