



**Northern Rivers Capital Management Inc.**  
 Royal Bank Plaza  
 North Tower, Suite 2000  
 200 Bay Street, PO Box 66  
 Toronto, Ontario  
 M5J 2J2 Canada

Tel: 416.597.1226  
 Fax: 416.597.8926

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Dear Partners and Friends:

December capped a miserable 2008 with continued forced selling in financial markets (as many hedge funds wound up operations, and those continuing to operate de-leveraged), a deepening of the severe recession that is still unfolding, and the most intense tax-loss selling season that anyone I know can remember. Taken on their own, the core positions in the portfolios did not do too badly in December; it was “farm team” positions, as well as taking further write downs and write-offs in the private portion of our portfolios that gave the Innovation mandate one final drubbing for 2008. The Northern Rivers Innovation Fund LP (the Innovation Fund) was down -13.65% in December, and the Northern Rivers Innovation RSP Fund (RSP Fund) was down -12.12%.

	Average Annual Returns to December 31, 2008*							
	2008 YTD	1 mo.	3 mo.	6 mo.	1 Yr.	3 Yr.	5 Yr.	Inception**
<b>Northern Rivers Innovation Fund LP</b>	<b>-65.23%</b>	<b>-13.65%</b>	<b>-45.56%</b>	<b>-64.49%</b>	<b>-65.23%</b>	<b>-13.22%</b>	<b>-2.52%</b>	<b>8.96%</b>
<b>Northern Rivers Innovation RSP Fund</b>	<b>-64.60%</b>	<b>-12.12%</b>	<b>-43.42%</b>	<b>-62.74%</b>	<b>-64.60%</b>	<b>-11.76%</b>	<b>N/A</b>	<b>-5.69%</b>

\*\*Northern Rivers Innovation Fund LP inception date: May 8, 2001.  
 Northern Rivers Innovation RSP Fund inception date: March 1, 2004.

It has been shocking and stunning to me, and very sad for all involved, to see just how many of my former competitors are now out of business, or in the process of winding up operations. Indeed, there are some on Bay Street who are surprised to see me enter 2009 still in operation. For still being here, I have to deeply thank:

- 1) first and foremost, my investors for sticking with me through this very difficult time, even as their faith in me must have been sorely tested, and
- 2) the management teams at the companies comprising my core positions, who have proven—at least from a business fundamentals and business model standpoint—that I was correct to stand by them through these past six months as the financial crisis and economic woes intensified. (By the way, don’t take from this statement that I haven’t learned anything from my experiences in the last 6-36 months; I will spend an entire section on “lessons learned”.)

Frankly, if I had arrived at the end of 2008 with the dismal performance I have had this year, AND a portfolio of fundamentally *broken* companies, I would have thrown up my arms in despair, apologized deeply to all of my supporters, and closed down my funds. HOWEVER, we have arrived at the end of 2008, yes, with the core stocks beaten down to levels I could never have imagined seeing again, BUT, in almost every case, both the business fundamentals *and* valuations of the core positions better than they have ever been. Based on those facts, I can do nothing but

resolve to persevere, believing that we will ultimately thrive again, and work to realize the value that I know is being created by the companies in these portfolios.

**A critical question: what economic outcomes are priced into the markets *already*?**

Trying to get a handle on that question is *almost* as important as trying to figure out what is *actually* going to happen in the economy. Another way to put this question: Will reality six to nine months out end up being better or worse than what was priced in at the lows of November and at current prices?

In partial answer to that, I think two examples are worth exploring:

- 1) The XEG: The XEG is the ETF symbol for the TSX energy stock index. The XEG hit \$12.00 on October 16, 2008. Crude oil closed at about \$70 that day. Today, with oil at close to \$35, the XEG is 15% higher than it was on October 16<sup>th</sup>. That is really quite startling: oil is 50% lower, yet the energy index is 15% higher, and the XEG chart actually looks quite constructive. In October, I don't think there was *anyone* predicting that oil would be at \$35 by mid January, let alone *anyone* predicting that oil could be 50% lower (at \$35), and the energy index could be simultaneously 15% higher than when oil was at \$70. This makes one's head spin. Yet, it also points to the extent to which markets had already, back in October and November, priced in some horribly bad scenarios for oil stocks.
- 2) Nvidia: Nvidia (NVDA on the NASDAQ) makes graphics chips found in many desktop and laptop computers. The stock's low so far was \$5.75 on November 20, 2008. Around that time, they told the market they expected Q4 revenue to be down 5% sequentially (their fiscal Q4 ends on January 25); then, on January 13, they told the market that they now expected Q4 revenues to be down 40%-50% sequentially. Anyone following this stock expected it to be killed. Stunningly, the stock ended up four cents on the day at \$7.65. This suggests that, at the stocks low of \$5.75 on November 20, the stock was *already* factoring in a WORSE outcome than a 50% sequential revenue decline in Q4. Amazing.

