

## Long and Short for Value

*Mid-cap companies in Canada are generally under-researched and have many attractive inefficiencies that can be exploited by astute value investors. Canada-based JC Clark Focused Opportunities Fund manager Colin Stewart and his 14-member team use a focused long-short strategy to look for investments mainly in the Canadian mid cap arena. They aim to get absolute return on capital, which they believe is best achieved by a long-short approach to investing.*

**Q: What is your investment philosophy?**

**A:** We are long-short equity managers, we look for investments predominantly in mid cap companies trading in Canada. Our goal is to get absolute return on capital and we believe we can achieve this best through a long-short approach to investing. Ours is a value-based philosophy and we look to invest “long” in healthy companies trading at a significant discount to their intrinsic values and go “short” companies having weak fundamentals, inefficient and overly promotional management teams as well as aggressive accounting tactics.

**Q: Why do you look for investments predominantly in Canadian mid cap companies?**

**A:** While many Canadian companies are large and some are global corporations, the Canadian stock market has many of the inefficiencies of developing markets. Few companies are thoroughly followed and fewer companies are shorted. Canada has a healthy economy and stable political and economic climate but lacks a critical mass of sophisticated investor base. Therefore, we find that we’re able to identify lots of attractive inefficiencies to exploit in the Canadian market, which today can be compared to the situation in the U.S. market 10 or 15 years ago.

We focus on mid-caps that generally lie between the 300th and the 1,000th largest company, because this group has a significant number of inefficiencies making it an attractive market in which to identify opportunities. Our presence in Toronto with a strong local contact network is an added advantage in identifying opportunities.

We do sometimes look at U.S. opportunities but mainly when we possess a particular industry expertise, or where a company has a division in Canada where we have a particular edge over other investors who may not be able to recognize its real value.

**Q: How do you identify candidates for your long and shorts?**

**A:** To invest long, companies that attract us are those having high barriers to entry, strong market position, pricing power, management teams who are aligned with shareholders, businesses and industries that we understand and can reasonably predict future cash flows. Typical examples are industries in service businesses, consumer products, and consumer non-cyclicals. Our valuation is based mainly on a discounted cash flow analysis and we try to identify and buy a business at 30% to 50% discount to its intrinsic value, and will hold that stock until its market price grows to reach a price closer to its intrinsic value.

We are also hands-on investors and focus on understanding both a company and its industry. Our approach is free cash flow centric and we always carry out a discounted cash flow analysis of companies in our universe.

Our short investing approach is different. We first identify a business that has fundamental weaknesses, maybe due to a secular decline in its industry, very low barriers to entry, steep competition, pricing pressure, rising input costs, etc. Typical examples are companies in the highly competitive manufacturing industries. If we find that even though these companies appear to trade close to their perceived



**COLIN STEWART** is a director and portfolio manager at JC Clark—a hedge fund management firm specializing in alternative investment products for institutional and high net-worth investors. Together with John Clark, Stewart is responsible for the investment activities at JC Clark.

Stewart started his career in the Corporate Finance division of CIBC World Markets and then joined Connor Clark & Co. Ltd. as an analyst where he worked directly with the Chief Investment Officer. In February of 2001, Stewart joined JC Clark as one of the founding shareholders. Today, he manages the JC Clark Focused Opportunities Fund, a concentrated long/short equity hedge fund focusing on the firm’s highest conviction investment ideas.

Stewart holds an Honours Bachelor of Business Administration degree from Wilfrid Laurier University and is a Chartered Financial Analyst.

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intrinsic value, our analysis identifies declining fundamentals and reveals that the company's value is going to decline sharply in the next 3 to 5 years, we will short the stock.

Some criteria that guide us to shorts are: weak cash flow relative to earnings; an over-levered balance sheet; aggressive growth through acquisitions with significant one-time goodwill; overly promotional management teams not aligned with shareholders. A significant red flag is a recent first time earnings miss of a company that may be the result of a fundamental problem that could take longer than one quarter to fix.

**Q: How do you generally weigh the longs and shorts in your assets and how much leverage do you use?**

**A:** We measure ‘gross exposure’, which is the overall weighting of our longs plus the absolute value of our shorts. We cap that at 150%. Our typical profile might be something like 70% long, 40% short for a gross exposure of 110% and a net exposure of plus 30%. Hence we're leveraged only 10 cents on the dollar, a fairly modest amount. The average gross exposure since inception has been between 110% and 120%. There are times when our gross exposure is, as it is currently, below 100% and we have more than 10% of the overall portfolio in cash.

