

CANADA TIP SHEET: Graham Ignores Sizzle, Waits For Steak

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TORONTO (Dow Jones) -- David Graham ignores the sizzle, preferring to wait until he can taste the meat before he buys any up-and-coming small-cap stock.

"I get all these calls to buy some small cap because they have some hot new product or they're turning things around," Graham says. "I would prefer to wait and see that things come through as expected."

And even when he decides to take a bite of a company, it's a dainty 0.5% morsel to which he can slowly add - or easily divest.

If that means he leaves money on the table, so be it. As manager of the Renaissance Canadian Small-Cap fund, he's a member of TAL Investment Management's value team. And that means he aims for solid, consistent returns by buying solid, profitable companies, preferably at a price-to-forward-earnings ratio of less than 20.

"More steak and less sizzle" is how he characterizes his style.

Barbecue analogies aside, his performance numbers show the wisdom of that approach. The C\$93 million fund has returned 9.03% a year since inception in 1996, with the one-year return to Aug. 31 a whopping 35.5% compared to the BMO Nesbitt Burns Canadian Small Cap Index gain of 26.6%.

Some credit for that strong return has to do with his overweight position in oil and gas, even though many small-cap companies in that sector don't fit the criteria Graham traditionally uses to select issues for his portfolio.

For the most part, he prefers companies with earnings and tries to avoid leverage, having learned a painful lesson a few years back when Slater Steel Inc. (SSI.YY) went bankrupt while he held the stock. He likes strong return on equity, and looks for cash flow - especially what's left after capital spending. He prefers a growing backlog and management that can clearly articulate its business plan.

Graham says most junior exploration companies don't have earnings, and their valuation has been rising, making his search difficult.

Adding To Income-Trust Holdings

Nevertheless, he's managed to add a healthy roster of small resource companies to his portfolio, mainly those with production coming on line next year or those in the oil-services field. Among his picks are Calfrac Well Services (CFW.T), True Energy Inc. (TUI.T) and Crew Energy Inc. (CR.T)

"Until the consumer stops consuming gasoline, oil prices are going to stay where they are or go higher," Graham reasons. "I don't see going underweight that sector, although I may trim a bit."

He also has been able to access the sector through the income-trust side, and says that will grow. His firm recently approved moving the limit on income trusts in the portfolio to 25% from 8%. He owns Trinidad Energy Services Income Trust (TDG.UN.T) and Labrador Iron Ore Royalty Income Fund. (LIF.UN.T)

Industrial supplier Wajax Income Fund (WJX.UN.T) and transportation company Mullen Group Income Fund (MTL.UN.T) had been in the portfolio before they converted to income trusts, and remain there.

Similarly, although many small mining companies are exploration plays with no revenue, Graham holds Inmet Mining Corp. (IMN.T), Golden Star Resources Ltd.(GSS) and Yamana Gold Inc. (AUY) He remains underweight the materials sector, although he has moved his exposure to golds to 5.5% this year from 2-3% last year, as the U.S. dollar has weakened.

He's underweight in healthcare despite the plethora of small-cap stocks in that sector, mostly because he likes to "stick to things I understand."

About the closest he gets is a handful of Systems Xcellence Inc. (SXC.T) shares, which makes software for use by pharmacists and healthcare-benefits managers.

Graham's most overweight in consumer staples because of his hefty stake in convenience-store operator Alimentation Couche Tard Inc. (ATD.SV.B.T), a strong defensive play. He's also a big fan of Rona Inc. (RON.T), the building-supplies store that has successfully built a mix of big-box and small stores across most of the country.

Other consumer names he holds include Lakeport Brewing Income Fund (TFR.UN.T) and Brick Brewing Co. (BRB.T), which he bought when the scorching-hot summer began. He also likes their focus on lower prices, reasoning that should continue to support good volumes.

One of the biggest names in his relatively concentrated portfolio of about 50 issues is Home Capital Group Inc. (HCG.T), which comprises about 4.7% of the fund. That's down from more than 6% earlier this year but Graham has been trimming as the stock has gained. He has held it for four years and seen its return on equity grow to more than 30% from around 20%. Its track record is impressive, its adjudication policies disciplined, and it has just moved into the credit-card business. Demographics and other trends also favor the company, which provides mortgage financing to customers who don't qualify for bank loans.

And he's recently begun to buy GMP Capital Corp. (GMP.T), encouraged by the brokerage's decision to convert to an income trust. Graham believes it has a strong niche position in the financial-services industry, boasts low costs and produces ROE of 25-30%.