

Small fund produces really big returns

FRONT STREET SMALL CAP

By OLEV EDUR

The Front Street Small Cap Canadian Fund is a diamond in the rough - a small (\$16.6-million in assets) and hence largely unnoticed fund that, nevertheless, has been producing phenomenal returns during the past 15 years.

For the 15 years ended Dec. 31, the fund generated an average annual compound return of 19.4%, nearly treble the 10-year average for Canadian small-cap funds.

That average has been bolstered by fund manager Normand Lamarche of Front Street Capital in Toronto. He posted healthy numbers in each of the five years since he took over the fund, while most other equity funds were losing money.

The icing on the cake was the 62.4% return the fund rendered in 2003, earning a Fundata Fundgrade rating of A in the process.

This is a fast-paced fund, with turnovers of as much as four times a year in a portfolio typically comprising 35 to 40 stocks. Volatility is high, too - the three-year standard deviation is 7.6%, compared with the small-cap fund average of 5% - but that is in part due to the fund's enormous return in 2003.

To achieve those superior returns, Mr. Lamarche first looks at the big picture. "The style is very much top-down. We're thematic in how we structure the portfolio; these themes can be economic, political, geopolitical or industry-specific. This approach allows us to home in on certain groups and, equally importantly, to avoid weaknesses," he says.

The portfolio is weighted heavily in the resource sector, although Mr. Lamarche says this is really a function of the Canadian small-cap marketplace. "If you look at the Nesbitt Burns Small Cap index, for example, more than 60% of the index is in resources. That's the nature of the small-cap market in Canada." Oil and gas represent 28% of the portfolio, base metals 17%, and gold was recently reduced to slightly more than 10%. "We've pulled back on gold - it was a bigger driver last year," he says.

Overall, the fund is broad-based and embraces all sectors of the economy, including industrials (18%) and technology (11%), but some sectors represent as little as 2% of fund assets.

Mr. Lamarche contends the resource sector will continue to drive the portfolio for years to come. "There will be good plays in resources for a number of years. I think now we're in a big cyclical economic recovery, with the potential for a super-cycle."

A recent buy is Sherritt International Corp., which was a pick primarily for its thermal coal operations. "This company has always traded at a deep discount because of its involvement in Cuba - because of the embargo, nobody has been covering it.

"Nobody wants to touch it, but it's managed by Ian Delaney, one of the smartest guys on the street," Mr. Lamarche says.

He says the company will likely split in two - a Cuba spinoff and the rest of the company, and once that happens there is potential for its shares to go to \$9 or \$10, from a recent \$7.

"We're big on thermal coal as well as uranium, which we think is the commodity of the future," Mr. Lamarche says. "If you look at generating electricity in North America, where do you go? There are no new dams being built, no new rivers, and coal and uranium have been viewed as 'dirty'."

Mr. Lamarche says the United States has been relying on hydrocarbons that come from unstable parts of the world, because it does not have any of its own. "I think we're going to see a huge long-term capital-spending cycle, hundreds of billions of dollars to rebuild their power generation infrastructure.

"Coal is plentiful in North America and thermal coal is much cleaner burning, so we think that's going to get a lot of attention in the near future," he contends. Longer-term, nuclear power is the domestic solution, so the fund has a good position in uranium mining.

A non-resource name recently added to the portfolio is Rutter Industries, which provides technological solutions for the marine industry. "It's a well-managed company that's done a great job of building their revenue base in the past couple of years," Mr. Lamarche says, adding that marine traffic is growing with the demand for high-tech solutions in the wake of concerns about terrorism.

Mr. Lamarche says he is confident the Front Street Small Cap Canadian Fund will continue its winning ways. For the record, this little fund has one of the best long-term track records going.