15 July 2020

2020 Semi-Annual Letter

Barrage Fund

Management report

From 1 January to 30 June 2020, the S&P/TSX Index returned -7.46% (including dividends) while the S&P 500 returned 1.80% (in Canadian dollars and including dividends). The return of the Barrage Fund for the same period was 21.40% before fees and 17.34% after fees.

The Barrage Fund ended the first half of the year with a net asset value per unit of $249.07 from $212.26 on 1 January 2020.

The annualized return of the fund since inception in 2013 is 18.52% after fees. At the time of writing, the portfolio consists of 6 securities and has a 31% cash position.

The S&P 500 index fluctuated a great deal during the first six months of the year. As of 23 March, the index had dropped 31% since 2 January. A spectacular rebound brought it back into positive territory.

We had a hedge on the U.S. dollar, for about 50% of the portfolio's value. We opted not to renew this hedge, as we believe that the US dollar becomes a safe haven of sorts in times of crisis. Given our bleak outlook for the short and medium term, we prefer to take full advantage of any appreciation in the US dollar.

Please note that answers to investor questions submitted to us for the cancelled 2020 annual meeting are incorporated throughout this letter.

Market Commentary

Our section on markets is much longer than usual, given the coronavirus crisis. It has been without precedent and has disrupted our lives, both as citizens and investors. Although our attention has focused primarily on stock picking, the effects of the crisis cannot be ignored. Many strategies and business models have or will have to be changed permanently. In our opinion, brushing aside these effects could lead to bad decision making for the portfolio. It is therefore incumbent on us take in account all possible scenarios in order to avoid unpleasant surprises.

For a long time, the arrival of the next recession was the main fear of investors. We can say that this recession is indeed taking place now. At the beginning of the year, we had no idea that it would be caused by a pandemic. COVID-19 created a very problematic situation for the leaders of our society by forcing the closure of most businesses. The goal was to save as many lives as possible or not to overload our hospitals, and to do that, extraordinary measures had to be taken. This was an unprecedented event, the impact of which was difficult to predict.

Of course, we had some clues as to what was going to happen: a skyrocketing unemployment rate, business bankruptcies and skyrocketing government debt. There was every indication that the economy was going to collapse to a greater degree than we had seen during the financial crisis of 2008-09. Still, we were surprised by the rapidity of the stock market decline to the March lows.

Even more surprising for us was the rebound! While much of the economic damage caused by social distancing and the many business closures had not even occurred yet, stocks were rapidly racing higher as if the pandemic was on the verge of being stopped. What has happened? Are we really witnessing a V rather than a U-shaped recovery?

Let's go back a little bit before the spectacular rally in equities. Charlie Munger, Warren Buffett's long-time business partner, said in an interview with the Wall Street Journal: "Well, I would say basically we're like the captain of a ship when the worst typhoon that's ever happened comes. We just want to get through the typhoon." He went on to say, in reference to Berkshire Hathaway, that he'd rather hold on to as much cash as possible than dive headfirst to grab bargains. He also mentioned that all this printing of money by the government could start to cause problems.

That is a very bleak picture. Berkshire Hathaway is in a unique position to survey the economy. Its many subsidiaries provide valuable real-time information on a wide range of sectors.

Berkshire is active in the transportation sector with its freight railroad company and car dealership, in the energy sector with its power plants and gas pipelines. It has subsidiaries in retail, manufacturing and homebuilding, insurance and food distribution, among others. So when Mr. Munger or Mr. Buffett speaks, we assume that they have such information on hand, giving a lot of credibility to what they're saying.

Just two weeks before the interview, we learned that Berkshire had divested itself of some of its shares in Southwest Airlines and Delta Air Lines. Both of these stocks had suffered heavy losses since the beginning of the year. Why sell now? And why only part of it? It should be noted that the company had increased its position in Delta Air Lines in February, at a much higher price!

Perhaps a rule by the American securities regulators will help us to better understand the second question. Under the Exchange Act in the United States, any shareholder who holds at least 10% of a class of shares of a public company must report their transactions within two business days. Berkshire's partial sales of the two airlines' shares meant they would fall below the 10% mark, and thus probably allow them to continue selling the rest of the shares quietly, without alerting the investing community. Berkshire held positions in 4 airlines (American, Delta, United and Southwest). This partial sale decision, combined with Charlie Munger's not very reassuring comments, led us to believe that the subsequent sales were in fact much higher than those announced.

