



Northern Rivers Funds
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Dear Partners and Friends:

The Northern Rivers Innovation Fund (“the LP”) was down 21.3% in June and the Innovation RSP Fund (“the RSP Fund”) was down 17.5%. The returns as June 30 are set out below. It goes without saying that these portfolio returns - as well as those of last month - reflect disheartening (and **not** anticipated) market valuations of the core positions.

	Average Annual Returns to June 30, 2010*							
	2010 YTD	1 mo.	3 mo.	6 mo.	1 Yr.	3 Yr.	5 Yr.	Inception**
Northern Rivers Innovation Fund LP	-32.49%	-21.32%	-29.42%	-32.49%	-41.35%	-37.69%	-9.24%	3.68%
Northern Rivers Innovation RSP Fund	-22.31%	-17.55%	-21.61%	-22.31%	-16.63%	-29.79%	-2.49%	-4.24%

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

It is apparent that since the late Spring of 2008, it has generally been a mistake to be invested in non-resource, small/microcap Canadian companies. The situation has been compounded for the LP and, to a lesser extent, for the RSP Fund by being “under diversified”, and by a series of company-specific, negative developments at Webtech Wireless.¹ “Under-diversification” worked favourably, for the most part, from the inception of the Funds until late Spring/early Summer of 2008. At that time, the market and economic backdrop changed to an extent I simply did not imagine ever happening, and under diversification has worked in reverse for the Funds since then.

So where do we go from here? As I sit here writing on July 12, 2010, I do not believe it would be in the best interests of my investors to liquidate any of the core positions at current prices. I remind investors of something I wrote following the conclusion of the -65% year we experienced in 2008: “If I had arrived at the end of 2008 with...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.”

The key aspect to the current situation is that none of the core positions are fundamentally broken companies. With the returns experienced in the last two months, one would be inclined to think otherwise, but I still believe that their investment hypotheses are intact. Unfortunately, in the current economic and investment climate, the valuations put on these companies by investors will reflect market conditions. As a consequence, negative incremental developments will have a disproportionately large impact compared to positive developments.

¹ Having said that, the recent insurance industry win—a purchase order of 10,000 units by their UK-based distributor—may represent the inflection point for Webtech’s fortunes.

A look at the universe of other non-resource, small/micro cap companies

I will start by simply going through the returns of the LP's four largest positions (Neptune, Webtech, Vendtek and Aeromechanical), versus their best comparables. I am using the percent decline from 2010 closing highs as the comparative statistic for all stocks cited below.²

- Neptune is down about 42% from its 2010 high; three of Neptune's best comparables are down 67%, 65% and 21%, respectively.
- Webtech is down 49% from its 2010 high; three of Webtech's best comparables are down 63%, 47% and 19% respectively.
- Aeromechanical is down 46% from its 2010 high; its two best comparables are down 61% and 33% respectively.
- Vendtek is down 19% from its 2010 high; its two best comparables are down 21% and 57% respectively.

Looking outside the core positions and their comparables, the carnage is generally similar. Sensio, a former high-flying IP-licensing story, is down 73% from its 2010 closing high. Intermap, another formerly widely-held Canadian small cap company, is down almost 70% from its 2010 closing high. Even Electrovaya, a company which has seen a number of truly company-transforming developments in 2010, is down almost 1/3 from its 2010 closing high. Indeed, looking at a universe of 38 non-resources, Canadian small/micro-cap stories that I have followed for several years:

- 10 (or 27% of them) are now trading in the \$0.03- \$0.10 range;
- 20 (or 52% of them) are now trading 25%-75% below their 2010 closing highs; and
- Only 8 (or 21% of them) are now trading within 20% of their 2010 closing highs.

In citing these statistics, I do not mean to be 'making excuses'. I am setting out these comparative statistics so that Fund investors will understand that the sharp declines in the share prices of the core positions do not necessarily mean there is anything horribly wrong with the *businesses* of the companies in the LP and RSP; similar declines have occurred in many small-microcap stocks. My stop-loss discipline for the core holdings (a discipline which worked well during the 2001-2007 timeframe) was never based on stock prices. It revolved around whether or not a stock's investment hypothesis was intact; I still believe that the investment hypotheses for the core positions remain intact. (I understand that this statement is only of limited comfort—if any—after the dismal performance of the funds.) The point of this section is that much of the move in the core positions' stock prices in 2010 has been in-line with the evisceration which has been visited upon most non-resource Canadian small/micro caps.

Completing an undertaking: an update on Vendtek

I have been waiting until after the FQ2 conference call to write in detail about Vendtek, as I was expecting updates on their initiatives in various parts of the world as part of this call.

² If anyone is interested in the names and symbols of the comparables, please ask, and I will send the list.

I am going to begin by framing this update with a very “big picture” view of the company: both Glenn Jamieson (the analyst at Macquarie that covers Vendtek) and I see many parallels between SXC Health Solutions and Vendtek, both in terms of the companies’ business model and in terms of the way Vendtek may grow over the coming years. (Indeed, a recognition of this parallel is why I pursued Gordon Glenn, the former Chairman and CEO of SXC to join Vendtek’s Board, and is one of the reasons Gordon agreed to join.) The simplest parallel in terms of business model is that both companies are, at their core, transaction processing platforms around which services can be layered.

