barrage capital

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# 2016 Semi-annual Letter

# Barrage Fund

## Management Report

For the period of January 1st to June 30, 2016, the S&P/TSX Index provided a positive return of 9.85% (including dividends) while the S&P 500 Index generated a negative return of -2.89% (in Canadian dollars, including dividends). Over the same period, the Barrage Fund's return was 5.87% before fees and 5.27% after fees.

The Fund now holds 16 securities. Our cash position is currently negligible, as the Fund is fully invested in equity.

## Markets' Commentary

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, with one exception: Boardwalk Pipeline Partners. After multiple sweeps in the $10 range, we liquidated our position following a quick appreciation of 60%.

During the first two months of the year, China scared investors. Then, after calm resumed, Brexit brought its share of concerns. Normally, we appreciate the gloom in markets, as without it, searching for bargains would be challenging. However, we barely have time to digest our old catches when new game presents itself. Opportunities abound, without us being able to profit from existing positions.

We are not denying the lacklustre economic growth of the developed markets. Corporations struggle to grow their revenues. We think this lack of growth is already priced in our securities. Many of them trade as if we were heading into recession.

Drawing a comparison with the 2008-2009 financial crisis is difficult. During that period, some corporations were dealing with a heavy debt load. In the same vein, financial institutions were highly levered. The ratios of assets to net values had reached dangerous levels. The crisis struck with full force the financial institutions that had riskier profiles. Once they disappeared from the financial landscape, the surviving ones dealt with the prudence of greedy regulators, as we can see from much higher capital ratios. So while the majority of financials stocks are not trading at the same level as during the crisis, the risk/reward equation is comparable in many cases.

Markets continue to offer us exceptional opportunities. Being fully invested, we must be patient and closely follow our holdings' progress.

Some investors believe global risks make equities a less appealing option. China is about to implode, our governments are extremely indebted and the current low levels of interest rates indicate the central banks have run out of bullets to jump start their respective economies.

Let's not forget those risks have been real for a while and will subsist for the years to come. We have been fearing a real estate meltdown in Canada since 2007. As of today, not all of our fears have materialized. The same thinking applies to China: for the past ten years, we have questioned the country's true financial health. Maybe we will only find out how the story ends in five or ten years. If we had remained on the sidelines for every plausible catastrophe, we would have been inactive for a very long time.

Other crisis will happen, without us being able to predict the exact moment they will occur. Sovereign debt, for example, represents a ticking time bomb. Its possible explosion will create turmoil. With every fall in interest rates, the meter has an extended grace period before the detonation. How long will this last? No one knows.

A few years ago, Warren Buffett expressed his concerns over rising interest rates. Last year, during his annual meeting, he admitted to being wrong on the subject. Even worse: market participants are now talking about NIRP (Negative Interest Rate Policy). Was he wrong to worry about it? We don't think so. However, as he does with all his holdings and with his own firm, we keep in mind all the possible risks when we invest. By acquiring securities at a price well below our estimates, we benefit from a margin of safety that lets us sleep at night.

Our objective is not to invest in markets once fears have faded. There is only one certainty: uncertainty! Its form will vary over time, but it will shine permanently. We try to find organizations whose price offer us a sufficient margin of safety to weather upcoming storms. We will favour cash the day we are unable to fill our portfolio with such securities.

Our Energy Stocks

Crude prices bounced back more than 50% since hitting bottom at the beginning of the year. Natural gas, which rapidly plummeted 30% in two months, made back lost territory to finally close up 30% above its price at the beginning of the year.

The preferred share of our natural gas producer, Chesapeake Energy, appreciated since the transfer of our common shares, to end the semester at $23. Recall the nominal value stands at $100, and we are hoping for a rebound to $90. The dividend has been suspended, depriving investors from current revenue so far in 2016. It does remain cumulative. At $4.50 per share, it represents a return close to 20% on the price an investor would have paid at the end of June.

Back in February, rumours concerning its potential bankruptcy circulated in the industry, dragging its preferred share to a bottom of $5! Then, in April, it was announced that its revolving credit line would not be cut, and it would not be reviewed before June 2017. This exceeded expectations and somehow brought down fears concerning short-term liquidity management. The corporation is now better equipped to face the storm, which puts it in a favourable position compared to competitors.

