barrage capital

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2017 Semi-annual Letter

Barrage Fund

Management Report

For the period from January 1 to June 30, 2017, the S&P/TSX index posted a return of 0.71% (including dividends) while the S&P 500 generated a return of 5.8% (in Canadian dollars, including dividends). For the same period, the Barrage Fund produced a return of 10.4% before fees and 8.83% after fees.

The Fund currently holds 9 securities. Our cash position reached a historic high, closing the half-year at 29%.

Market Commentary

We currently only have 9 securities in the portfolio, compared to 14 in December last year. While we decreased the number of securities in the portfolio, this was not because we decided to concentrate our capital in our remaining securities, but because of a lack of appropriate bargains in the current market. At present, it is difficult to unearth situations that meet our evaluation criteria.

We hear that the American S&P 500 index has become expensive, so we would like to invest prudently. Its price-earnings ratio is surpassing its historical average by more than 50%, rising to approximately 24 times current profits. However, as you may already be aware, we do not take into account general assessments of the markets as the basis for our decision-making. Are we on the brink of a correction? We leave such predictions to economists and speculators.

Our current cash holdings of 29% are a reflection of the decrease in prospects that meet our criteria. If a market correction occurs, our work will certainly be made easier; crises, both large and small, create volatility in markets and we regard such events positively because they often generate circumstances, which lead to the creation of bargains.

Given the impossibility of determining when a crisis will occur, we strive to let our evaluation criteria guide our decisions. When prices are attractive, we seek to optimize our portfolio, and reduce our cash position. When the situation is reversed, we decrease our investments. We never try to anticipate market downturns.

Our search for bargains continues independently of the overall market price. If we discover two or three excellent prospects in the coming week, our cash holdings can be deployed rapidly.

Trump's Promises

Six months ago, we mentioned changes that might occur on the U.S. side of the border:

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

Because of a lack of consensus within the government, the implementation of these catalysts, in whole or in part, has become increasingly uncertain. For this reason we must consider them the icing on the cake and securities should pass our selection process without the help of these catalysts. We can control our evaluation criteria, but the unfolding of political events is completely out of our hands.

We try to avoid situations where we win if we are correct, but lose heavily if we are wrong. We prefer to win, regardless of the scenario. Thanks to the margin of safety we look for in our selections, we are not dependent on one element in particular that might undermine our chances of success.

Consequently, we have not changed the weighting of certain securities in response to what is happening on the political scene.

Our Investment Portfolio

BT Group

Leader in the telecommunications sector of the United Kingdom, the BT Group saw its stocks suffer repercussions from two notable events. Having attained a peak of almost $36 in 2015, the share price plummeted to $25 on the day of the Brexit results. Certain doubts were cast as experts attempted to predict the consequences of the departure of the United Kingdom from the European Union.

Then, in January of this year, a scandal erupted at BT's Italian subsidiary because of inflated revenue declarations, which were the result of misconduct by its executives. The company had already warned shareholders in October 2016, but predicted charges increased from £145 million to £530 million. This was too much for the markets and the stock price plummeted 20% in a single day, erasing £8 billion from its market value.

This situation reminded us of the summer of 2012, when JP Morgan's London Whale was making the headlines. A colossal loss of $6 billion USD was predicted following an error or poor judgement by one of their negotiators in the United Kingdom. In the space of three months, the stock fell from $45 to $30, cutting their market value by nearly $60 billion.

Many investors seemed to focus their attention on the total amount of the loss without putting it into context; JP Morgan was accruing operating profits of more than $25 billion USD annually. Some quick math revealed that a single quarter would be enough to recover from the "enormous loss". As a result, it only took a few months for the company to regain lost ground on the market, and bargain hunters had a golden opportunity to make a quick profit.

Thus, if we consider the BT Group's losses in context, we obtain similar ratios. The company expects to generate cash flows of £3 billion in 2018. With stable revenues and a dominant position in the United Kingdom, the company's stock is an investment with a good margin of safety, despite the foreign exchange risks that it entails. The British pound was trading at $1.70 US at its peak in 2014 compared to $1.29 US at the time this letter was written. We acquired the stock at an average cost of $19.

AutoNation and General Motors

These two securities continue to trade at attractive prices, with price-earnings ratios of 10 and 6 respectively. The latest quarterly results were satisfactory, particularly in the case of GM. However, an increasingly noticeable trend in the automobile sector is appearing on the horizon, and we are working hard to estimate its impact in the medium and long term. We are referring to the mass arrival of electric and autonomous vehicles.

