

THE INVESTOR'S DIGEST INTERVIEW

Risk management helps Northern Rivers fund steer clear of rapids

Hugh Cleland thinks a mutual fund need not always be fully invested. That's why Mr. Cleland, who runs the Innovation Fund for Toronto's Northern Rivers Capital Management, once left 40 per cent of his fund in cash. Other risk management techniques he uses include puts, calls and short selling



If Hugh Cleland knows more about mining exploration than most folks on Bay Street, it's no accident.

When he was just 16, he spent the summer at a mining camp in northwestern British Columbia, splitting core samples 10 hours a day, seven days a week — and getting paid \$10 an hour for doing so.

Five summers later, he did another mining stint in B.C., but at a different site.

And although the hours were long, the pay was OK and the food was good, says Mr. Cleland who runs the Innovation Fund for Toronto-based Northern Rivers Capital Management.

Moreover, the work — blowing up rocks and cutting down trees — was a lot more interesting than splitting cores.

Born and brought up in Toronto, Mr. Cleland, 37, was educated at Harvard University, where he earned a B.A. in political economy in 1997.

He co-founded Northern Rivers with Robert Blakely in May 2001.

At Harvard, you majored in international affairs. You even toyed with teaching the subject, while doing consulting work on the side. So what turned you on to fund management?

A summer job with Sceptre Investment Counsel in Toronto. It put me in touch with such visionaries as Jim Balsillie, the man who developed the BlackBerry. In fact, the first research report I ever wrote was on Research In Motion, the company Mr. Balsillie helped found. Yet, I don't regret the liberal arts education I got at Harvard. It taught me to think analytically. Indeed, I think it's Bay Street's loss that it often seems to prefer B.Comms, MBAs or CAs to liberal arts grads.

Tell us a little bit about your portfolio.

Set up in May 2001, the fund is designed for folks with high net worth. In fact, the fund's minimum initial investment is \$100,000. Our focus is on technology, health care and

resources — all sectors of high reward, but also high risk. So, if you think you won't be able to sleep at night when we hit a rough spot, our portfolio isn't for you. Yet, without the rough spots, we wouldn't get the good returns that we have. And our returns have been good. Since inception, we've had a compound annualized return of 30.5 per cent. And over the last 12 months, we've risen 64 per cent. As of Oct. 31, we had \$73 million in assets under management.

A part from the high initial investment, what else separates your portfolio from most mutual funds?

Our ability to short-sell, as well as use puts and calls. And unlike most funds, which have a mandate to be fully invested, we can theoretically hold as much cash as we like. (Our cash position has been as high as 40 per cent). This gives us a lot of flexibility. It also enables us to allocate assets according to our macro-economic view. And there are times when our view dictates we be only partially invested. At such times — the bear market of 2001-2002, for example — it's more important to focus on capital preservation than capi-

tal growth. Why be 100 per cent long in a bear market? You're only going to get killed. So for us, asset allocation is very important. I personally believe that a fund manager who's fully invested at all times is shirking his duties.

Most of your fund is invested in Canada and the U.S.

Because North American companies are what we know best. And in investing, it's important to stick to what you know. I suppose I could always learn about corporate practices in other parts of the world. But this would probably spread me too thin. And, it's practical, as a Toronto-based fund, to focus on Canada and the U.S. With any North American company, at most a five-hour flight away, due diligence, at least logistically, is relatively easy.

Your portfolio also focuses on small caps.

Because for maximum growth at prices that are comparatively low, small caps are hard to beat. Small caps aren't as picked over as large ones. You have that much more opportunity to snap up a growing company that hasn't yet

made a splash. Of course, we're not forever limited to small caps. We can switch to large caps, or any configuration we want. We can also add other sectors to our three main areas of investment.

Yet you do have a yen for all three sectors.

More accurately, a long-held interest. I became intrigued with high tech, as I've said, while at Sceptre. And biology was my favorite subject in high school. Why my interest in commodities? Common sense, I guess. In 2002, a bull market seemed to be looming in metals, minerals and the oilpatch. It didn't seem right to remain on the sidelines.

As a fund manager, you're probably deluged daily with dozens of investment ideas.

