barrage capital

January 12, 2017

2016 Annual Letter

Barrage Fund

Management Report

For the period of January 1 to December 31, 2016, the S&P/TSX index posted a return of 21.17% (including dividends) and the S&P 500 generated a return of 8.21% (measured in Canadian dollars, including dividends). For the same period, the Barrage Fund produced a return of 49.56% before fees and 42.03% after fees.

The Fund currently holds 14 securities. Our cash position remains negligible, as the Fund continues to be fully invested.

Commentary on the Markets

Three major factors defined 2016: China's economy, Brexit and the American presidential elections. For investors who had previously experienced the tech bubble and the 2008-2009 financial crisis, 2016 probably felt more or less like a regular year. For investors who did not undergo these two major market events, the first half of the year likely appeared as cause for concern.

Fear Creates Opportunities for Some While Scaring Away Others

Back in fall 2015, we spoke with a very disciplined saver who had not yet experienced the wonders of compound returns on a long-term investment in the stock market. Despite having limited financial knowledge, he was very interested in current economic affairs. He shared his predictions on the impact of oil prices on the economy and felt that financial experts and analysts were underestimating the damage caused by the collapse in crude oil prices. Consequently, he had the same old instinct as many educated and informed people who closely follow the media: to wait until things settle down before investing.

This instinct cost him an opportunity that would have yielded a 30% return between October 2015 and December 2016. By staying on the sideline when things are at their worst, some investors lose out on amazing opportunities to make a profit.

Our investor was absolutely right over the short term: a few months after he decided not to invest, our Fund dropped by 17% (February 2016). However, soon after this temporary loss, the net opportunity cost rose to more than 30% by the end of the year.

After avoiding the temporary loss, had there been a sign that the perfect entry point had come? He would have benefited from a 56% return from that point on!

Even if he had had a crystal ball showing him the future and the perfect entry point, we are sure he would still have had his doubts. With so much media buzz, including talk of a global recession, he would have probably come to the conclusion that the crystal ball was broken.

Few Changes for Canada

For several years now, we have shared our fears regarding the Canadian economy. This opinion hasn't changed despite the lack of a recession and the Canadian stock exchange's strong performance in 2016. There is no doubt that you can find occasional good deals, but those that we come upon south of the border are much more attractive.

Our largest source of anxiety regarding this market is household debt and the long up cycle in real estate. Low interest rates stimulate household spending, while considerably lowering the cost of debt. As a result, low lending rates mean steady demand for particular assets, especially assets like real estate which require major financing.

As in past years, we cannot predict whether there will be a significant rate hike over the short- or medium-term. We are also unable to predict the scale of the impact it would have.

We search for opportunities on a global level and find increasingly lucrative securities in other countries, like the United Kingdom. Nonetheless, most securities that meet our strict criteria are still found in the United States.

The U.S. and the Presidential Election

Trump's rise to power significantly changed investment perspectives in several U.S. sectors. We are mainly focused on three of the new president's ideas and intentions:

1) lowering the corporate tax rate
2) offering tax breaks to encourage businesses to bring offshore liquidity back into the country
3) deregulating several sectors, including the financial, health and energy sectors

Trump will be sworn in as president on January 20, 2017. We will reassess the value of several securities we are following based on the scale of the planned changes and the speed at which they're implemented. Since these changes are looking positive overall, American securities remain attractive despite the stock market rise in the last few years.

Difference in Returns from One Year to the Next

Some people wonder how our Fund can have such a low return one year and achieve a much higher return the next. Our Fund generated a 0.79% return after fees in 2015, and a 42.03% return in 2016. What happened?

In our 2015 annual letter, we said: "The second half of 2015 proved particularly frustrating for investors looking for bargains. [...] the majority of our holding stock prices fell, preventing us from seizing new opportunities as they arose." Then, in our last letter from July 2016, we stated: "The first half of 2016 bears resemblance to the previous six months: despite attractive valuations based on our estimates, our holdings continue to be shunned by the market."

It's quite simple; our securities finally yielded the expected returns, at least in part, since some positions only posted modest gains.

We seek out securities at bargain prices, generally at a 30% discount or more, based on our valuations. In some cases, the undervaluation of securities is only temporary, which means fast gains for us. In others, it takes time for investors to recognize their value, as was the case for several securities in 2015 and 2016.

Some of you may be wondering how it's possible to generate 40% profit without taking any major risks. Remember our 30% discount? When we pay $70 for a security that's worth $100, we come away with a 43% increase once it has reached its estimated target. If the security requires a year to reach its estimated value, the return would equal 43% for that year, not including the dividends paid out over the year, nor the company's increase in value over the same period.

We would never consider it a risk to pay $70 for a security whose value we estimate at $100. The actual risk would lie in calculation error, such as paying $70 for a security under the assumption that it's worth $100 when it is actually only worth $50. It is our job to have an in-depth understanding of companies we invest in to minimize this type of risk.

Remember that investing in the stock market is a very dynamic process. If some of our securities are stagnant or drop, as we saw in early 2016, we try to maximize weightings by taking advantage of new opportunities that arise. This was the case for our securities in the energy and financial sectors. While several of these securities simply returned to

their original price, purchasing shares at much lower prices boosted the portfolio's performance significantly.

Our Investment Portfolio

Chesapeake Energy

Our preferred shares at Chesapeake Energy continued to increase over the last six months, doubling in value again and ending the year at $46 per share. Let's not forget that in February 2016, the security hit a low of $5. The dividend was suspended over a year ago, and once it is restored, we will be entitled to a total of $4.50 per share.