On 2 May, at Berkshire's annual meeting, Mr. Buffett announced that he had sold his entire investment in the four airlines, confirming our suspicions. This is only one sector. Indeed, all the comments made during Buffett's speech were sobering. Charlie Munger's interview two weeks earlier seemed only a preamble to his long-time partner's pessimistic comments.

In the past we have always been used to an "optimistic" Warren Buffett, normally greedy when others are fearful. This time he gave us a speech that seemed to prepare us for darker years. He referred to the 22 years (1929-1951) it took for the stock market to rebound to its pre-Great Depression peak.

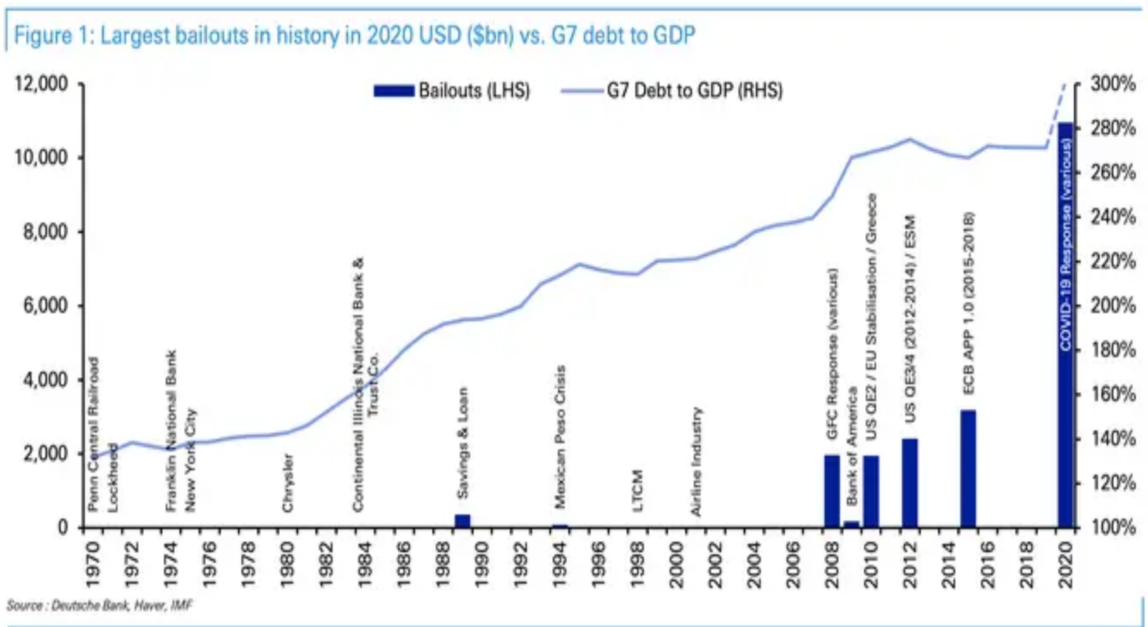
Mr. Buffett also explained his inactivity during the market bottom by saying, "We have done nothing because we see nothing attractive to do." Referring to the company's large cash balance, he said that US $137 billion is not that much money if you think of the worst-case scenarios.

Regarding share buybacks, it should be noted that the company repurchased Class B shares between $214 and $226 during the first 3 months of the year. However, only a few weeks later, the opportunity to buy back more shares between $160 and $180 was passed upon. During the annual meeting, Warren Buffett explained that the relative value at that time was not that interesting. In other words, the decision was to focus on capital conservation rather than buying shares at a price about 25% cheaper!

Among the personalities we admire, we often found this pessimistic attitude. Stanley Druckenmiller, a well-known hedge fund manager, thought that the risk-return equation was at the worst level ever in his career. David Tepper, another hedge fund manager, said on 13th May that this was the second most overvalued market he had seen, behind only 1999 (tech bubble).

In all humility, we also adopted a pessimistic attitude towards the markets, despite the decline in March. Our worries were fuelled by the expected job losses, the numerous business failures to come and the permanent change in consumer behaviour. It was difficult for us not to foresee a much more severe stock market decline, which led us to err on the side of caution. For this reason, we substantially increased our cash position, crossing the 30% mark in the portfolio. By keeping about two-thirds of the portfolio in the stock market, we felt that we were well positioned regardless of the expected scenarios of either deeper declines or a rebound like the one we experienced.

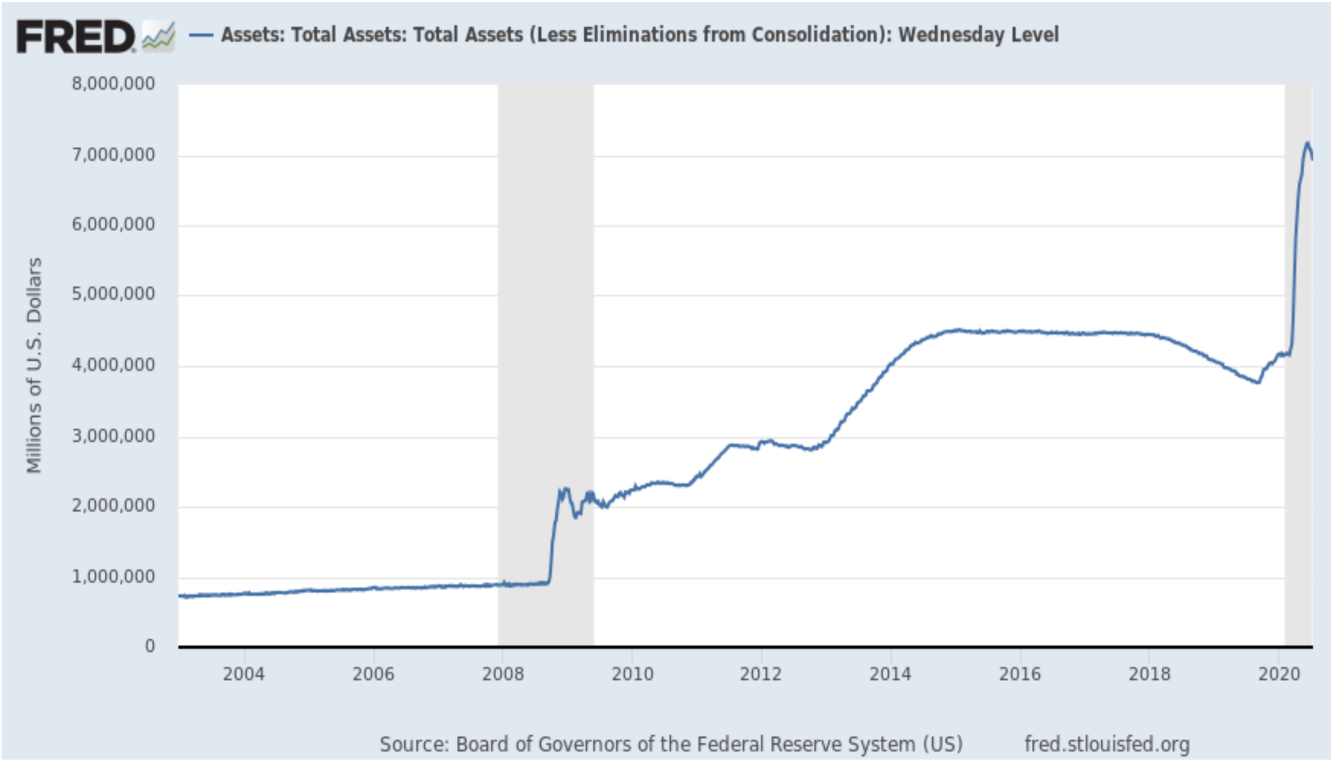
What has happened in recent months? President Trump signed a US $2.2 trillion aid package on March 27, unheard of in the United States. To date in 2020, the various American interventions come to about US $4 trillion, and when we include the other G7 countries, this amount reaches more than US $10 trillion! To put it in context, just take a look at the following graphic:



Source: Business Insider, April 22, 2020

As can be seen, what has been spent overall to counter the pandemic in recent months far surpasses the interventions that occurred during the Great Recession.

The balance sheet of the Federal Reserve has also changed drastically over the past 15 years. Prior to the financial crisis of 2008-2009, assets were kept below US $1 trillion. After the financial crisis, it was between 2 and 3 times that amount. Today, it is 7 times!