Ninety per cent of which I can eliminate right off the top — often in a matter of minutes. A company might be overvalued. Or its cash flow might be thin. And while high tech and healthcare abound with innovative ideas, many generate no cash. So, it's not as if I'm forever sinking beneath the waves. But I'll admit that one of the hardest things facing a fund manager is deciding how he should spend his time. Of those companies that do pass my quantitative screen, I look for a sustainable competitive advantage. And determining if a company has one is more of an art than a science. There are no hard and fast rules of what a competitive advantage actually is. Although all our core holdings have one, it differs from company to company. But when I do find a company with such an edge, I subject it to technical analysis — what I call the voodoo of stock charts. Technical analysis is useful in deciding when to buy a stock — and when to sell.

In your due diligence, you can veer off the beaten track.

I often go to industry conferences that are poorly attended by the Street, if that's what you mean. These are sessions where sales people mingle with competitors, as well as potential clients. They're also occasions where you often get the best sense of which companies have a competitive edge. In addition, you're able to meet key people. Take last January's conference of the National Ass. of Chain Drug Stores in Palm Beach, Fla. Not only was I the only attendee from either Bay Street or Wall Street, I ended up sitting beside the director of business development for one of Systems Xcellence's rivals. And since Systems Xcellence is one of my fund's top holdings,

this person was a godsend. Of course, in sizing up any company, I'll try to talk to its customers. For example, I just got back from Brazil where I met with clients and business partners of one of my top stocks. Conversations with such folks are crucial. After all, customers, unlike company brass, are less inclined to snow you.

You've already noted that Systems Xcellence is a top holding. But you also say it has defined a new business model.

A model that's enabled it to carve out a sustainable competitive advantage. Simply put, the company, which makes software, is changing the business of pharmacy-benefit management. And in doing so, it's giving rivals, such as Express Scripts, a run for the money. Meanwhile, its numbers look good. At 28 per cent, its EBITDA (earnings before interest, tax, depreciation and amortization) is high. The company is on track over the next few years to deliver robust revenue and earnings. It also has enough cash on hand to make an acquisition. If it does — and it has said it will — 2007 earnings stand to rise by \$0.10 to \$0.25 a share.

Neptune Technologies is another one of your top holdings. What's its sustainable competitive advantage?

A cholesterol-management product that's more chemically effective than the competition. Indeed, the company makes the most effective booster of HDL, or "good cholesterol." And because HDL is an important factor in lowering the risk of heart disease, Neptune's drug is important. In the meantime, the company is looking for a partner to commercialize the product as a drug.

WebTech, which is based in Burnaby, makes mobile wireless networks.

And because it makes the entire system — from software to hardware to user interface — it has a leg up on the competition. WebTech has worked hard to justify every sale on a stand-alone basis. It hasn't, in other words, sold at a loss just to bring in sales. Then, too, thanks to a deal it inked in January with Volkswagen Brazil, WebTech should see 2007 revenue rise as high as \$100 million — a more than fivefold increase, year over year.

Western Goldfields' principal asset is the Mesquite mine in California's Imperial Valley.

Which, because it was originally developed by another company, reduces the amount of money that Goldfields must spend on infrastructure. And, in Randall Oliphant and Raymond Threlkeld, chairman and president, respectively, Goldfields has managers that are world class. Both gents, you may recall, held senior posts at Barrick. In the meantime, the company remains a bargain, given the current price of bullion. At US\$500 an ounce, for example, Goldfields' net asset value is \$6 a share; at \$700 an ounce, \$9.50 a share.

Routers and switching devices made by QuStream are impervious to eavesdropping.

Giving this high-tech firm a big edge when selling to governments. Another plus? The efficiency of its products. For instance, one of QuStream's core devices does the job of three, put out by its closest competitor. Meanwhile, the company's comparative cheapness makes a takeover likely — possibly from Evertz Microsystems or Grass Valley, both of which are rivals.

STOCKS HUGH CLELAND LIKES

Systems Xcellence Inc.
(SXC-TSX; \$21.80)
Phone: 905-876-4741

Neptune Technologies
& Bioresources Inc.
(NTB-TSX/V-\$3.15)
Phone: 450-972-6291

WebTech Wireless Inc.
(WEW-TSX/V-\$3.20)
Phone: 604-434-7337

Western Goldfields Inc.
(WGI-TSX; \$1.75)
Phone: 416-324-6020

QuStream Corp.
(QVC-TSX/V-\$1.65)
Phone: 416-385-2323