

## FUND PROFILE

# Small-cap ethical fund targets high profitability, lower risk

Joe Jugovic, co-manager of Ethical Special Equity Fund, says the goal is to manage risk through investment management

**J**OE JUGOVIC, THE 33-YEAR-old co-manager of Ethical Special Equity Fund, recalls the anxiety he felt about two months ago, when he stepped into the market and bought a handful of income trusts that had lost an average of 30% in four days. The sector had been pummelled by Ottawa's decision to revise taxation on the investments.

"That's tough to do. As much as you think it might be easy right now, it looked like the world was coming to an end back then," says Jugovic, vice president of investments at Calgary-based QVGD Investors Inc.

Jugovic and Leigh Pullen, QVGD's president and chief investment officer, co-manage the \$280-million small-cap fund for Ethical Funds Co. of Vancouver,

Jugovic and Pullen bought even more shares of a top holding — Altagas Income Trust — that they had pared down somewhat in the first quarter of 2006, when the trust market was particularly frothy.

"We have been increasing purchases of Altagas in the past few months, especially after the change in the trust rules," Jugovic says. "We were lucky because it went on sale

for us in November. That's how we look at it."

The decision provides a window on QVGD's investment philosophy and its buy/sell discipline. In QVGD's view, Altagas is a strong business — as either a corporation or a trust — that was "tainted" broadly by investors concerned about the government's taxation decision. As a trust, Altagas has a prudent distribution payout ratio and, relative to its peers, it is trading cheaply. QVGD also has confidence in Altagas's management, which QVGD has known for six years.

The trust taxation decision marked a way for Ethical Special Equity Fund to deploy some of the large cash position — in the high teens, at one point — that it had accumulated by selling shares in some of its most highly priced securities. In May 2006, cash equivalents topped out at 19.7% of the fund, but as of Nov. 30, 2006, cash equivalents had been reduced to 11.2%.

"We've held steel, copper, oil and gas positions since 2001," says Jugovic. "And if we didn't trim those back, our portfolio would be 41% oil and gas, with other resources exposure on top of that."

"You sell these things when

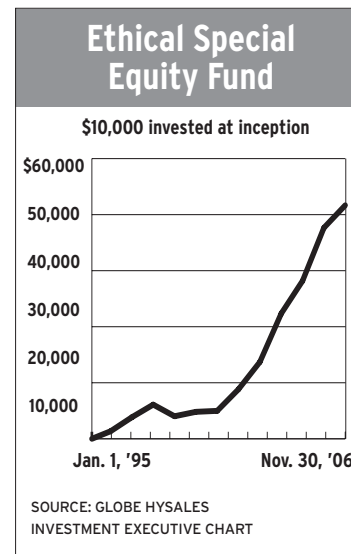
everybody believes that the natural gas price will stay at \$10 per cubic metre," he adds. "And you buy it when everybody believes it will stay at \$5."

According to Morningstar Canada, the fund has had an average annual compound return of 14.1% in the 10 years ended Nov. 30, 2006. Over the same period, its benchmark — the BMO small-cap blended weighted average index — returned just 10%. The fund is in the first quartile for both the five- and 10-year periods. Partly because of those numbers, the fund was named Small-Cap Fund of the Year at the 2006 Canadian Investment Awards and was a runner-up three years ago. But it is the fund's low volatility that has impressed analysts and advisors alike.

"We like to say our goal is to manage risk with investment management," says Jugovic. "In doing so, we're creating a portfolio with higher financial profitability than the market, with lower valuation risks."

The fund won the award with a broad range of risk-adjusted performance from different assets. The managers did not rely on the resources sector alone to power performance. Often when commodities were performing the best, the fund was underweighted in the sector, Jugovic explains. Overall, the fund carries an average price/earnings valuation of 13.5 times, against the index's ratio of 17 times.