**Q: Can you give examples of how you picked a couple of your long and short positions?**

**A:** We have owned Arbor Memorial for the past six years. It is the largest domestic funeral and cemetery company in Canada. Seven years ago we began evaluating the overall dynamics of this industry that had gone through a very significant acquisition binge in U.S. markets in the 1990s. But during 1998 and 1999 all that

started to deteriorate. There was a multitude of problems and the unavailability of capital led to a significant re-valuation so that the combined market capitalization of that industry, slumped from over \$25 billion to less than \$2 billion in two years.

We were attracted to this industry because, fundamentally, a funeral home and cemetery are very good underlying businesses. They have very high barriers to entry with a lot of permits and real estate requirements that need to be secured to enter this business. There's also a significant heritage linked to funeral homes that have been in a particular location in a city like Toronto for 80 years and generations of the same family have used that funeral home, and particular cemetery.

Significant future benefits such as changing demographics, pricing power and consistent volume growth of people that funeral homes and cemeteries are going to serve - all attracted us and I think with the problems in the industry we saw this as a restructuring type of opportunity. Hence about six years ago we bought Arbor Memorial. Fortunately Arbor was not significantly involved in the acquisition binge that had punished many of the U.S. players. We found they were still generating a significant amount of free cash flow. The business had also been repriced to a very significant discount to its intrinsic value and we bought it at a very attractive price, of C\$8 a share.

Today, the stock price is C\$30. Still owned by the Scanlan family who established it in Canada, 50 years ago, it is now a national business and continues to trade at a very modest 13 times earnings. They have compounded earnings growth of approximately 13% over the last 5 years, generate significant amount of free cash flow, and have a healthy balance sheet and a strong management team. This is a company that we expect will be a long term holding for us on the long side of our portfolio.

A good short side example is a US company called Georgia Gulf. About a year and half ago, Atlanta-based Georgia Gulf, a chemical PVC company, acquired Royal Group Technology, a Canadian plastic extrusions company, one that we had been watching and thought had many fundamental problems. Royal Group made products for the housing industry that were supplied for both the new home and renovation

markets. Now, Wall Street thought that there were going to be significant synergies with this business and liked the fact that Georgia Gulf was vertically integrating their business. Georgia Gulf's stock price surged significantly based on that acquisition.

At that point we started to do some due diligence on Georgia Gulf and discovered it as a good short opportunity for a number of reasons. One, they were acquiring a business that was very dependent on the housing market at a time that market was extremely vulnerable. Two, the acquisition was financed entirely with debt. They had also leveraged up their balance sheet significantly as Royal Group was a very large acquisition and almost doubled the size of Georgia Gulf's business. Third, that Royal Group was a unique Canadian company started by a very entrepreneurial guy named Vic De Zen. He had a very loyal employee base, played a key role in his company's R&D and also had a strong relationship with the suppliers and customers. However the deal was, after the acquisition, he would leave his post at the company. We were therefore gravely concerned that it would be a daunting task to integrate the two businesses without the presence of Vic De Zen.

So we initiated a short position in the relatively modest 1% to 2% range and then gradually saw, over the last year and a half, that the company has run into significant problems and missed Wall Street consensus earnings estimates on several occasions and as we saw that thesis play out, we have gradually increased our short position along the way. Generally, a lot of the problems we were concerned about, have come to fruition. After the acquisition of Royal Group, Georgia Gulf traded on the New York Stock Exchange in the \$28 to \$29 range. We initially put our short position in the \$26 range. Today our position is much smaller and the stock has gone down significantly to the \$12 to \$13 range.

**Q: How is your research process organized?**

**A:** We are a small team of fourteen people at JC Clark. Research as a whole, is a six-step process. They are: idea generation, information gathering, analysis, company visits, portfolio construction and weighting, and lastly, trading. However, only the first four steps come under research while the last two would

basically come under the portfolio construction umbrella.

The first step, idea generation, is a multi-pronged approach having four key tools that we use and apply consistently over a long period to identify companies. They are: a network of contacts; quantitative screens that include traditional valuation metrics to identify companies with high free cash flow yield; reading trade publications; and lastly, company visits particularly of those less covered by sell-side analysts to discover and exploit bottom up, undiscovered opportunities.

The second step, information gathering on both the company and industry, begins with talking to industry experts, reading trade publications and reviewing industry data. Analysis of individual companies involves, reading past several years' annual reports, scrutinizing their 10-year historical financial track records focusing on free cash flow generation stability, return on invested capital, and other fundamentals.

