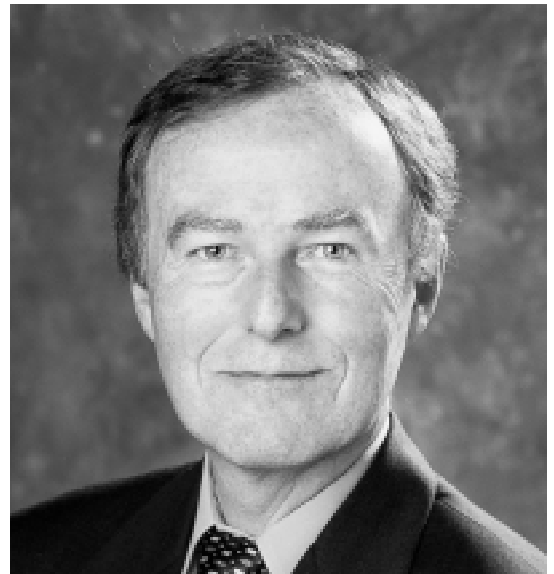
THE INVESTOR'S DIGEST INTERVIEW

TAL fund sees small caps as nimble, fleet of foot

Because of their size, small caps usually react better than large caps to consumer demand, says David Graham, who runs the Renaissance Canadian Equity Fund for TAL Global Asset Management. He also views small caps as better able to respond to sudden shifts in the economy



David Graham can't think of a better way to stay plugged into corporate Canada than the investment business.

"You're on top of all the new trends because the companies involved are all trying to raise money," notes Mr. Graham, who runs the Renaissance Canadian Small-Cap Fund for TAL Global Asset Management in Toronto.

"You get the chance to see how different management teams react to the economy or to competitive threats."

And whether the execs themselves have the right stuff.

"You get a sense of how to evaluate a manager, whether he knows what he's doing, whether he can lead the ship or not," Mr. Graham says.

Born in Brampton, Ont., Mr. Graham, 56, earned a B.A. in economics at the University of Western Ontario and an MBA at York University. In his 33 years on Bay Street, he's done research, institutional sales and, of course, fund management.

Tell us a little about the small-cap fund itself.

Set up in 1997 by Merrill Lynch Canada and bought by CIBC in December 2000, the fund is intended for value-oriented investors who lean toward small caps. With $88.6 million in assets under management, we've regularly outperformed our benchmark, the Nesbitt Burns Small Cap Index. We've also consistently finished in the second quartile of 50 Canadian small-cap funds, as measured by Morningstar. And we stand to do even better now that eight per cent of our holdings are in income trusts. With annual returns averaging 25 per cent, trusts have historically outperformed straight equities. Of the $88.6 million in the fund, 22 per cent is invested in energy; 18 per cent in metals and minerals, 13 per cent in industrial products, 12 per cent in consumer discretionary, 11 per cent in financial services and nine per cent in both consumer staples and high tech. The rest is cash.

With a possible economic slowdown on the horizon, some mavens are saying it's time to unload energy stocks.

But is it? Yes, interest rates are rising. And North America, as a result, may be slipping. But China, already booming, will probably continue to surge forward. So it would now seem to make little sense to leave the oilpatch or start dumping metals and minerals.

What type of small caps do you typically look for?

Those with the potential of becoming large caps — in other words, small players in a big and growing market. RONA is a good example. A few years ago, this Quebec-based chain of hardware and home renovation stores was tiny. Now, it's much, much bigger. In fact, it has become a large cap. Alimentation Couche-Tard, also Quebec-based, is another example. Originally, a small player in the convenience store market, Couche-Tard has grown dramatically through acquisitions in both Canada and the U.S.

But aren't there good bets in small caps that aren't necessarily going to grow?

There are. But why waste time with a company whose market share will probably stay put? That's the main reason I've passed up Exco Technologies, an otherwise top-notch maker of molds for auto parts and components. It's also why I've passed up Westcast Industries, an Ontario-based maker of auto exhaust manifolds. Westcast is cheap. But its market is going nowhere.

What else do you look for in selecting small caps?

Predictable results. So I try to find companies with a steady revenue and earnings base. (Mississauga-based Vincor is a good example). There's always security in knowing a company has a full order book or a strong share of the market. So I tend to shy away from companies which are exploration-oriented or whose production has yet to come on stream. Consequently, the fund holds few mining companies and no biotech. Of course, because I'm value-oriented, I look for low multiples, both price-to-cash and price-to-earnings. I also want outfits where management has shown it can deliver. A company that's just starting out may be a real leap of faith, whereas one with five years' of steadily improving earnings is a much better bet.

Most investors, concerned with stable returns, gravitate to large caps. So why should they consider the small fry?