If concerns about the solvency of Chesapeake Energy fade, we believe the share price will go back to $90 or $100. Preferred shares share more similarity with bonds than with common shares, but their current valuation looks more like the latter.

Considering the current level of interest rates, an investor looking for yield would be more than happy with a 20% return if they felt secure about the survival of the corporation.

As mentioned in our previous letter, these preferred shares offer an interesting protection in the event of a dilution. When the company issues common shares, our shares are not penalized, because of their superior rank. Chesapeake has reimbursed debt in exchange for common shares three times so far this year. The amounts involved remain modest, with dilution in the order of 11%. Nonetheless, we appreciate this protection, as new issuance could come to market soon.

As with WPX Energy, the sale of its subsidiary Piceance strengthened its balance sheet, providing comfort in the short and medium term. It holds roughly $1 billion in cash, and its next tranche of debt maturity occurs in 2020. The share recovered nicely during the semester, rising 60%.

Concerning the overall sector, we believe the current economic forces are doing their work to slowly rebalance the crude market. American producers have cut their production of oil by 900K barrels per day since the peak of April 2015. Capital expenditures, in America and the rest of the world, have been drastically cut in 2015 and 2016. In addition, capital markets are difficult to access for many producers. It is now very difficult for the industry players to grow production at current prices. And annual worldwide demand for oil products continues to grow at a steady rate of more than 1 million barrels per day.

General Motors

Six months ago, we described general market fears related to a marked slowdown of vehicle sales in China. We did not share those views: the numbers did not point to a dire situation, and management was confident in the short and medium-term prospects. Two quarters later, China does not make a lot of headlines and Brexit has taken over on the news front.

GM sales in China grew at 5.3% for the semester. A rise of 11.2% was recorded just in the month of June. We can't predict future quarters. However, the risk of a Chinese slowdown has been real for many years now. The divergence between reality and the markets is a matter of awareness. When we think and focus on it, we panic. When we forget about it, we smile again. Personally, we prefer to maintain a neutral and realistic attitude. To let oneself be carried away by the ups and downs of the stock market can only be detrimental to investors.

We already stressed that even in the absence of profits from the Chinese division, GM valuation remains attractive. And we were very pleased with the last quarterly earnings release (Q1). Profits rose strongly, making our forecast of a $5.50 earnings per share for the year quite achievable. The ambitious buy-back program of nine billion dollars, announced in January, will also contribute to the reach of this forecast. At the multiple of 10 times earnings, we derive a $55 target. The current $30 price provides us with a good discount.

Considering this excellent news, how can we justify the constant gloom from investors on the stock? We can only guess that a piece of data is misleading a large number of investors. Our position is that it is total and retail sales.

The company is currently trying to maximize its margins by reducing its sales in less appealing segments. We are referring to daily rental vehicles included in the fleet segment.

Let's take June sales: GM recorded a drop of 1.6% when its competitor, Ford, showed a 6.5% rise. GM's plants are running at full capacity to produce the most profitable vehicles, notably the ones that are more fuel inefficient. Its retail sales grew by 1.2%, while the fleet segment declined 22%. This reduction was planned by management. As expected, the percentage of this less desirable segment keeps on declining, and its impact on the global picture keeps on diminishing. It now represents 18% of sales, while GM was predicting 20% for the year.

The implementation of this reduction plan in the fleet segment causes confusion in the bigger picture, and probably causes confusion in investors' minds.

Bank of America (BAC) and Citigroup (C)

Our two bank holdings reported satisfying earnings during the first quarter, despite high volatility and loan-loss provisions in the energy sector. The annual return on tangible capital reached 5.6% for BAC and 8.6% for C. We estimate that under normal conditions, those returns should rise substantially without, however, reaching the same levels that prevailed before the start of the financial crisis.

Back then, with more modest capital ratio requirements and the use of higher leverage, these banks could generate returns of 20% to 30%. As an example, in 2005, Bank of America produced $16B of profits on a net asset value of $100B. Once intangible assets were subtracted, we had a return north of 30%.

Using a net adjusted asset of $53B (and even less if we decided to subtract the mortgage service rights), we derive a loan-to-asset ratio surpassing 10X. The same formula today gives us a value of less than 6x. Without analyzing loan quality, we rapidly notice the reduction in risk borne by the firm through its diminished leverage.

For our two banks, the financial crisis created asset categories that are challenging to evaluate, like deferred taxes. Those are made up of taxes to be recovered as the firms generate eligible profits to their recovery. These assets are quite significant for Citigroup. As of last quarter, recovered taxes reached $1.6B, contributing to a rise in the total regulatory capital recognized of $6B. Still, $46B of these assets are on the balance sheet.

Deducting the totality of deferred taxes assets to derive the amount of capital would represent a severe adjustment for our estimate value. Without a doubt, our banks will recuperate part of these taxes over the long term. That is why we have elected to choose the most conservative capital among those required by regulators that have become quite demanding since the crisis. We are referring to the Common Equity Tier1. In Citigroup's case, the calculation of net capital takes into account the deduction of $30B of deferred taxes, about 65% of the total recorded on the balance sheet.

For BAC and C, these capital calculated in accordance with new regulations correspond to $158B and $153B respectively. We are using the full approach; in reality the new calculation will be slowly incorporated over a five year period. As per Basel III regulation, the adjustments will be applied at 60% for 2016 and at 100% in 2019. If our banks did not generate a profit for the next three years, they would see their Tier1 net asset ratio gradually erode. We prefer using data incorporating the full restrictions of 2019.

With these data, we eliminate the need to estimate the totality of the intangible assets, which are sometimes hidden in balance sheet categories like "other assets" or mortgage service rights.

It is difficult to refrain from commenting on rules that give, more than ever, a preferred status to sovereign debt over other loans. In the capital ratio calculation, assets supported by this capital are evaluated based on their potential risk. As such, certain corporate loans, like in the construction industry, are hit by stricter requirements in terms of required capital to support them. On the opposite side, U.S. Treasury bills are considered risk-free. Holding them in a portfolio does not lead to a rise in required regulatory capital. The conclusion? We strongly encourage financial institutions to contribute to sovereign debt.

For the moment, interest rates are so ridiculously low that the situation is not alarming to anyone. Germany just issued bonds with negative rates with a maturity of 2026! Sooner or later, a faster rise in sovereign debt over the underlying economic growth will end. Deficits will have to be eliminated at once. And when concerns show up on investors' radars on this particular subject, required interest rates could soar.

As we have witnessed over the last few months, it does not take a whole lot to make investors panic. If we add all the other problems that have not been dealt with and have planted panic seeds over the last five years, a crisis seems to be inevitable!

Knowing this, should we shun all bank investments? Luckily, today's banks are far more solid than they were just a few years ago. Their resilience to absorb financial shocks has substantially risen, as they need to comply with extremely strenuous constraints from regulators. Last June, 31 of 33 banks targeted by the "Fed Stress Test" aced it. The two institutions that failed were in fact U.S. subsidiaries of European banks.

This test provides for a rather somber scenario, in which the unemployment rate rises to 10%, the stock market loses half of its value and the inflation rate becomes negative. For the largest institutions in terms of assets, we must add the liquidity crisis risks, the risks of a generalized asset sale in the industry as well as the bankruptcy of parties it deals with. With all of these negative elements in play simultaneously, the bank must maintain a ratio above the required minimum despite the storm. Said differently, it is required that it keep and raise more capital, or that it reduces the risk profile of its business. For all these reasons, we are not too worried about the macroeconomic risks.

In addition, we have a margin of safety through the price paid for our two banks' holdings. On the basis of the reference regulatory capital, we estimate a stock market value of 1.7 times this value. This ratio is justified if the return on capital reaches 12% or 13%. For example, at 12%, the price/earnings ratio is at 14x, whereas at 13%, it would be at 13x.

A Few Words on Brexit

Citigroup employs 9,000 people in the United Kingdom. As of December 31, 2015, its total workforce was 231,000 employees. At Bank of America, we estimate the number of employees on the territory at 5,000, on a total of 213,000. At JP Morgan, CEO Jamie Dimon declared, right before the referendum, that his firm could cut up to 4,000 jobs in the event of Brexit. As JP Morgan employs a similar number of people as Citigroup, it is a relatively small number. It is imperative to put things in a global perspective before starting to panic.

