

CANADA TIP SHEET: Kaul Just Follows the Numbers

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TORONTO (Dow Jones) — For Arun Kaul, picking stocks is a science, not an art.

"We just follow the numbers," he says.

There are numbers that tell him the fundamental value of a company: profitability, earnings, earnings trend, and share valuation. Numbers that provide a technical analysis of the stock price: relative strength, for example. And numbers that quantify sentimental factors at work in the equity market: put-call activity, short-selling, and volatility, among others.

Once he puts them all together, the final number in what Kaul calls his "multifactor approach" is fed into a model that ranks each Canadian small-cap company against its peers.

Then Kaul, a portfolio manager at **Hillsdale Investment Management**, buys the stocks in the top quartile and sells anything that appears in the "bottom two-thirds."

"It's a very disciplined approach we've developed over time," he says.

It also produces some stellar numbers of its own. Kaul's Canadian Performance Equity fund has returned 21.6% annually since inception in January 1996. In the last year alone, it has returned more than 54%, just above the 52.6% BMO Nesbitt Burns Canadian Small-Cap Index. Over the past five years, its returns of nearly 23% were double the index returns. Globefund rates it five stars and Fundata rates it an A.

The C\$15 million fund has about 40 names, all Canadian companies with market caps below C\$1 billion - although he won't necessarily sell them if they grow beyond that limit while in the portfolio.

He updates the numbers weekly to monitor any change in ranking among the 400 names monitored. Because there are so many factors involved in how a company is measured, a drop in ranking become a "nice, non-emotional way" of deciding when to sell.

For example, Kaul recently sold Rogers Wireless Communications Inc. (RCN), a mobile telephony company. Its earnings growth was slowing and its price momentum was relatively weak. "There was nothing inherently wrong with the company," Kaul says. "We were just able to find better opportunities elsewhere."

Limits Sectoral Exposure

Occasionally, changes in trends can foreshadow other problems. Kaul recently sold his position in Hip Interactive Corp. (HP.T), a producer of video and computer games, when it slipped in ranking as factors such as price revisions, earnings trend, and relative strength fell to "neutral".

Not long after, the company revised guidance on the discovery of accounting errors in its two most recent quarters. The stock had done well in the portfolio and Kaul sold just below C\$3. It's now trading at about C\$1.75.

While he doesn't like to let emotion get in the way, Kaul doesn't just blindly follow the numbers. He limits his sectoral exposure even if all the top companies in his pecking order are in one industry. This is especially key in Canada where there is a large cyclical component, he says. He'll also limit his exposure in one name to 5% of the fund.

"This keeps the portfolio attributes very stable over time," he says. "The portfolio always has better earnings, better momentum than the model."

Among recent newcomers to the portfolio are Dundee Bancorp Inc. (DBC.A.T), a financial holding company with "decent" earnings growth and reasonable valuation, and Gerdau Ameristeel Corp. (GNA.T), a steel company in a very "neglected" sector on the cusp of a turnaround.

Kaul also recently bought Russel Metals Inc. (RUS.T), a metal distribution company. Its price-to-earnings ratio is in the single digits, making it relatively inexpensive, and it yields 4%. Kaul doesn't look for yields, "but in this case it's a bit of a bonus." Trading activity in the stock has begun to trend higher and there's been an uptick in its earnings.

Kaul will generally hold onto a stock for nine to 12 months. One that has been in the portfolio for some time now is Cedara Software Corp. (CDE.T), which has reported strong revenue and profit growth and has held on to its ranking for some time.

Other stocks that remain in the top quartile include Peyto Energy Trust (PEY.UN.T), a natural gas producer, and Toromont Industries Ltd. (TIH.T), which operates a Caterpillar agency and installs compression and refrigeration equipment.

Kaul co-manages the fund with Chris Guthrie and Tony Batek.