Because small companies, by virtue of being more flexible, are better able to meet consumer demand. Take Sleeman, the Guelph-based micro-brewery. Labatt or Molson Coors may have known there was a market for specialty beers. But it took a small player like Sleeman to put specialty beers on the map. Moreover, small caps because they're nimbler, are better able to respond to economic ups and downs. Indeed, they're usually first out of the gate. In addition, because most small caps tend to be management-owned, there's a much stronger likelihood the top brass will take a real interest in how the company performs.

With the hundreds of companies that have come into your ken, you've undoubtedly run across a clunker or two.

Indeed, I have. One of the first companies I looked at when I started out on Bay Street in the early '70s was a Toronto-based outfit called Aquablast. It believed that water blasting, rather than sand blasting, was the best way to clean buildings. The stock was hot. Indeed, a lot of our European clients were pushing us for it. And the company did have a market cap of a few million dollars. But when I actually went out to Scarborough to visit Aqua's corporate headquarters, I found nothing but three or four trucks. There were no major tangible assets. There weren't even any employees, except the owner and his receptionist. Basically, the company was a farce. Not surprisingly, it eventually flamed out. I guess this case once again shows that although a stock can easily become a sensation, it can still lack anything of substance.

Calgary-based True Energy is one of your favorite oil plays. Still, it has missed some of its earnings estimates.

But since it appointed Joan Dunne as chief financial officer three years ago, True is back on the straight and narrow. It's now beating its own estimates, finding costs are lower than the competition. And with its shares trading at four times the Street's 2006 cash flow estimate, the company is a bargain. Moreover, thanks to its acquisition earlier this year of Meridian Energy, True has much more exploration land at its disposal — 160 drillable wells, to be precise. And with 5.3 years' worth of proven reserves, True is hardly what you would call a one-note wonder.

You see Wajax, which sells heavy equipment, as sitting in the catbird's seat. Why?

Because its primary markets, such as mining and energy, are literally going great guns. Indeed, the company has more than climbed out of its earnings trough. And because it's now in the process of converting to an income trust, its shares have been on the upswing.

Because of the worldwide boom in steel making, iron ore prices have soared 70 per cent since the beginning of 2005. That's obviously good news for Labrador Iron Ore.

It is indeed — especially when you consider that prices will probably remain strong for the next three years. And since Lab Ore has access to 40 years' worth of reserves, it should have no problem meeting this increased demand. Moreover, now that the company is considering expanding its daily output, its cash flow is likely to increase.

Toronto-based Home Capital lends mortgage money to folks who wouldn't otherwise get it. But doesn't this leave the firm dangerously exposed?

Not really. The company's impaired loan portfolio is less than half a per cent of its loans outstanding. And since the low housing prices of the early '90s, the company has become much more cautious in approving mortgage applications. Meanwhile, given its return on equity (32 per cent), Home Capital is obviously doing well. Moreover, its Visa card business is growing strongly. And although the company has made a name for itself as the home lender of last resort, it nonetheless estimates it has captured only five per cent of the total available market.

With all the guilt out there about smoking, Rothmans continues to rack up earnings of $1.40 a share. Why?

Periodic price increases in a pack of smokes have offset the slow, but steady, drop in Canadian cigarette sales. Then, too, Rothmans has captured more of the light brand market. So it's no surprise that it's now able to pay an annual dividend of $1.20 for a yield of 4.8 per cent. And with the $185 million ($2.75 a share) in free cash it has piled up, it's not unlikely that it might pay out an additional dividend. Of course, Rothmans could also use the money for acquisitions — something it has wanted to do for some time. But because it hasn't yet found one that's a good fit, it has chosen instead to let its cash build. True, rivals like Imperial Tobacco long ago branched out into other sectors, such as pharmaceuticals (Shoppers Drug Mart), banking (Canada Trust), and fast food (Hardee's). Rothmans, however, has chosen to stick to its knitting.

But given the growing movement to exclude tobacco companies from mutual funds, aren't you a little queasy about owning a cigarette maker?

Not at all. Rothmans is a legitimate company making money in a legitimate fashion. So we consider it fair game. Moreover, if we were ethical about everything, where would we stop? There are companies in the nuclear business. There are weapons manufacturers and defence contractors. Would we therefore avoid them as well?

STOCKS DAVID GRAHAM LIKES

True Energy Inc.
(TUI - TSX; $4.01)
Phone: 403-266-8670

Wajax ltd.
(WJX - TSX; $18.81)
Phone: 905-212-3300

Labrador Iron Ore Royalty Income Fund
(LIF.UN - TSX; $23)
Phone: 416-863-7133

Home Capital Group Inc.
(HCG-TSX; $35.40)
Phone: 800-990-7881

Rothmans Inc.
(ROC - TSX; $25.15)
Phone: 416-449-5525

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