NATIONAL POST

Looking for trouble

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Tim McElvaine looks for problems. The president of Vancouver-based McElvaine Investment Management and portfolio manager of the Mackenzie Universal Canadian Value Class deals in "the castaways, the forgotten and the unloved."

For example, he bought a large position in Torstar Corp. (TS. b/TSX) at about $4.75 per share when it was removed from the S&P/TSX composite index in mid-2009. McElvaine explains that this meant there were sellers in the market disregarding price -- exactly the type of situation he looks for. He still owns the stock and it currently trades at around $12.50. (It closed yesterday at $12.31.)

The manager aims to have 20 to 25 substantial holdings, and thinks a lot a about management compensation and directors' interests. While Mc-Elvaine builds the portfolio on a stock-specific basis, he acknowledges how the macro situation affects opportunities.

"When you see an ant crawling along your counter, it is unlikely to be the only one. You open your cupboard and there are a million of them," the manager says. "It's the same with value investing. When there is a problem in one area, it is unlikely alone."

That is kind of the case with Japan today, given the high yen and political uncertainty, McElvaine notes. He had no Japanese exposure until relatively recently, but started buying again and expects to increase this weighting.

"From a value-and asset-base investor's point of view, it is by far the cheapest market right now," the manager says, noting Japan makes up roughly 21% of the fund. He owns big multinational companies such as power tool maker Makita Corp. (6586/TYO), soy sauce producer Kikkoman Corp. (2801/TYO), musical instrument company Yamaha Corp. (7951/TYO), and kitchen and bathroom fixture expert Toto Ltd. (5332/TYO)

"We're not buying obscure things in Japan, we're buying global branded companies that in many cases are significantly below their multi-year highs," McElvaine says. "These aren't stocks that have always been cheap, these are stocks that have come off significantly in the past couple of years."

While the manager admits he doesn't know if the yen will go higher or lower, he is confident that names such as these provide a margin of safety given their strong balance sheets, brand names and operating cash flows.

"Sure, the corporate governance isn't North American, but North American corporate governance isn't all that you'd like either sometimes," he says.

While Canadian names make up about 54% of the portfolio, it also has a roughly 6% cash position. The cash weighting was more than 40% a year ago, but McElvaine has been aggressively putting that money back to work. If the market remains relatively unchanged in the next three months, he expects both the cash position and Japan weighting will be higher, while the current U.S. exposure of about 11% will likely be lower.

"The only thing I'm somewhat interested in the United States right now is some of the TARP warrants, which were sold by the U.S. government on a number of the banks," McElvaine says. "They are a rel atively low-risk way to get leverage if there is any type of stabilization in the United States."

Not only do investors get a large seller in the United States, but the manager points out that pricing of these instruments isn't as fine-tuned as it could be since many investors aren't aware of them. They also have an eight-year life -- "a long time in the investment world."

PROFILE

Manager Tim McElvaine, Mc-Elvaine Investment Management

Fund Mackenzie Universal Canadian Value Class

Description Generally targets out-of-favour stocks at discounted prices

Style & Process Value, bottom-up, focused on accidents

Assets under management $225-million

MER 2.38%

Performance 1 year +3.4%, Since June 2009 inception +8.2% (as of Sept. 30, 2010)

BUYS

MAKITA CORP. (6586/TYO) AND YAMAHA CORP. (7951/TYO)

Currently trading around Y$2,800 per share, McElvaine purchased shares of professional power tool company Makita for about Y$2,400. It now makes up about 4% of the fund.

Given the company's very strong balance sheet, McElvaine feels he paid nothing for the brand, which he says is worth a significant amount of money.

Yamaha represents a similar situation as the manager paid a price much lower than the company's tangible assets. As a result, McElvaine says he got the music business for free.

"It's come off because of the strong yen," he says. "Both companies have been pretty good managers and certainly aren't particularly highly paid, certainly by North American standards."

INDIGO BOOKS & MUSIC INC. (IDG/TSX)

This relatively recent addition currently makes up about 4.75% of the fund.

McElvaine notes that while the company has competitors in Wal-Mart and Costco, its core book retailing business is different from the United States in that it has higher market share. So he feels Indigo is a little bit more sheltered.

"CEO Heather Reisman has been very aggressive in changing the makeup of the stores," McElvaine says. "They've been thoughtful in their management process and they have good corporate governance."

Since it is a very strong cash flow generating business with high returns on invested capital, he thinks the book business and cash are probably worth $20 per share. As a result McElvaine thinks investors get the Kobo e-Reader business as a free call option.

He highlights recent announcements that it will be pre-installed on tablet devices from Research In Motion and Samsung. "I don't know if it is going to work or not, but you're not paying for it."

RHJ INTERNATIONAL SA (RHJI/BR)

The manager points out that this Brussels-based firm was one of the first private equity funds to go public. The publicly listed spinoff of Ripplewood Holdings debuted at Đ20, but by the time Mc-Elvaine got interested, it had fallen to Đ3.

"What got my interest was the announcement that they were buying a private bank called Kleinwort Benson," he says. "The seller was a German bank who was forced to do so because of a merger -- they didn't really care about price."

After purchasing Kleinwort Benson, RHJ decided to exit the industrial business and focus on private banking. Mc-Elvaine likes the fact that RHJ paid a good price for a company that isn't particularly leveraged. He also points out that RHJ's board owns a lot of stock, "so they are focused on the same things we are."

While the stock currently trades at about Đ5.50, Mc-Elvaine thinks it is probably worth Đ10. "If they can execute well on their private-equity strategy, I think it will go up many times," he says.

RHJ currently represents about 5% of the portfolio.

SELL

GOLD

While this is not a prediction that the price of gold will fall, McElvaine simply believes bullion isn't the type of investment he is looking for.

"You're more of a psychoanalyst than an investor if you're buying gold," he says. "When an investment is advertised on television, I have hard time thinking it will fit in to what I do."

On a fundamental basis, the manager notes that three years ago, net producer output of gold (less hedging, plus scrap) came to about 3,000 tonnes per year. Meanwhile, fabrication demand -- industrial, dental and jewellery -- came to roughly the same amount. So fundamental supply was roughly in line with fundamental demand.

Fast forward to today and McElvaine expects we'll have about 4,000 tonnes of production and scrap. However, lower fabrication demand will only absorb about 2,000 tonnes.

"My issue with that is I don't like situations that are so dependent on emotion. Could that demand double? Of course. Could it halve? Just as easily."