The company sold off assets for a total of 2.5 billion dollars in 2016, in order to improve its balance sheet. Chesapeake's CEO Robert Lawler recently mentioned that additional strategic asset sales were on the horizon. Each asset liquidation further secures our preferred shares, while the company continues to improve its natural gas production methods. The money collected allows the company to continue its operations while its production costs go down, greatly improving its long-term perspectives.

The dividend yield of our preferred shares at their current price is approximately 10%. We think that it's only a matter of time before dividend payments are restored.

As for the oil market, OPEC has agreed to cut 1.2 million barrels of its daily output starting this month. We cannot say whether the OPEC members will respect this agreement, but they clearly intend to make prices increase over the short- and medium-term.

General Motors

We have held shares in this company for over two years now and admit that this security has underperformed. Despite our $55 valuation, the stock is still trading at a bargain price. That said, all of the economic drivers played out as expected: profits increased in the U.S. and China, litigation for past errors had positive results, and a there is a plan to buy back major shares.

We predict that we are extremely close to hitting the peak phase for U.S. car sales. As for China, their economy is experiencing a slowdown and we do not think it's wise to take the official figures published by the Chinese government at face value. Plus, along with Trump's election came the new risk of tariff barriers on cars imported to the U.S.

For these reasons, we have reduced our position, despite the stock's poor valuation. At an average price of $32, plus dividends received, this security still posted a 15% to 20% return to date.

AutoNation

This is the second time we have become shareholders in this company. We first bought shares for $48 in fall 2014. Following a sharp rise in value, we liquidated them in order to seize another opportunity. Two years later, they were being sold for a modest price of $40.

Just as we had done for GM, we tightened our criteria for securities in the automotive sector. A particular advantage of AutoNation is its auto parts division. When car sales slow down, vehicle owners continue to replace worn parts, which somewhat tempers results over a cycle (the highs and lows of U.S. car sales). This division is very lucrative. Even though it only makes up 15% of sales, it accounts for over 40% of gross profits.

Just as it did two years ago, the security's value increased rapidly, leading us to reduce this position. As you can see, some holdings quickly turn a profit– we held on to our GM security for over two years, while in under two months, AutoNation generated a greater return of approximately 25%.

We can never predict at the time of purchase how long it will take for a position to yield a return. However, we have a degree of control over certain factors: watching our investments—which are low-risk thanks to low stock prices and higher estimated values—and closely monitoring the companies' progress. Portfolio turnover will depend on recognition of the companies' worth on the stock market. The faster is this recognition, the greater is the return.

Financial Companies

Unsurprisingly, financial companies' securities increased in value after Trump was elected. The Fed is forecasting three rate hikes in 2017, which bodes well for the banks whose net interest margin shrank over the last several years.

We sold our position in the Bank of America for $19 per share. It is important to consider the significant impact of buybacks when a security collapses. After taking a position at $16 a share, the shares weakened in 2016, enabling us to buy more at $12. The shares rising to our initial price generated a return of 30%. When our valuations remain unchanged, we try to benefit from these fluctuations in the stock market.

We have kept our Citigroup shares and the AIG stock warrants. We intend to take full advantage of the Republican's regulatory reform, as well as the American economy's overall solid economic performance.

We were briefly shareholders of Wells Fargo. However, last September, news of a scandal leaked—bank employees had secretly opened over two million unauthorized accounts without their clients' knowledge. The security quickly dropped by 10%. Even though it had not been a great bargain (at 1.5 times its book value), we predicted that the drop would be temporary. It bounced back quickly, gaining 13%, thanks to the elections.

Best Buy

Once again, the electronic appliance retailer has contributed positively to our performance. For a long time, investors regarded CEO Hubert Joly's overhaul of Best Buy in a negative light. With a 1.8% rise in comparable sales in the last quarter, and a 24% increase in online sales, the skepticism seems to have died down somewhat. As a result, the market value is now approaching our valuation, leading us to its liquidation.

Sale of Securities

We sold off our positions in Franklin Resources, Macy's, Nordstrom and Dillard's. Franklin, an asset management firm dealing in mutual funds, faces fierce competition from popular exchange-traded funds, as well as low-cost passive management. The new regulation requiring that investors disclose all investment fees to clients will boost the popularity of low-fee products.

As for the three retailers, their comparable sales suffered largely due to a decrease in in-store traffic and increased popularity in online shopping. We were counting on their real estate value but doubt that returns will be generated any time soon or at a good profit given the current bleak climate throughout the apparel industry.

We liquidated these three securities due to their market valuation. Despite a recent correction for some of those, we are not interested in buying them back.

Administration

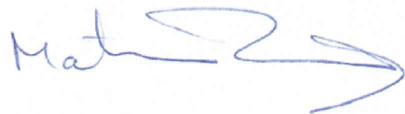
At year end, our net asset value per share was $208.45 before the 2016 distribution of $6.51 per share, and $201.94 right after. Shareholders who opted for automatic reinvestment of the distribution will see their updated number of shares on their first account statement of the year.

As you know, we have changed how we charge performance fees for the Fund. They are still calculated on a monthly basis, however, they will now be paid only once a year. During the first years of the Fund, these payments were made every three months, when applicable. This new payment schedule will allow us to better align performance fees with returns from one year to the next.

Best regards,

Patrick Thénière

Rémy Morel



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