■ BY GAVIN ADAMSON



"If you look back at 2003, our benchmark was up 45%, while we were up 35%. That's exactly what you'd expect," he says. "We have always had a more defensive portfolio, and we'll still make gains in that environment. So, keeping those risk measures of lower valuations and higher profitability is the key."

Risk management starts with a maximum 6% holding in any one stock and 25% in any one industry, which helps to avoid the temptation to dip heavily into any one of the resources sectors that dominate the small-cap arena in Canada even more than the large-cap scene. The fund holds about 40 names; most

of them have been held for a minimum of four years, and some since the inception of the fund in 1996.

The fund, which is almost identical to the QVGD-managed Clarington Small Cap Fund, has an above-average 2.79% management expense ratio, but, Jugovic says, management works for it. Jugovic and Pullen subject their investment picks to about 12 quantitative screens, including such valuation ratios as historical return on equity, debt to equity and cash flow to debt.

Apart from quantitative analysis, the pair turn their attention to companies and sectors when they hear about "oddball ideas" from newspaper stories, for example. "Stories may tell us about changes in boards and directors, new managers and bigger themes within a business that we try to latch on to," says Jugovic. "We do a lot of reading that draws blueprint ideas."

In addition to the income trust opportunity, QVGD has been eyeing the paper and forest products industry, which has been depressed for some time. Auto parts makers in North America also have attracted attention because of both the auto market slowdown here and in the U.S. and the internal problems of the big U.S.-based car companies.

"It comes down to being opportunistic and looking for opportunities that will generate returns for us — not in six months, but in a few years," says Jugovic.

**QVGD has been eyeing the paper and forest products subsector, which is depressed**

From a broad market standpoint, Jugovic acknowledges that the discount on small-caps versus large-caps has played out, especially in the U.S., and that the small-cap sector may suffer from the “flight to quality” as global economic growth slows at the end of this cycle.

But he also notes that interest rates seem to be on their way down, which is good for small-caps in general. In any case, he says, it’s pointless to try to time these events.

In spite of this quandary, he suggests, “It’s time to be defensive. And if small-caps do underperform relatively, at least we’ll be in the best

companies we could find. We know there will be another cycle, whether it’s in 12 or 24 months. And, long term, we’ll do well with the prices at which we’re buying these companies.”

A University of Calgary economics graduate, Jugovic began his investment career while earning his chartered financial analyst designation with Schacter Asset Management Inc., a now-defunct Calgary-based firm that ran a resources fund in the late 1990s. The fund held about 50% of its assets in resources. Jugovic recalls that six months after he joined the firm, the

infamous Bre-X Minerals Ltd. stock scandal exploded when it was discovered that an insider was using gold to salt ore samples from a soon-to-be-worthless mining property in Indonesia.

“This was my first exposure to the investment industry. And six months after that, oil hit its bottom at about US\$11,” says Jugovic. “Two years in a bear market vs 10 in a bull market — you probably learn a helluva lot more.”

By the time Jugovic joined QVGD in February 2000, several institutional clients had walked away, seeing no immediate promise in either

the small-cap sector or the value-inspired style to which the firm was adhering at the time. “The fact that we stuck with it allowed us to make the returns that we have over the past five years,” he says.

The son of Croatian immigrants to Canada, Jugovic points to his parents for the heart of his style. He says they instilled in him the value of saving and investing money smartly.

He takes a broad perspective on investment management from his hometown, Calgary, a city with a growing investment industry but no pedigree.

Although QVGD believes firmly in the Warren Buffett-style “common sense” approach, Jugovic admits he is inspired by good managers everywhere. To that extent, his style is reflected in the firm’s style and its name, an acronym for “quality, value, growth and diversification.”

“I’ve always enjoyed reading about different pension managers and people who have been very successful,” says Jugovic, who is married with a three-year-old daughter and an 18-month-old son. “There’s no one magic formula. The key is in finding something you believe in and being disciplined to do it.” **IE**

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