Brexit consequences could be detrimental to the United Kingdom, but we are not too worried about the long-term. Many institutions with European operations largely based in London's financial center will not automatically have easy access to start up offices, sell services or trade in the other 27 member countries of the European Union. In the short to mid-term, costs will need to be incurred for relocating and for changes in procedures to pursue their operations. However, the Brexit process is expected to last over two years. The consequences will not be felt overnight, and financial institutions have sufficient time to reorganize their operations in continental Europe.

We have seen some quick repercussions, like the stock market's retreat, and the possible scrap of the MBNA credit card asset sales by Bank of America in the UK. However, in our view, investors' fears are exaggerated.

With Brexit, our very long-term perspectives for Europe have not changed, neither did our holdings valuation metrics. With or without Brexit, since most European Union members have chronic fiscal deficits, we struggle to see a happy ending, as each country will have to make tough decisions sooner or later to balance their budget. The majority of them cannot rely on currency devaluation to address their constant indebtedness. We will be hearing about Europe for a while.

Best Buy

Despite meeting its cost-cutting targets, Best Buy struggles to boost its growth. In the U.S., same store sales were flat during the first quarter. The industry continues to suffer from a slowdown, as seen in the numbers published by the NPD Group[1], which have declined by 1.9% over the same period.

Best Buy represented an important weight in our portfolio at the beginning of the year. We have progressively reduced it in January and following first-quarter results. The

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[1] The NPD Group covers 1,200 retailers, totalling 165,000 stores. The category used for comparison by Best Buy is the consumer electronics. It contains televisions, computers, tablets excluding Kindle, digital imagery and a few others. This category covers roughly 65% of Best Buy's sales.

industry in general is facing headwinds, and other opportunities abound in the stock market. So we did not hesitate to reduce.

Following its price correction in June, we added to our position. We will continue to seize price opportunities and closely follow the company in this difficult environment.

AIG Subscription Warrants

In our last letter, we mentioned this insurer was in our sight, with the arrival of activist Carl Icahn. The stock is now part of our portfolio, through subscription warrants.

These allow us to profit from a leverage effect. Each warrant gives the right to acquire 1,009 common shares at a price of $44.58. At first, the exercise price was $45. However, a protection mechanism against a regular or special dividend payment brings both a price and exchange ratio adjustment in case of exercise. With the current quarterly dividend of $0.32, we are getting a return equivalent to the one of common shareholders.

Our position is currently 3%, but with a leverage of two to three times, we consider our real position to be 6% to 9%. At all times, we remain prudent with these instruments, by limiting our weighting. The conversion to a common share equivalent allows us to keep in perspective the total financial impact the warrants have on the portfolio.

Other Holdings

Five new holdings joined the portfolio during the first semester: Franklin Resources, Dillard's, Macy's, Nordstrom and Hugo Boss.

The first one is an asset management firm, similar to ours, except its size differs. Franklin managed $732B as of last June. It offers a diversified range of funds, with half of the assets in fixed income and the other half in equities. The firm is a strong active manager, and faces challenges with the current trend towards passive investment vehicles at much lower costs. We like its balance sheet, with plenty of cash, and the stock has rarely traded at such an attractive price.

The other four securities all operate in the clothing retail segment. The sector is hit by what appears to be a change in consumer behaviour. Store visits are declining as on-line purchases gain in popularity. Same store sales have also been impacted, considerably dragging down stock valuations. Many of them hold significant real estate assets, which adds a margin of safety for patient investors. We believe current multiples offer investors an interesting risk/return profile.

Management Fees

The fund's return, in 2015, was 4.69% before fees, and 0.79% after fees. We explained in our last letter the reason for this difference, created by the payment of quarterly performance fees.

Although this method does not disadvantage our unit holders in the long term (through the existence of a "high water mark"), we took measures to avoid this type of distortion from occurring in the future.

From 2017 onwards, performance fees will be charged on an annual basis, as opposed to quarterly. Therefore, fees will only be paid when returns are kept until year-end, in line with yearly performance.

Regards,

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Maxime Lauzière