Source: https://fred.stlouisfed.org/series/WALCL

We believe that government intervention has played a key role in the stock market's performance since March. We clearly underestimated the extent of the intervention and its impact. That is why, although we made some interesting purchases at the bottom of the market, our strategy remained more defensive than aggressive. For example, after cutting our biggest positions, including Facebook and Google, we took a small position in MasterCard at $200. That was a starter position for us, and we were thinking of buying a lot more at around $150. Little did we know that just three days later, the stock would be up 30%, prompting a sale.

It is quite unusual for us to hold a stock for only a few days. However, we had some unusual moments! And even though at the bottom of the March stock market turmoil, we were beginning to see some interesting bargains, the economic horizon seemed darker for the months and even years to come.

Many companies do not have the financial cushion needed to absorb a near-complete halt in sales over a short period of time. Let's take the case of a small restaurant whose owner makes a net profit of $50,000 a year. With that profit, he contributes to his household, either in salary or in dividends. He needs that money to live on. The typical rent for a restaurant ranges from 5% to 8% of revenue, and in the case of a well-trafficked shopping centre, it can be as much as 20% of revenue.

Let's assume total revenue of $600,000 a year, with $30,000 in rent. If the business closes, revenues drop to $0. As a result, the owner can no longer rely on his business to pay a salary. It is as if he has lost his job. It does not end there. Since the business must continue to meet its obligations, the owner will have to dip into the cash from his business or his personal savings to pay the $2,500 monthly rent, in addition to probably absorbing losses in food and inventory.

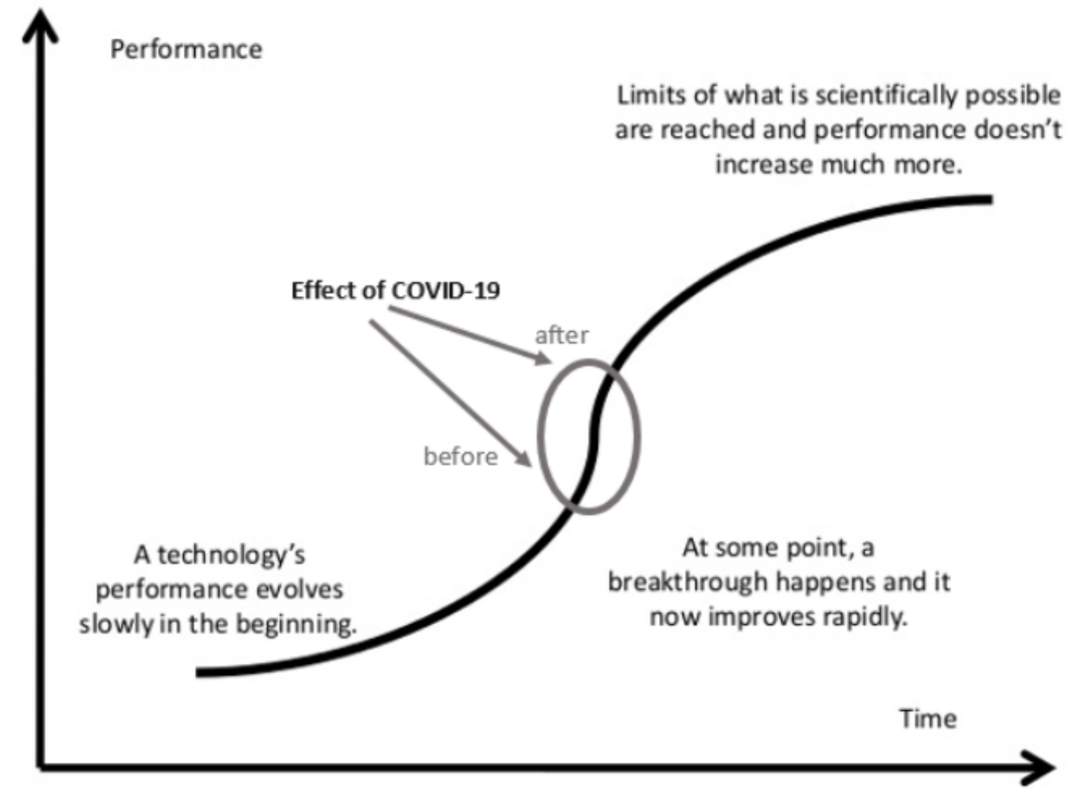
Most businesses have not been structured to withstand a 100% drop in revenue. In the event of a recession, we obviously expect a drop in revenue, but not the complete disappearance of it! Howard Schultz, former CEO of Starbucks, recently predicted that 20% to 30% of small businesses could close permanently. This does not bode well for the employment rate. Unfortunately, the end of lockdowns does not translate into a return to normality. By operating at reduced capacity to meet social distancing guidelines, restaurants will not be able to return to profitability. For many of them, the situation was already difficult before the pandemic.