The point of these two examples is that markets, during the October-December timeframe, priced in some pretty horrible (and at the time *unimaginable*) outcomes. In a sense it comes back to something I wrote in the last letter: "The 40%-60% declines seen in major global equity indices in the September-November timeframe have ALREADY told us that the North American and global economies are going to get MUCH worse between now and next May..." (These examples also bring us back to many of the ideas expressed in Warren Buffet's October 16, 2008 New York Times op-ed including: "Bad news is an investor's best friend. It lets you buy a slice of the future at a marked down price.")

**Although I feel strongly that 2009 will be significantly better than 2008 in the markets, that is not a particularly heroic statement: how *much* better is the important question**

Ten out of ten equity strategists quoted in the recent Barron's magazine are expecting the S&P500 to rise 10%-20% this year. I react to such unanimity in the same way that Ken Fisher (a portfolio manager who writes a monthly column for Forbes) does: it almost surely must be wrong; we will almost surely do either much better or much worse than that.

So, for purposes of this discussion, I will lump possible market outcomes into three categories:

- 1) much better than 20%,
- 2) -10% to +10%, and
- 3) worse than -10% (which would feel much like 2008).

I spent much of the last three weeks reading as many bullish and bearish arguments as I could find. I read the Barron's annual Roundtable, countless forecasts by countless investment and economic research firms, Don Coxe, ISI, Eric Sprott, and Doug Kass's "Top 20 Surprises for 2009" (Kass's surprises were surprisingly bullish, for such a renowned bear). I also re-read all four of Warren Buffett's op-ed pieces that he has written since 1974 (link provided here for those that are interested: [www.tilsonfunds.com/4BuffettMarketCalls.pdf](http://www.tilsonfunds.com/4BuffettMarketCalls.pdf)), and spent a lot of time pouring over the "raw data" that economic research groups like ISI produce.

One of those people that I am happy to see has come out in favour of the "much better than 10%-20%" outcome is Byron Wein, formerly a senior Morgan Stanley strategist, and now Chief Investment Strategist of Pequot Capital Management. Among his credibility-boosting credentials, he predicted the 2008 recession, and forecast a down market for the year (although his market forecast for 2008 was not as glum as the actual devastation experienced). He is careful to say that his 33% "surprise" return for the S&P500 is based on a back-end-loaded *economic* recovery that will not show any signs until the second half of the year. The two analytical pieces that most impressed me, however, were the forecast by John Mauldin (an independent analyst who has had an impressive track record of identifying key economic and market drivers, especially over the past five years), and the January 9, 2009 "Global Investment Strategy" piece from BCA Research (formerly known as The Bank Credit Analyst).

John Mauldin's piece (link provided here: [www.frontlinethoughts.com/gateway.asp](http://www.frontlinethoughts.com/gateway.asp) January 10th issue) is quite bearish about 2009, clearly supporting either scenario 2 or scenario 3. His views are best summed up by the following quotations: "...the U.S. and much of the world are going to see their economies shrink for at least another year...[the markets] will at the very least test the [November] lows this summer, if not set new lows." His caveat is for a potential upside surprise (i.e., the monetary and fiscal stimulus being more effective, more quickly than he envisions), and he writes "I expect this year will bring a few surprises that will cause me to change my opinion; when the facts change, I will try to change with them."

The BCA piece, on the other hand, is supportive of scenario 2 (or better) returns. In the first paragraph on the second page of the piece, there is a sobering statement that is seemingly at odds with their ultimate conclusions: "Chart 1 shows that all signs point to a very disruptive and devastating economic contraction in the first quarter." (Of course, that is exactly what the 40%-60% declines in global equity indices between September 1 and November 30, 2008 *already* told us...) The BCA's chief strategist (after carrying a very low equity exposure through most of 2008), points out that he started increasing equity/risk exposure in October of 2008, and in the piece *he argues for continuing to increase exposure to equity/risk on pullbacks*. In a sense, the BCA piece provides quantitative underpinnings for Buffett's mantra "Be greedy when others are fearful, and fearful when others are greedy."<sup>1</sup>

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<sup>1</sup> Note that Buffett has continued to stand by his New York Times op-ed of October 16<sup>th</sup> of last year, in which he exhorted investors to buy stocks NOW.