The arrival of Tesla has forced vehicle manufacturers to start a shift towards electric vehicles. For autonomous cars, our estimates suggest that there are at least forty corporations working on this kind of project, either through direct investments or alliances with key partners. For example, Google founded Waymo, GM invested $500M in Lyft, and Apple recently announced that they will be testing vehicles with the car rental company Hertz. The movement towards autonomous cars has begun and will not be completed any time soon. The future of many sectors is in play.

Numerous questions arise, such as: What will the manufacturer's margins be like for these types of cars? Will automobile maintenance be carried out in the same locations? Will a dealer like AutoNation be able to generate as much profit as before from its automotive parts division? To give a practical example, the number of moving parts in an electric car is considerably less than in a vehicle powered by gas, which obviously then has implications for suppliers of automotive parts.

We live in an era where technology is evolving rapidly enough to disrupt the business models of manufacturers and retailers. The way information is collected and processed makes it possible to create new ways to sell and supply services at increasingly competitive prices. A prime example of this would be how quickly Uber has been able to disrupt the taxi industry.

With these risks in mind, we are endeavouring to understand and analyze the technological trends that are rapidly transforming industries. AutoNation and GM remain highly profitable companies, and we like their valuations, but we will nevertheless remain vigilant.

Even if, as is often the case, it takes many years for these changes to have a significant impact on profits, investors can anticipate their effects in advance, exerting a constant pressure on stock prices. In part for this reason, we reduced our position in GM during the last six months.

<u>Amazon</u>

You may be surprised by our decision to take a position in Amazon, the undisputed leader of online shopping. Amazon is the type of company whose stock market value has often left us cold, but whose fundamentals have never ceased to impress us.

Five years ago, we considered Amazon to be one online retailer amongst a number of competitors with which retailers from other sectors would have to compete. Now, they have become a serious threat for many companies, and bring into question the very future existence of several sectors.

Amazon's increasingly imposing presence has created a multitude of value traps in the stock market. For example, in the past, we have held stock in several retailers, such as Macy's, Dillard's and Nordstrom. Faced with the constant migration of in store sales toward online sales, we chose to sell our shares and have not repurchased them. We sold our shares in Macy's at $40 in August 2016 after starting a position at $31 three months earlier. Despite the current price of $21, the stock is no longer of interest to us. We could also mention our investment in IBM as a value trap caused by Amazon Web Services, a division of Amazon.

Studying the evolution of online sales, and more specifically Amazon's strategies, led us to further measure the risks, which must be faced by a retailer such as Macy's. At the same time, the study of this colossal competitor helped us better appreciate the strength of their business model.

As it seeks to constantly improve its offer to consumers, Amazon is prepared to invest massive sums over a period of years to obtain the results that it desires. For example, in an interview with Charlie Rose a few years ago, Amazon's founder, Jeff Bezos, mentioned that one could take a look at women's jeans to get an idea for the kind of direction that the company was taking. Seven years later, we learn that Amazon is probably going to overtake Macy's in clothes retail. More recently, we heard about their newest initiative, "Amazon Prime Wardrobe", which allows shoppers to buy up to 15 items of clothing with the possibility of returning them at no cost.

In another notable development, Nike, the shoe manufacturer, recently announced that they would finally be making their products available on Amazon, after years of refusing to do so, and thus again demonstrating Amazon's dominance in the retail sector.

Amazon has solidified its position in online retail by offering their customers the opportunity to become Prime members in order to take advantage of certain benefits, such as free two-day shipping. The number of Prime members is now estimated at nearly 85 million and is growing at a rate of more than 30% each year. These numbers call to mind the very successful membership strategy that was used by Costco. An Amazon Prime member is both more likely to begin their shopping on Amazon and to spend more than a non-member.

Amazon's dominance in online retail has allowed them to develop and offer a range of services that are tangential to their original vocation. These services have become important sources of income and profitability:

- Third-party retail services
- Amazon Web Services (AWS)
- Online advertising

These divisions have very interesting economic characteristics and should experience significant growth in the long term. It is difficult to imagine a company with an equally strong competitive position in several fields. What's more, the company is likely to benefit from the move towards online sales for years to come. For all of these reasons, we recently took a position in Amazon.

Sale of Securities and Cash Position

After evaluation, we have reduced our positions in Citigroup and Allergan. In addition, we sold our securities in Lee Enterprises, AIG stock warrants and WPX, due to our reduced confidence in their future prospects.

Administration

The minimum amount that can be invested in the Barrage Fund is now $75,000.

For those interested in buying units through their advisor, the FundServ platform is now available.

Best regards,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière