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Dear Partners and Friends:

The first quarter of 2009 saw extraordinary volatility in financial markets, with new bear market lows being set in the first week and a half of March, followed by the best equity market rally (as measured by many factors) since 1982 (which happened to mark the beginning of The Great Bull Market of 1982-2000). The volatility is well captured by the following statistics:

- 1) As of March 9, 2009, year-to-date returns for the S&P500 and the TSX were -25.1% and -15.8% respectively. (This, of course, was on top of the devastating declines already seen in calendar 2008.)
- 2) From March 9 to March 31, 2009, the S&P500 and TSX rallied +17.9% and +15.2% respectively.
- 3) The net effect of the decline and subsequent rally was that the returns for the S&P500 and the TSX in calendar Q1 were -11.7% and -3.0% respectively.

The Northern Rivers Innovation Fund LP (the Fund) was much less volatile than the markets during the quarter (ending the quarter down 3.92% as of the close March 31, 2009) in part because a material portion of the Fund was in private companies at the beginning of the year, and in part because most of the public companies (with the notable exception of Webtech) put in their 52-week lows in the October-December timeframe of 2008.

Average Annual Returns to March 31, 2009*

	2009 YTD	1 mo.	3 mo.	6 mo.	1 yr.	3 yr.	5 yr.	Inception**
Northern Rivers Innovation Fund LP	-3.92%	1.78%	-3.92%	-48.22%	-63.32%	-20.06%	-5.18%	7.98%

**Northern Rivers Innovation Fund LP inception date: May 8, 2001.

In the midst of the worst recession since WWII and the accompanying market volatility, I continue to be happy with the way the *business fundamentals* are playing out for our core positions, and I am now much happier with the way the stocks are behaving technically: almost all of our core positions have now made technical upside break-outs (on strong relative volume) above their 50-day moving averages (with Webtech having finally made this move in the past week), and Neptune (which is our best performing core position year-to-date) having broken out above its 200-day moving average on April 14, on its third highest volume day of the year. The six-month chart for NTB is truly a thing of beauty, having just yesterday set a new recovery high on its *highest* volume day of the year. Aeromechanical and Webtech, too, look poised to make similar breakouts.

An important performance characteristic about the funds I run: historically, their performance has always lagged the broader markets by 1-3 months coming out of mid-to-long-term market bottoms (such as September 2001, October 2002 and March of 2003), before ultimately catching and

surpassing the indices. This appears to be unfolding again, with the Fund having lagged the market rebound in March, but now (at least so far) playing catch-up because of strong up moves in most of our publicly traded core positions in April. If appropriate, I may address this dynamic in more detail in coming letters.

Where does my base case stand?

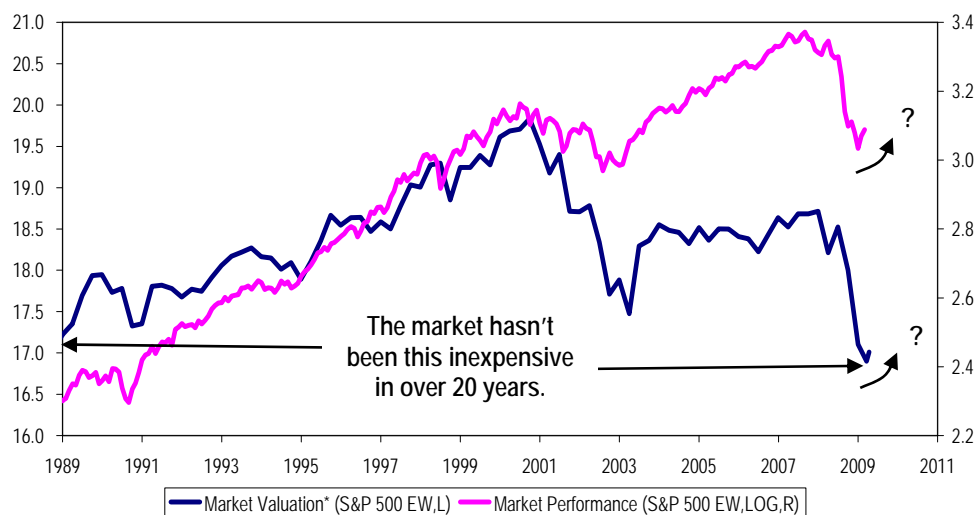
As of March 9, with the major indices being down anywhere from 15% to 25% year-to-date, and with the NASDAQ100 being the only major index in the western world hanging in above its November 20 lows, my base case of -10% to +10% returns in the U.S. markets and a bottoming in U.S. GDP in Q4 was looking increasingly over-optimistic. Developments since March 9, however, (including most notably the beginning of “quantitative easing” by the U.S. Fed) indicate that I may yet be proven correct in this scenario. (The advent of quantitative easing has even caused many of the believers in depression-scenarios to reconsider their apocalyptic visions—although it has reinforced their strong belief in gold as an asset class.)

