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STRATEGIES FOR SUCCESSFUL INVESTING

SMALL-CAP INVESTOR

Small-cap potential in energy, mining, and agriculture

HUNTING QUALITY

David Graham

The small-cap segment of the S&P/TSX Composite Index has had excellent relative performance since 2000. The BMO Nesbitt Burns Canadian Small Cap Index has posted a 15.1% annualized return since 2000 compared with 8.2% for the S&P/TSX Composite Index as a whole. The question is, given the robust outperformance for this length of time, should investors still hold small caps?

I believe that you can always find good small-cap investments. By the same token, though, in light of increasing uncertainty and volatility in stock markets, it is not prudent to ignore the big picture.

From a valuation viewpoint, small caps are just as expensive today as large caps. Both the BMO Nesbitt Burns Canadian Small Cap Index and the S&P/TSX Composite Index price-to-earnings ratios are about 15, whereas in March 2000 the small-cap p/e was 13.9 while the large-cap p/e was 26.1. While some investors might think this is a reasonable price to pay for the potential growth possible with small caps, others might rather wait until the smaller companies become relative bargains again.

A second consideration for investors is investment trends. As the Canadian dollar has been rising since 2002, investors have been reducing their foreign investments and adding more in Canada. But the view on our currency is changing, and the consensus is that the Canadian dollar should stay within its current range, or even fall if commodity prices weaken.

We have recently seen a renewed interest in foreign investments, with money starting to flow out of Canadian equities, including small caps. The Investment Funds Institute of Canada reported that in the last half of 2006, $430.7 million was withdrawn from small-cap mutual funds. Withdrawals in any six-month period are not unusual, but the largest prior withdrawal was $123 million between March 2004 and September 2004. If this trend continues in 2007, it could cause selling pressure on these securities.

Given these cautionary notes, the focus on the funds that I manage, the **Renaissance Canadian Small Cap Fund** and the **Talvest Small Cap Canadian Equity Fund**, remains on quality companies that we believe offer good value. We are looking for companies that can achieve earnings growth regardless of the economic environment — perhaps a result of dominance in a niche market or proprietary interest in a hot product or service.

We also favor companies with foreign exposure, where, for example, sales or operations outside Canada might buoy earnings

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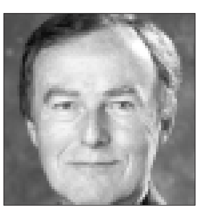

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should the Canadian economy soften or the dollar weaken. But in all cases, we try to find companies with fairly predictable results. Companies that miss expectations in today's markets tend to be severely punished because of investor nervousness about the overall market.

The growing interest in global warming and other environmental issues is fueling new investment opportunities. One area we have been investigating recently is renewable energy.

Here's an example of how this interest can translate into investment opportunity. In his State of the Union address earlier this year, US President George Bush called for a greater use of ethanol in gasoline. Corn is one source of ethanol, and farmers are expected to plant more corn in response to expected rising demand.

Instead of buying large-cap ethanol or fertilizer producers, we took a position in **Ag Growth Income Fund** (TSX: AFN.UN; recent $19.73), a manufacturer of conveyor systems, augers, and other crop-handling equipment. Management believes it has a 40% market share in agricultural augers in North America. Ag Growth is trading at about 8 times estimated 2007 distributable cash flow. With its distribution of $1.68, it has a yield of 8.57%.

Another area that interests us is the move by utilities around the world to find alternative ways to generate electricity, and we are seeing much more interest in hydro, nuclear, solar, and wind power. One company in this area is **Boralex Inc.** (TSX: BLX; recent $12.20), which has developed diversified expertise in four types of green and renewable energy production.

Boralex owns 21 power-generating facilities in Canada, the US, and France, with an installed capacity of 333 megawatts (MW). Six of the facilities use wood residue to create thermal power.

Boralex also manages 10 power stations on behalf of its 23%-owned **Boralex Power Income Fund**. In the past two years, Boralex has developed six wind farms in France with 89MW of power capacity. Quebec has asked for bids this May on 2,000MW of wind farm capacity, which will be phased in from 2009 to 2013, and we expect Boralex to be a bidder in association with **Gaz Metro**, a major energy player distributing approximately 97% of the natural gas used in Quebec.

At 18.6 times 2007 and 15.2 times 2008 estimated earnings per share, we have added Boralex to our portfolio. We believe it offers good value considering the potential new business it might get. Quebec paper and packaging company Cascades Inc. holds a 43% interest in Boralex stock.

An interesting way we participate in the mining sector is through **Gemcom Software International Inc.** (TSX: GCM; $1.85), which sells integrated resource asset management software to mining and exploration companies to help develop optimal mine plans. The company's products are used at more than 1,000 mine sites in over 90 countries.

Last year Gemcom acquired its main competitor to double its market share and has become the largest supplier of specialized mining productivity solutions in the world.

With an actual market cap of approximately $90 million and about $35 million estimated revenue for its fiscal year ending in March 2007, Gemcom is small, but we see opportunities in its linked management information systems. Earnings are estimated at $0.12 per share for fiscal 2008, climbing to $0.15 in fiscal 2009.▼