More long-term changes are expected to occur. The travel industry has been affected by the halt in air travel. Meanwhile, companies that used to fly their employees to negotiate international contracts or attend events have likely discovered the benefits of teleconferencing. The use of software such as Zoom or Microsoft Teams has exploded in recent months. Once companies become accustomed to these applications, they will consider these inexpensive alternatives long after the pandemic is over. As a result, it is difficult to see a full return of business class travelers, which is the most profitable category for many airlines.

Performance of our stocks

Despite our prudence and generous cash position, the fund's performance has been relatively good. Among the questions we received from our investor clients, many were concerned about these results and wanted to better understand our buy and sell process during these tumultuous times.

The following graph, which we have already reproduced in a previous letter, illustrates what happened with our securities:



Before the crisis, we were somewhere in the middle of the curve, moving towards global digitisation, both at the business and consumer level. In retail, Amazon was taking market share. In software and data processing, the leaders were Amazon, Microsoft and Google. Entertainment was led by Netflix, Spotify, Apple and Microsoft. In advertising, it was Google and Facebook. Finally in social networking, we see the similar domination by Facebook and Tencent.

The COVID-19 pandemic required drastic measures, such as social distancing, which simply caused an acceleration in the curve. We wouldn't be surprised if we learned that this phenomenon was pulled forward by two or three years, or 5 years in some cases even. The companies mentioned above all benefit, to varying degrees, from this transition, and therefore from the acceleration. Since our portfolio included only 6 to 8 stocks, all of which are long-term beneficiaries of the online transition, the performance is easily explained. Several of them have become somewhat "defensive" stocks.

<u>A strong short-term tailwind for two of our companies</u>

At the height of the crisis in April, Amazon had to hire 175,000 people to meet demand. The situation was becoming critical: management decided to temporarily prioritize orders for basic essentials. Unsurprisingly, the company's retail sales in North America grew by 29% in the first quarter of 2020.

As for Netflix, lockdowns obviously favoured home entertainment. With cinemas, restaurants and amusement parks closed, consumers had much more time to watch exciting movies or series on Netflix. The first quarter results fared well. Management had anticipated 7 million new paying subscribers, but the actual number was 15.8 million, more than twice as much.

Despite this tailwind, it should be noted that for some of our investors, the company's debt position is a cause for concern. Here is an interesting comment from the release of the first quarter results in April: "Due to the production shutdown, some cash spending on content will be delayed, improving our free cash flow." In other words, the company's debt and content spending is a direct result of management's desire to remain a dominant platform in its industry. If necessary, Netflix could slow its pace and focus on debt reduction and profitability.

In Q4 of last year, Netflix mentioned in the letter to shareholders that 2019 would be the worst year in terms of cash flow, at negative US $3.3 billion. At that point, the company expected to improve cash flow to a slightly positive amount, but did not specify the number of years it would take to do so. In summary, the strategy is to maintain the lead the company enjoys in terms of content variety, and then move towards profitability once dominance is achieved.

The cloud: sector with a long-term tailwind

Microsoft and Amazon, both have subsidiaries that are ideally situated to take advantage of the online transition. Azure and AWS (Amazon Web Services) are experiencing extraordinary growth. For the first quarter, they recorded revenue increases of 59% and 33% respectively. At the beginning of the crisis, we were wondering whether these subsidiaries would be temporarily affected, given the significant economic downturn. We believe that the online transition, accelerated by the pandemic, is clearly in their favour. Having a wide range of products across the cloud (infrastructure, data integration, programming and software), we do not necessarily expect a temporary slowdown in the event of a severe recession. However, even if that were the case, we like the long-term outlook very much.

A new stock

We began acquiring Spotify shares in November 2019. This Swedish company is the world leader in music streaming. It had 286 million users as of March 31st, including 130 million for its premium service, for which members pay a monthly fee. This is a 31% increase over last year.