An April 14, 2009 research piece by ISI titled “Finding value in equities after a 25% recovery in the market” provided a nice summary of an economic and market view that makes sense to me following the unprecedented avalanche of fiscal and monetary stimulus that has been thrown into the global economy by governments and central banks around the world:

“It is difficult to believe in a market rally when it is the fifth one of the past year, all of which fizzled out and ended in the market making new lows. It is even more difficult to enter equities when the index is up a full 26.9% in little over a month. We have argued in our strategy work that this rally is a little different from the prior ones because it seems to be happening alongside a pick-up in economic *prospects*, or *leading* indicators. This is what makes it legitimate in our opinion. The rally is based on economic improvement, not just an oversold pop. Still, investors appear skeptical. One of the many pushbacks we have received is that there is no value left after the recent rise in stocks. Interestingly, our preferred valuation tool, a concept called “equity duration”, indicates that the market is still inexpensive by historical standards (see below).

Valuation

Valuations Not A Headwind To The Market ... Even After Such A Big Rally!



Current valuations continue to suggest the market offers a good tradeoff between risk and return.

Indeed, the chart above shows that the market is just slightly higher than it was a month ago, and is still cheaper than at the bottom of the recession of the 1990s. In essence, our work shows that valuation is not a headwind for stocks yet. Of course, no one should ever buy the market because of valuation alone. It is but one part of the equity equation. Still, at this juncture, valuation is a green light for investors. As we cover in the following pages, our valuation tools detect the most value in small-caps and in growth indices. Moreover, our measure of ‘equity duration’ prefers the cyclical sectors of the market (technology, energy and discretionary) over the more defensive segments (telecom, utilities, staples).”

Some important points regarding ISI’s view, and some caveats

ISI’s strategist has been quite consistent in this view since January, telling investors that they expected an improvement in leading indicators to begin sometime in Q1 or Q2, and on that basis, investors should start legging into more cyclically-oriented equity exposure (technology, energy, discretionary) over the course of Q1 and Q2, but should not become overly committed to remaining positioned for a recovery until the leading indicators actually legitimized such positioning. Fortunately, the leading indicators have come through as ISI’s strategist was hoping.

ISI’s position is actually quite similar to The Bank Credit Analyst (BCA) as laid out in their January 9, 2009 Global Investment Strategy piece (which I cited in my January 16 letter). BCA’s position has been remarkably prescient: in the first paragraph on the second page of the piece, they made a sobering statement that was seemingly at odds with their optimistic conclusions and aggressive investment recommendations: “Chart 1 shows that all signs point to a very disruptive and devastating economic contraction in the first quarter.” The BCA’s chief strategist was arguing in the piece, however, that investors should be increasing exposure to equity/risk on the pullbacks that would accompany the devastating economic contraction, because they expected (similar to ISI) an improvement in LEADING indicators to emerge in late Q1 or Q2—an improvement which would be reflected in the equity markets at about the same time.

The most important point to be made about the position of the BCA and ISI is that there is a critical distinction between an improvement in economic *prospects* (as embodied by leading indicators) and an improvement in the *economy*. The idea is that the economy can continue to contract sequentially for quite some time even after economic prospects/leading indicators have turned up. In fact, both the BCA and ISI are expecting U.S. GDP to contract sequentially through at least Q3 or Q4 of 2009 before bottoming (at earliest) in Q4. YET, strategists at both organizations believe that Q1 and Q2 are the time to be gradually increasing one’s exposure to equity/risk!

The key is that leading indicators are now indicating a bottom in U.S. GDP in Q4. *In order for this rally to be sustainable, this anticipation actually has to turn out to be correct*, and this is something we will only know with certainty in retrospect. (Also note, however, that this means the rally can be sustainable *even if* U.S. GDP continues to decline sequentially until Q4 i.e., even if the economy and the accompanying news continues to get *worse* until Q4! In order for the rally to be sustainable, what we need is the economy to become worse at a decelerating rate until GDP finally bottoms in Q4, and Q1 2010 GDP cannot be sequentially worse than Q4 2009.)

So what kind of macro developments could underpin a bottom in U.S. GDP in Q4-09?