One of the aspects that I found most useful about the BCA piece is that they provided some very valuable historical perspective on depressions of the past (the “Great Depression” and Japan’s “Lost Decade”) together with arguments as to why they don’t believe a depression will unfold now.

Some of the most valuable perspective they provide is simply reproducing a graph of U.S. GDP and M2 Money Supply from 1922-1938. It shows that U.S. nominal GDP fell 10% (yes 10%!!) in 1930, the first year of the Great Depression. *U.S. nominal GDP continued to fall dramatically every year for four years (until December 1934), bottoming almost 50% (yes, 50 %!!) below the peak from December 1929.*

Comparing the Great Depression numbers to what has happened so far today (and to what bearish forecasters are expecting going forward) shows that a truly-depression-like outcome has an extremely low probability. (I am not going to tempt fate by saying “zero” or “impossible”.) For example, it was stunning to me when I looked at the underlying numbers from the first twelve months of *this* recession: U.S. nominal GDP has likely fallen NO MORE THAN 1%. In fact, when the final numbers for this year are published, the facts will likely be staring us in the face that nominal GDP was UP during the first twelve months of this recession. (To reiterate: nominal GDP fell 10% in the first year of the Great Depression.) Further, if one looks at the underlying nominal GDP numbers for even the most bearish forecasts<sup>2</sup> for Q1-09 and 2009 as a whole, they show a sequential decline of only 1.2% for Q1-09, and a decline of no more than 3% or 4% for 2009 as a whole. Even the most bearish forecasts<sup>2</sup> for this recession (such as those by analysts like John Mauldin) actually only imply a peak-to-trough decline of something like -5% in nominal U.S. GDP. (Compared to the -50% experienced during the Great Depression, this is a cakewalk.)

This ties into an important point: one of many sources of confusion and fear in the current recession stems from the way U.S. GDP is expressed when it is reported and forecast every quarter. To illustrate: right now, published forecasts for U.S. Q4 GDP are sitting around -6%. This is what you see in the papers and hear on the business channels. The critical point to note is that this is a “quarter-over-quarter ANNUALIZED” number, which would equate to only a 1.2% sequential (quarter over quarter) decline. The problem is that the media reports the -6% forecasts without explaining what it actually means, so when someone hears of a -6% forecast for Q4 and -4% or worse forecast for Q1, they think it means a drop of 10% in GDP in six months. **THIS IS NOT WHAT IT MEANS**; unfortunately, on top of VERY REAL and legitimate fears about jobs, etc., this adds to people’s terror.

### **Back to the issue at hand: what IS my base case for the economy and markets for 2009?**

To summarize: a LOT of bad stuff has already been priced into stocks and the markets as a whole. If what we end up with is a severe recession (which is what I believe is currently in process), then I think the markets will be scary and choppy this year, but ultimately ok, probably in the -10% to +10% range. (I would certainly welcome being wrong in the direction of Byron Wein’s “+33% surprise”, but I doubt that is likely.) On the other hand, if we are truly headed into a depression, then the markets have further downside.

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<sup>2</sup> Other than the forecasts of people actually calling for something resembling The Great Depression II.

So, I am moving forward on the basis of a -10% to +10% year in the markets. This will not feel comfortable. It will be choppy, and sometimes (like this week) scary. I don't believe a "true" depression is a possibility, however, given the massive fiscal and monetary stimulus being provided globally. Obviously, I will be thrilled if the markets in 2009 return anything greater than 10%, but I believe it is more realistic and appropriate based on the difficulties still ahead to plan for -10% to +10% as being the likely outcome. *Fortunately, this should also be a market outcome under which I believe the core positions would ultimately perform well*, if even half of the company-specific developments I am expecting come to pass. 2008 was not a "stock-pickers" year; it was an "asset-allocators" year, i.e. if you got the asset allocation right, you did better than almost everyone else. (I clearly got the asset allocation horribly wrong.) On the other hand, if 2009 is a -10% to +10% year in the markets, it becomes a stock-pickers year, and I welcome that.

### **Looking at this from the standpoint of the core positions...**

On a one year basis, I believe that the core positions have very likely put in their bottoms already; how large the gains in their share prices will be this year will depend partly on whether we get scenario 1, 2 or 3, and partly on how powerful the fundamental developments are on a company-specific basis. Importantly, given my macroeconomic view (that the U.S. and global economy bottoms somewhere between May and December of this year), I am much more confident *on a two year basis* that each core position will be at a multiple of its current price by then. I still believe that in the long-term, the best way to invest in the stock market is to invest in the shares of companies that are on long-term secular growth paths, and *I believe that the secular growth path for each of my core positions remains intact*.