The third step is when the research team builds, from an analytical point of view, our own financial model on a particular company. The one common factor will be our focus on a discounted cash flow analysis for we believe that having a significant free cash flow yield in a company, is a sure way to avoid a value trap. For example, if we buy a company that generates a 10% plus free cash flow yield, then, as equity holders, we are getting paid over time even if the multiple or the stock price does not immediately climb.

The fourth step would be company visits and very active interaction with management teams. We also like to develop ongoing relationships with the management teams of the companies that we're involved in. Particularly in Canada, often in the mid-cap space we find many well managed businesses with efficient management teams but ones that are not savvy on matters like capital allocation and corporate finance. Therefore we indulge in "friendly" activism and provide management with ideas and suggestions that might help create value in their businesses.

**Q: How do you go about building your portfolio? What is your buy and sell discipline?**

**A:** We have a very focused approach to port-

folio construction. We have only 30 names in our portfolio. We overweight the top ten names and often they may represent more than 50% of the overall portfolio. We are also relatively long-term investors and hold a position for anywhere from three to seven plus years. There are some positions in our fund that we have held from the time of our inception eight years ago. If a company is consistently performing and creating value, it's much more tax efficient to have a low turnover and hold that position over the long term.

Our buy discipline involves the gradual building up of a weighting or a position in a particular company over a long period. This is not a sudden one-day action. From the long side of the portfolio we initially acquire a position with a 1% to 2% weighting and then gradually, as we gain higher conviction after seeing signs of confirmation of our initial investment thesis, we increase that position to about 5% to 10% of the portfolio.

Two reasons prompt our sell decisions. First, if something fundamentally changed in the business that had a material impact on our initial investment thesis; a related reason is if something very broad changed in that industry like the entrance of significant new competition or technology. The second reason would be a significant change in valuation.

Finally, we have trading, which is basically of three types. The first is position building. Second, would be selling a position or short covering that position, the third would be opportunistic trading. That involves adjusting the size of the weighting of our core position depending on how it is trading vis-à-vis its intrinsic value.

**Q What is your risk perception and how do you manage it?**

**A:** We believe that the real risk in owning any business or equity is permanent loss of capital and hence we evaluate every opportunity on that basis before investing.

A key method to reduce risk is identifying businesses having a significant margin of safety, as seen from solid balance sheets, low debt to equity ratios, significant free cash flow generation and the ability to meet all future obligations. From an overall portfolio perspective we try to maintain a low net market exposure.

## JC Clark Focused Opportunities Fund

Website	<a href="http://www.jcclark.com">www.jcclark.com</a>
Address	JC Clark Ltd. 130 Adelaide St. West, Suite 3400 Toronto, Ontario Canada, M5H 3P5
Tel. No.	416-361-6144
Inception	June 2005

<b>PORTFOLIO</b>	
Total Net Assets	N/A

<b>INVESTMENT INFORMATION</b>	
New Investment	Open
Min Initial Investment	\$150,000
Min Subsequent Investment	N/A
Hurdle Rate	6%

<b>RISK S&amp;P/TSX COMPOSITE INDEX</b>		
	Fund	Index
Ann Std Deviation *	6.99%	9.85%
Kurtosis	0	-0.04
Skewedness	-0.26	-0.66
Sharpe Ratio (4% rfr)	2.14	1.52

<b>RETURNS VS. S&amp;P/TSX COMPOSITE INDEX</b>		
	Fund	Index
Since inception (Ann.)	19.00%	18.99%
1 Year (Ann.)	N/A	N/A

<b>MARKET EXPOSURE S&amp;P/TSX COMPOSITE INDEX</b>	
	Index
Correlation to Benchmark **	0.24
Beta (last 12 months)	-0.21
Alpha (last 12 months)	28.67%

<b>FEES AND EXPENSES</b>	
Management Fee	2.00%
Performance Fee	20%


<b>PORTFOLIO MANAGER</b>	
Colin Stewart	2005

\*since inception \*\*weekly

Data through: 10/31/2007

Source: Company Documents; Lipper

For example, our current net exposure is in the 20% to 30% range net long.

Other risks include liquidity and exposure in different positions and sectors. Our sector exposure is typically below 30%. We limit our position level exposure from the long side at around 10% and on the short side it is 7 ½% for maximum position sizes, so that we do not take an inordinate amount of risk in one particular name. 

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