Setting aside for a moment the lagged effects of the massive monetary and fiscal stimulus (which should start to be felt in the second half of 2009), I keep coming back to two critical variables driving corporate profits (inventory destocking and cost-cutting) which suggest that we will start

to get an upturn in year-over-year aggregate corporate profits by Q4 at the latest. (This is important because it is an upturn in profitability which will lead to actions such as a resumption of hiring at companies, or at the very least, a cessation of lay-offs.) To oversimplify: two of the most important features of this severe recession have been a massive destocking of inventories and massive corporate cost-cutting. CFOs and CEOs on a number of earnings conference calls this past week (Intel's and Nokia's to cite two) have explicitly stated that the inventory destocking process is either finished, or is almost finished. The importance of this is that once the destocking process is "complete", then new orders from customers actually result in new production. Simultaneously, massive cost cutting has been implemented. So, with inventory destocking having almost run its course, and massive cost-cutting having resulted in cost structures where much lower levels of revenue will result in accelerating profitability, many companies are now positioned for a turn in sequential profitability by sometime in the Q2 to Q4 timeframe, as incremental orders lead to new production, which should in turn lead to (at least) a halt in the lay-offs, or perhaps even some new hires by Q3 or Q4.

The points I am making here tie in well to the section of my January 16, 2009 letter in which I grappled with the question "what economic outcomes are priced into the markets already?" by looking at the behaviour of Nvidia's stock (NVDA on NASDAQ) and the XEG (an ETF for the TSX energy index). Interestingly, the XEG put in its bear market low on October 16 (despite the fact that oil was at \$70 then and subsequently declined to the low \$30s), and NVDA put in its low on November 20—despite the fact that they warned of a 50% sequential revenue decline on January 25. The point of the two examples (which are worth a re-read if one has the time or inclination) is that markets, during the October to December timeframe, priced in some pretty horrible (and at the time unimaginable) scenarios. Yes, those unimaginable scenarios *have* come to pass, but the markets were *already* pricing them in (or even something worse) *well before* they happened. Once again, it reminds us of the wisdom of Warren Buffett's quote from his October 16 New York Times op-ed: "Bad news is an investor's best friend. It lets you buy a slice of the future at a marked down price."

"We are on a volatile journey to a new normal"

I first heard these words spoken by Mohammed El-Erian, the CIO of PIMCO, during an April 7, 2009 appearance on CNBC. It makes a lot of sense to me, and in fact captures in one sentence a number of concepts that I have been struggling to explain to myself. On April 16, El-Erian expounded on this concept in another appearance on CNBC: "The global economy and global markets suffered a major cardiac arrest in September, ended up in the ICU, an enormous amount of medicine was administered, and now we're seeing certain parts stabilize." Those stabilized parts include financial markets, the credit markets, and certain banks, but certain parts of the economy (such as housing) are not yet recovering and are still under pressure. "The patient as a whole is somewhat stabilized, but far from cured, and we're going to continue getting mixed signals...*The critical thing to remember is that when the patient comes out of the ICU, he or she will be different.*" He believes (as do I) that when the economy makes a full recovery, there will be much less leverage and credit, more government intervention, and more caution on the part of consumers. "The result of that is an economy that grows less fast than it has in the past." This will be the new normal.

We aren't there yet, and the journey to get there will be volatile and sometimes scary, but I believe that, with the avalanche of global fiscal and monetary stimulus which has been unleashed, we HAVE emerged from the worst of it, at least in terms of full-blown financial market seizure. This does *not* mean that phenomena such as a 1980-82-style double-dip are *not* possible; it also does

not mean that economic growth has bottomed—GDP will continue to decline in many parts of the world for a while longer. BUT, (and this is a very important ‘but’), it does mean that we are now in an environment that will allow companies on a secular growth path to thrive, both as companies and as stocks. Two points further to this:

- 1) in the “new normal”, growth will be more scarce in the past, meaning that companies that are actually on a secular growth path will be more scarce, and therefore, likely more valuable.
- 2) I continue to believe that all of our core positions remain on a secular growth path, and will actually grow their top-line and bottom-line in 2009 (recent guidance and developments at Webtech, Neptune and Aeromechanical certainly reinforce this assertion); if they can do this in 2009, imagine what they will be able to do in “the new normal”, once we get there.

A couple of notes in closing

In the last letter, I wrote that I would resume the in-depth review of our core holdings in *this* letter, starting with Neptune. This month, however, it appeared to make more sense to give priority to a detailed review of macro/market considerations, given the remarkable developments of the past two months. Further, I believe it makes sense to wait for some significant developments in Neptune’s food ingredients and pharma divisions before doing the detailed review of the investment hypothesis, because those food ingredient and pharma developments will allow me to do a more comprehensive sum-of-the-parts analysis, with the relevant facts in hand. (It is worth noting that I believe that the stock at its current prices is still only giving value to the nutraceuticals division, and owners of the stock are getting the “call options” on the food ingredients and pharma divisions for free.)

Separately: for those who have an interest in reading a discussion of Northern Rivers’ investment in Gastem, please refer to page two of Alex Ruus’ current monthly letter.

Thank you for your patience and trust as I strive to catalyze the value that I know is being created by the companies in the portfolio.

Best regards,



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 Fund invests 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 Fund normally follows 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 Fund 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.