The second parallel is in terms of potential growth profile. SXC’s revenue growth profile was as follows:

2006: \$80.9million 2007: \$93.1million 2008: \$862.9million 2009: \$1.438billion

Analysts expect 2010 revenue of \$1.95billion and 2011 revenue of \$3.1billion. Notable is that the revenue “catapult” between 2007 and 2008 was the result of a transformative and massively accretive acquisition.

Vendtek’s historical revenue profile is as follows:

2006: \$58.0million 2007: \$90.8million 2008: \$122.7million 2009: \$123.7million

The remarkable thing is that Vendtek has business opportunities (including expansions into new countries) as well as M&A opportunities (at the “right” cost of capital, which would be, say, a stock above \$1.00) which could “catapult” Vendtek’s revenue (and cash flow) similarly to the way that SXC’s was catapulted from 2008 onward.

With that framework having been set out, a bit of background is required before getting into the ‘here and now’ and looking forward part of the update. Recall that Vendtek was halted on February 9, 2009 because their new auditors (KPMG) could not reconcile the inventory balances that had been audited for October 31, 2008 by Vendtek’s prior auditors. As no quick resolution could be found, the stock had a “Cease Trade Order” imposed on it on March 9, 2009.

Unfortunately (*truly* unfortunately), it took over a year before the auditors and regulators were satisfied to the point where Vendtek was allowed to begin trading again, on April 22, 2010.

Importantly, no fraud or dishonesty or unethical intentions were discovered during the process of re-auditing 3 years of Vendtek’s financial history. Fortunately, KPMG decided to remain engaged as Vendtek’s auditor. Critically, Vendtek’s business developed reasonably well during the year that the stock was halted: the company was able to get licenses signed in 5 new countries, and in fact Vendtek grew its cash balance from the time of the halt until it began trading again, despite the fact the company incurred over \$1million in cash expenses related to legal and accounting expenses directly tied to the halt and re-audit.

Looking forward, I see at least two possible scenarios for the company's growth: the scenario that includes launching a business in Brazil, and an ex-Brazil scenario. (It should also be noted that various accretive M&A opportunities could be bolted on to either scenario, but I believe that management would like the stock to be closer to \$1 before making any acquisitions.)

Ex-Brazil scenario: Just looking at their current "book of business" (with full operations in Canada, and license deals in 7 countries), I would expect to see modest revenue growth, but dramatic growth in cash flow and net income, as the high margin (90%+) license revenue begins to accelerate (starting in calendar Q4, 2010) from the 5 countries signed in the last 12 months.

Brazil scenario: Vendtek has done a lot of groundwork preparing to launch a business in Brazil, Their business in Brazil would be similar to the business model they have in Canada. It is a matter of public record that Vendtek has hired a country manager and already has servers in Brazil processing transactions. But of course, until something is finalized, it is not done. IF they sign with one of the large Brazilian telecom carriers, this should allow Vendtek's growth to be catapulted in a manner reminiscent of what happened to SXC when they acquired NMHC. With points of sale (POS) in Canada doing an average of 2.5 transactions/day, versus likely closer to an average of 20 transactions/day for a POS in Brazil, and 143.7 million pre-paid users in Brazil versus only 4.9 million in Canada, one can see that revenue and cash flow growth should be able to take off dramatically in the event Vendtek can consummate a deal with a Brazilian telecom carrier. Based on simple math, it would appear that only 3,000 POS in Brazil could more than double Vendtek's revenue³, and have an even more dramatic impact on cash flow and net income. (For a point of reference: Vendtek has about 15,000 POS in Canada.)

Either way one looks at it, Vendtek's present business is solid, the future looks good (with accelerating cash flow and net income occurring under either scenario), and with the possibility of seeing a billion dollar top line a few years out, in the event of a successful roll-out in Brazil and/or opportunistic acquisitions.

A quick note on Webtech

The announcement on Friday, July 9 of a 10,000 unit contract with their UK-based distributor (specifically for installations with a UK-based insurance company) is solid evidence that Webtech is gaining traction with their insurance industry offering. As I have mentioned in the past, it is the insurance industry where the big upside lies for Webtech. Now, with their insurance customer in Mexico having ordered 10,000 units (6,800 units installed in customers' vehicles so far), the "proof of concept" for which we wait is traction with a US insurance company.


Where do we go from here?

Today the bottom line is that the core positions are once again trading at prices that I could not have imagined. My belief is that the market is significantly undervaluing them, but as some of you have pointed out to me, I have come to sound like a broken record on the subject. Not surprisingly, now is when hard-core contrarians have begun to get interested.

³ Based on the following assumptions, Vendtek would generate \$219 million from 3,000 POS in Brazil: 3,000 POS x \$10/transaction x 20 transactions/day x 365 days.

Some of the wealthy individuals I know (who got that way at least in part through their contrarian instincts) are poking around about how they can start putting money to work in this sector or in my funds. I just wish I had the capital to do the same.

Best regards,

A handwritten signature in black ink, appearing to read "Hugh Cleland". The signature is fluid and cursive, with the first name "Hugh" written in a larger, more prominent script than the last name "Cleland".

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. Commencing January 1, 2009, performance fees of 10% of net return above hurdle rate were paid by the Partnership.

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.