Although it dominates its sector compared to its main competitors Apple Music, Google Music and Amazon Music, streaming music is somewhat of a commodity. From one platform to another, the music you listen to remains the same. Spotify may stand out with its recommendation system, but we don't think that's enough to ensure its dominance in the future. Furthermore, despite an internet-based distribution model, the gross margins bear little resemblance to what we see for Facebook or Alphabet. Indeed, about three quarters of the revenue that Spotify collects goes to the music industry giants (Sony, Warner and Universal).

We like the founder, Daniel Ek, because he has a very specific strategy in mind: to become the leader in audio, rather than just music. Last year Spotify acquired Anchor and Gimlet. Anchor offers tools for users to create their own podcasts and has about 40% market share. Gimlet is a New York-based company that produces narrative podcasts. Both acquisitions demonstrated Ek's ambition to make Spotify a major player in the industry. In the US alone, we estimate that the radio advertising market is worth US $18B; podcasts are increasingly becoming an attractive alternative where users can listen to what they want, when they want.

Most recently, the company made it clear how serious it is about its goal to dominate the audio world with two key new transactions. On May 19, it signed an exclusive deal with podcast giant Joe Rogan. It has been estimated that by April 2019, there were 190 million downloads of his podcasts every month.

The second deal closed on June 17, with Kim Kardashian, for a criminal justice podcast. Once again, this is an exclusive deal that greatly enhances Spotify's presence in the audio world. These two deals have not gone unnoticed by the stock market. In just two months, Spotify's share price has risen by 70%.

<u>Digital advertising: victim of the crisis?</u>

In the midst of the stock market turmoil in March, we had many questions. Our companies were benefiting from the long-term trend towards digitalization, but with the economy coming to a near complete halt, how could we predict the impact of such an unprecedented event?

Take the case of Facebook, which has a wide variety of customers, with 8 million advertisers. If companies, both large and small, cut their advertising budgets, a direct impact on revenues could be expected.

So we managed the portfolio prudently, being prepared for any eventuality. However, we were pleasantly surprised when the results were released at the end of April. Management commented that sales have held up for the first 3 weeks of April compared to last year. As this was a short period of time completely affected by business closures, this was really good news.

As for Alphabet, it could be more affected by the crisis. Operating profits increased by 20% as of March 31, but the pandemic began its negative effects only in March. The travel industry, hard hit by the crisis, is estimated to account for about 15% of the company's revenues. According to some estimates, Bookings Holdings should reduce its advertising budget on Google from US$4B to between US$1B and US$2B. Barry Diller, Expedia's chairman, predicted that his company would spend less than US$1B on advertising this year, compared to US$5B in 2019.

Despite these impacts, which are predictable, we remain optimistic for the long term, and we will be opportunistic if the stock is badly hit again. Alphabet, with US $117B net cash on hand, is benefiting from the transition to the cloud (Google Cloud), and like Facebook, will continue to benefit from the migration to online advertising.

Sale of Apple and comment on Shopify

Two questions from investors concerned these securities. We had sold Apple last year for valuation reasons. Perhaps too quickly? That is a possibility. Extraordinary companies have characteristics that normally set them apart from all others. Sometimes we undervalue them and miss these opportunities. We try to make this kind of mistake as infrequently as possible, but we can assure you that, despite our hard work, it will be repeated from time to time in the future. Knowing when to sell is much more difficult than knowing the right time to buy.

As for Shopify, it's hard for us to arrive at a fair value. The company is still in a loss making position at the moment. It's true that it has benefited greatly from the digitisation trend, as have our companies. This company seeks to offer a merchant services alternative to Amazon, the industry giant. It has a good business model and seems to be well managed. However, the valuation seems exaggerated to us. Shopify's market capitalization as a multiple of sales over the last 12 months was 63 times at the time of writing, compared to 10 times for Facebook and Alibaba and 5.5 times for Amazon. We therefore believe that, despite the growth prospects, the company appears overvalued.

Sales of Alibaba and Tencent

We have eliminated these two positions from the portfolio. The main reason is our low confidence in the way of doing business in China. Most recently, we had an example of financial statement manipulation at Luckin Coffee. Sales were exaggerated and investors have experienced a 92% drawdown since the stock's peak at the beginning of the year. As the company is based on Chinese soil, it is difficult to get justice in such cases. Add to this the growing tension between the United States and China, as well as rumors of fraud at Alibaba, which have been going on for some time. We prefer to avoid these risks and invest in securities that we believe to be safer.

