

## Trusting Price Momentum

*Caldwell Canada Fund focuses almost exclusively on a universe of Canadian equities, income trusts, and companies having a minimum market capitalization of \$500 million. Fund manager Brendan Caldwell has adopted an investment strategy of stock selection that is strictly based on the chart and the price momentum that the stock has shown over the previous two years.*

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

**A:** Our fund focuses almost exclusively on buying Canadian companies, income trusts and equities, having a minimum \$500 million market capitalization. Our philosophy is pegged on the belief that stocks disliked by the market are likely to only worsen with time. We therefore just believe in share price and buy only the best performing equities in the country, ones that have shown positive price momentum.

We also believe in owning companies that provide some social benefit to the world. Consequently, we will not buy alcohol, tobacco and gambling stocks. Otherwise, we are open to investing in any company, sector or industry.

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

**A:** Being a price momentum driven fund, our stock selections are strictly based on the chart, and the price momentum of the stock in the last two years, on a time weighted basis over that period. Therefore, even if sometimes they may have got hammered due to volatility, overall they should have performed well and continued to do so over time.

Again, as we do not focus on individual holdings or companies, we often augment our returns by investing in a sector or area that we believe, we know better than everybody else. For example, we believe we know the

exchange sector, namely stock and commodities exchanges including option exchanges, probably better than anyone else. Consequently, we own big holdings of private and public stock exchanges including a few foreign exchanges like the Hong Kong and London Stock Exchanges. Otherwise, we have been exclusively, about 97.1%, invested in the Canadian market.

We look at each stock's price chart individually. In the case of sectors, we cap the weighting at 2x the index weight, or 50% of the total portfolio, whichever is greater. Therefore, if a sector weighting in the index is 30% we will cap the sector at 50%. We believe in sector diversity in the portfolio. Consequently, if a sector turns, we will not get completely hammered.

Thus, we let the market dictate our stock picks and do not fight the trend. If that trend starts to change, we change with it. More importantly, what we want to avoid in this fund, is the risk of long-term bear-market participation; hoping things will turn around. Our model therefore, will naturally seek out those stocks that are doing well no matter how obscure.

**Q: What is your strategy in a situation where a stock turns and falls steeply inducing you to sell, but later regains the momentum and accelerates considerably?**

**A:** If it involves a single stock it is imma-



**BRENDAN CALDWELL** is President of both Caldwell Securities Ltd. and Caldwell Investment Management Ltd., he is also the founding President of Caldwell Insurance Services Ltd.

In September 2004, Caldwell took over management of the Caldwell Canada Fund. He is also manager for the Caldwell Balanced Fund. Prior to joining Caldwell in 1995, he worked for Mackenzie Financial and RBC Dominion Securities, Inc.

Caldwell graduated Upper Canada College in 1987. He earned his B.Sc. from Trinity College at the University of Toronto in 1991 and his M.A. in English Literature from the University of London, England, in 1992. Caldwell is a Fellow of the Canadian Securities Institute and a member of the Toronto Society of Financial Analysts, as well as the CFA Institute

**“We just believe in share price and buy only the best performing equities in the country, ones that have shown positive price momentum.”**

rial because it occupies only 1% or 2% of the total portfolio. Again, it is not likely that a whole sector will turn over at once.

In times of change and transition, there will be a greater frictional cost to this fund than there would be with other funds because, as stocks or sectors roll over, we're going to be selling the ones that are going down. However, in case we feel there is a permanent change for the better in that stock or sector, we will not hesitate to buy it back again even at a higher price.

**Q: In your strategy, do you pay attention to valuations like price-to-earnings ratio that sometimes, in a normal cycle, become very expensive?**

**A:** In our model, we do not bet on a sector, company or management. We also do not bet on whether earnings multiples are justified or unjustified, or even whether the earnings that the managements produce are accurate.

We believe and care about only the stock price. Even if we get hammered in the short term, this fund thrives on long-term trends and a consistent bull market. Our model is designed to help us capitalize on a good market, and also protect people's capital in a bad market. Hence, in a market that goes up 10%, if the fund only goes up 6% or 8% that is fine. But in a market that goes up 20% or 30% we hope to go up 40% or 50% and that is how we augment our returns. However, if the market goes down 10%, and if we're able to hold the value of people's investments during that period, that's what this model is built to do.

**Q: Can you give some historical examples of holdings that illustrate your investment model and strategy?**

**A:** Research In Motion. This was one of our original positions when we resurrected the fund in 2004. The company's Blackberry had been hailed as one of the great Canadian success stories until Research In Motion got involved in a lawsuit that became a serious issue, and at one point it looked like the United States might cut off the service. The stock began losing its price momentum, which was when we sold it. The stock continued to fall steeply, settled at a much lower price and then again rebounded.

Subsequently, we ended up buying back the stock, this time at a higher price than what we sold it, raising questions about the rationale behind our action. However, people forget the fact that when we sold RIM, we would have bought other stocks with positive price momentum with the sale proceeds. Moreover, we were buying back RIM only after ascertaining that the stock was climbing and would continue to do so. This is an example of how we are only interested in buying and owning stocks that are upward bound.

Sometimes we select stocks that are smaller than our \$500 million market cap criterion, but they are in a minority. One such company is Photochannel Networks that trades on the Toronto Stock Exchange. It provides electronic plumbing that allows stores like Wal-Mart and Costco to develop their pictures. We originally bought it around \$1.25 and it's currently trading at about \$4. The stock has continued its excellent performance so we have continued to own it although it is not a large holding.

Besides market cap, another exception to our basic model that we sometimes make is the length of time the company is listed. We originally bought the Toronto Stock Exchange shortly after it became a public company, because we just felt it was going to keep climbing and it has done so. Initially, it did not meet our model criterion of being publicly listed for two years since we look for a 2-year price history. However, the advantage about exchanges is that, however well a stock market does, the exchange will do even better because of leverage to the market. Therefore, we buy exchanges as a way to leverage ourselves to the performance of the market.

Agriculture is a sector that lately, has shown a great deal of momentum. Agrium, and Sino-Forest have been two of our best performers in this sector. Sino-Forest is a lumber company based in China that trades on the Toronto Stock Exchange.

**Q: What is your research process? How do you identify a stock's price momentum?**

**A:** For 90% of the portfolio, our research process involves looking at the universe of

Canadian mid-to-large cap stocks and scrutinizing their share price chart.

Our proprietary model was built with the help of Thomson Financial. Based on accelerating price performance we rank all the Canadian equities, income trusts and stocks from one to several hundred. We then pick the top 60 stocks. However, if we were to get into a bear market situation where there weren't 60 stocks that had positive price momentum then we would own fewer than 60 and hold the rest in cash.

Next, in this list of 60 stocks we make allowances for sectors so that we are not unreasonably overweight or under weight in any particular sector. For example, through most of 2006 to 2007, the financial services sector performance was sluggish compared to that of energy and mining. Since we cannot be completely out of the largest sector in the country, we selected a few of the best performing among financial services stocks for our portfolio, although we were still dramatically underweight.

Again, if, on running our model we find there is a stock that qualifies because of its superior performance, but has just been the subject of a takeover, we will not consider such a stock because we are looking for companies that are still trading and will be likely to continue trading indefinitely.

Our model thus tells us the longer-term gains or momentum in price and also gives the recent short-term price momentum. It could be the stock price is lying to us but we would rather the stock price lie to us than the management. For instance, in the late 90's, and early part of this decade, there were a lot of managements from whom we couldn't get straight or accurate answers.

We believe the market probably knows better and is prepared to tell us what is going on in some cases, than the management. But again, we are not fully sure that a stock's price momentum will continue. We are just playing the averages and so far, they've worked out in our favor.

**Q: How do you go about portfolio construction?**

**A:** Our portfolio comprises the 60 best per-

forming stocks that are diversified across sectors, based on our proprietary model, allowing for reducing a few companies and adding a few just to provide some sector balance. In the last two to three years the fund was heavily weighted, about 60%, in resources. Lately however, this sector has fallen relative to others, to about 44%. The fund is bigger than market weightings in sectors like consumer staples, equal to market weighting in information technology and industrials and very low weighting in financial services. There are also a number of sectors that are relatively small, about 1% or 2% of the index.

In the portfolio, a position would initially start at about 1½% to 2%. We let our winners run as high as 5% of the portfolio. However, we remain disciplined and true to the chart and as long as the stock continues to be true to its track record, we'll just keep letting it grow. Examples of momentum stocks are Sino-Forest, Major Drilling, and Petrobank Energy which would be our 2%, 3% and 4% respective holdings in the current portfolio.

We rebalance at least quarterly, sometimes more often, especially if there's been a permanent change to a stock. For instance, if the company has been taken over or there has been a fundamental change in the company business, and likelihood of turnaround in the near future is remote.

Our benchmark is the S&P/TSX Composite Index. We're really looking at the weighted average of a stock's performance over two years with greater emphasis placed on the recent time periods. Therefore, we are hoping for a chart that looks like it's concave, and with accelerating growth. By the time it comes into our model, it's trading above a 200-day moving average. If we do this calculation for 60 stocks, a percentage of them may underperform the market and remain volatile. However, if we take the large majority of them in a market that has any sort of trend established then the majority of stocks will give a better-than-market performance.

#### Q: What is your buy-sell discipline?

**A:** Buy-sell decisions are strictly based on the price chart of the past two years. There-


fore, we try to buy and own a stock that is already performing well, and continue to accumulate that stock. Our sell discipline is to get rid of any stock in our portfolio that has fallen out of our model while their competition was still showing growth.

Furthermore, when we decide to sell, we generally exit the entire position. This means, if we owned a stock for a long time and it has grown from 1½% to say 4% of the portfolio, when we sell, it would be that entire 4% position. If a few months later it reappears on our model, we will buy it back at the 1½% level again and let it work its way back to being a larger part of the portfolio.

#### Q: What kind of risks do you see and how do you measure them?

**A:** This fund is concentrated in Canada and is leveraged to what is performing best in the Canadian market. Therefore, in the bull phase our fund should fare better than most other funds. If Canada were to underperform, on a global basis the fund would also underperform but we believe it will still continue to outperform the Canadian market.

However, we face a lot of sector risks because we are not index managers. We often cap sectors at 100% overweight relative to the index, which means if there is a lot of volatility in the sector that we're heavily overweighted, the fund will be more volatile than the market as a whole. Therefore in a choppy market, likelihood of risk is greater. If however, the trend is relatively stable and stocks that are doing well continue to do so, then the fund is going to outperform the market.

There is also a risk containment strategy inherent in our investment philosophy. This is connected with our refusal to stick with a stock or a sector or the market as a whole, if they are not performing well. The fund will, in a bear market, have increasingly fewer holdings and nothing at all if the situation is really bad. This way we avoid our clients' capital from eroding gradually over time. Our fund is thus designed to protect clients against risks arising from long term difficult situations like the tech bust, the geo-political events, and the Enron and WorldCom scandals. 

## Caldwell Canada Fund

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Inception	06/27/1997

#### PORTFOLIO

Total Net Assets*	\$8,083
MER%	2.75
Avg Mkt Cap (\$ Weighted)*	6352
Average Price/Earnings Ratio	27.65
Average Price/Book Ratio	5.4
Turnover Ratio	N/A

#### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$500
Min Subsequent Investment	\$100
RRSP	\$500

#### RETURNS VS. S&P/TSX COMPOSITE INDEX

	Fund	Index
1 Year (Cum.)	11.8%	6.3%
3 Year (Ann.)	23.6%	14.8%
5 Year (Ann.)	16.8%	18.3%
10 Year (Ann.)	3.3%	N/A

#### FEES AND EXPENSES

Max Initial Fee	5.00%
Max Deferred Fee	4.5%
Management Expense Ratio	2.75%
RRSP Eligibility	Yes

#### PORTFOLIO MANAGER

Brendan T. N. Caldwell	1997
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\*millions

Data through: 11/30/2007

Source: Company Documents; Morningstar

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