### **This brings us to the "lessons learned" section that I promised earlier**

I have arrived at the end of 2008 with many of my beliefs about investing intact (and even reinforced), but clearly, my results say that there is much I could and should have done differently, and therein lie lessons about how to improve my portfolio management process.

### **Lessons learned**

1) Lesson learned about managing the "core positions": this lesson is more about what to do when times are good than when times are bad. Simply put, I need to be more disciplined about trimming the core positions *even when everything is going well with respect to the core investment hypothesis, and in the economy and markets*. I am working on rules of thumb to apply here, but based on the fact that my core positions seem to go through two year cycles of up, followed by 12-24 months of mean reversion, it suggests that I should almost robotically be a trimmer of those positions after they have done well for 18-24 months. (Clearly, we are nowhere close to that now!) I will be putting more thought into this one, but however I proceed going forward, it will mesh well with an important half of Buffett's mantra: "Be fearful when others are greedy, and greedy when others are fearful." (i.e., I seem to get the "be greedy when others are fearful part" quite well...)

2) Lessons learned about managing the "farm team": it was painful for me to count up the losses I took this year from the part of the portfolio that I consider the "farm team". The two lessons here would be a combination of 1) being more disciplined about what goes onto the farm team in the first place, and 2) being even more brutal about selling farm team positions once it is clear that a recession has hit.

3) Lessons learned about *not* extrapolating the micro to the macro: I have been asked whether I simply wasn't able to see the extent of the ugliness in the macro economy because things were

going so well *fundamentally* in my core positions. Upon reflection, I have to admit that must have been part of my problem. It is a wake-up call not to confuse the micro with the macro; treat them separately, and act accordingly.

I will end the “lessons learned” section with a “positive” lesson. What I mean is that I will end with a lesson that reinforces something about the *validity and strength* of my basic approach to the due diligence process. It’s a different way of expressing what I wrote in the last paragraph on the first page of this letter: I strongly believe that the reason we *didn’t* arrive at the end of 2008 with a portfolio of core positions with broken fundamentals is that my due diligence process (seeking out “off the beaten path” industry conferences where I am—hopefully—the only financial professional, and where the sales people of the companies in that industry are mixing it up with their clients, competitors, suppliers and partners) really does do a good job of identifying companies with a “sustainable competitive advantage” that can remain on secular growth paths for years. In fact, seeing how much fundamental progress each of my core positions had made over the past two years (even as their stocks declined over that same timeframe to unimaginably painful levels) was what kept me going as the year drew to an agonizing close. At least I had been right that these were good companies that could continue to grow even under the most difficult of circumstances, and we should ultimately be able to benefit from that secular growth path as it unfolds. So again I say: based on those facts, I can do nothing but resolve to persevere, believing that we will ultimately thrive again, and work to realize the value that I know is being created by the companies in these portfolios.

### **In closing**

I will leave you with the following excerpt from Warren Buffett’s October 16, 2008 op-ed in the New York Times, which seems particularly appropriate given the trauma we are currently still going through: “In the 20<sup>th</sup> century, the United States endured two worlds wars, and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced President. Yet the Dow rose from 66 to 11,497. You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so, and then proceeded to sell when the headlines made them queasy.”

I give thanks to my investors who have been able to hold on, or even invest more, when the headlines and the reality around them (and my returns) made them queasy; I thank them for their patience and belief that we will ultimately thrive again.

Best regards,

A handwritten signature in black ink, appearing to read "Hugh Cleland". The signature is fluid and cursive, with a large initial "H" and "C".

Hugh Cleland, CFA  
Portfolio Manager

\*Commissions, trailing commissions, management fees, performance fees and expenses all may be associated with investment funds. Please read the offering memorandum before investing. The indicated rates of return are the simple returns (YTD, 1 mo, 3 mo, 6 mo) or the historical annual compounded total returns (1 yr, 3 yr, 5 yr, and since inception). All returns are net of fees but do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.

The Innovation Fund and the RSP Fund invest primarily in North American equities with a sector focus on technology, healthcare and resources. Geographic and sector allocations may, however, vary significantly over time. Investments made are primarily in small cap companies believed to be trading at a discount to their intrinsic value and which offer innovative products and services and a sustainable competitive advantage. The funds normally follow a more concentrated investment approach where the manager may overweight selected core holdings and industry sectors in which the manager has particular conviction and/or specialized expertise. The funds may engage in short selling and may also use specified derivatives, such as calls and puts, warrants, index futures and exchange traded funds. In addition, the fund is permitted to hold private entities that are not included on any public markets or indices. This may result in portfolio weightings and investment performance being substantially different from that of the S&P/TSX Composite, TSX Venture, Dow Jones Industrial or other market indices.