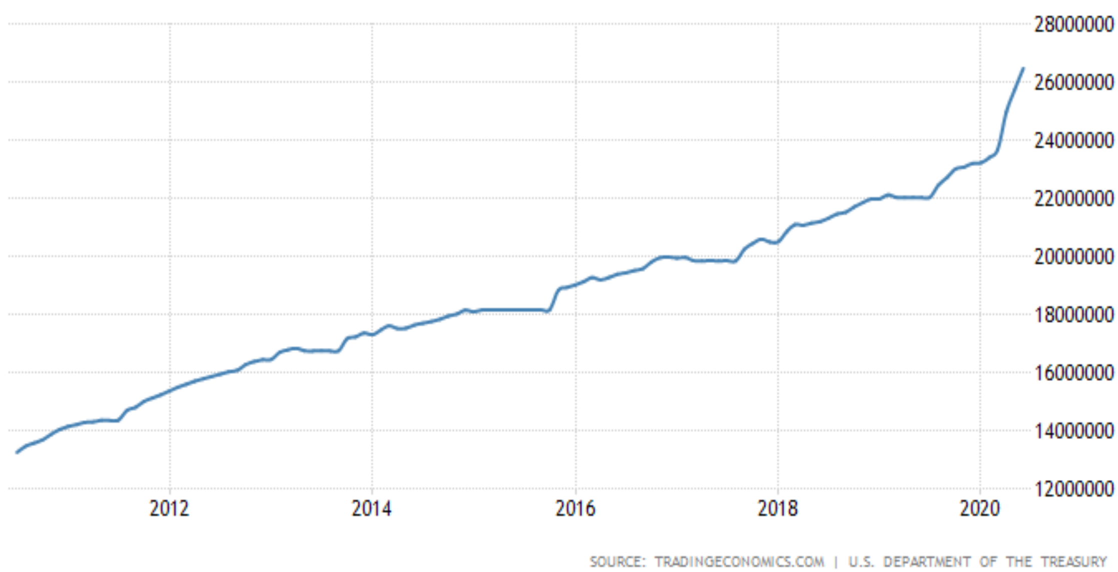
Conclusion: Caution is called for

We are still pessimistic about the markets in general. We believe that at the moment the economy is deteriorating, and if our governments had not intervened, it would have been a disaster. Unfortunately, this intervention could have an ephemeral effect. The Trump administration seems ready to do anything to support the economy and the stock market, at least until the elections in November. It should therefore come as no surprise to see stock market fluctuations. It is difficult for us to make decisions with a government that is so active in the market.

Indeed, one could compare investing in the current stock market with outdoor table tennis. The slightest gust of wind propels the little ball in an unpredictable direction. Everything suggests that it will fall to the ground, and suddenly it bends and lands on the table instead. Due to external circumstances, a clear assessment of the situation can be easily blurred.

However, we have a strong tailwind with our companies. Regardless of the direction in the short term, we are confident about where we will land in the future. Their unshakeable business models allow us to be optimistic about their prospects. In addition, most of our companies are financial fortresses. Their balance sheets are highly liquid, and their reliance on debt is minimal.

We are currently going through the pandemic crisis. However, we are already trying to anticipate the next crisis, one that could be much more financially damaging for the economy as a whole. We are talking about a debt crisis, the risk of which has increased as a result of the pandemic. The following table gives an overview of the evolution of US debt over the last 10 years:



We have already reached a level that we consider very high. However, the economic consequences of the pandemic are only beginning to be felt. Will the government have to intervene again? When this crisis is over, will we start to worry about the debt load of governments around the world?

Without trying to predict when the markets are going to go down, we are watching for that risk. Low interest rates and skyrocketing sovereign debt around the world would be expected to create inflation, but one can be left waiting a long time to see this come to fruition. We are, however, reassured by our choice of stocks. Our companies have little or no dependence on the debt market. The customers of these companies do not need to go into debt in order to afford their products, unlike, for example, a car dealer or an aircraft engine manufacturer. We couldn't have hoped for more for our portfolio!

Administration

The minimum amount to invest in the Fund is now $150,000.

Sincerely,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière