McElvaine Investment Trust

Morningstar Quicktakes™ Report
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This relatively unknown equity offering has a lot of appeal for those who can afford it.

Over the last 10 years, value investor Tim McElvaine has quietly established the strongest track record, on a risk-adjusted basis, among all equity offerings tracked by Morningstar. So even though this tiny fund has languished in recent years, investors who meet its high minimum investment requirement should benefit from McElvaine's disciplined investment strategy over the long haul.

The fund's long-term performance has been nothing short of phenomenal. Its 10-year annualized return of 17.3% is tops in the Canadian Focused Small/Mid Cap Equity category while its volatility -- as measured by standard deviation -- has been the lowest. In addition, the fund has never lost money over any two-year rolling period since its September 1996 inception. This compares quite favourably to the median fund, which experienced losses 13% of the time over the same time frame.

A main contributor to McElvaine's success has been his practice of running a very concentrated fund by investing heavily in his best ideas. While this strategy flies in the face of conventional notions of diversification, McElvaine has shown that taking sizeable positions in businesses he thoroughly understands is less risky than owning a large number of stocks in companies he knows little about.

In order to properly assess a security's worth, McElvaine spends a great deal of time assessing the qualitative aspects of a company, namely its management team. In fact, he has sat on a number of executive boards such as Rainmaker Income Fund (RNK.UN/TSX) and Humpty Dumpty Snack Foods in order to stay abreast of shifts in corporate strategy.

McElvaine's modus operandi has not been to enact change as an activist investor, but to learn the underlying business dynamics of a company and its industry, which has helped him identify investment opportunities elsewhere. For example, his time on the board of Sun-Rype (SRF/TSX) taught him the financial prospects of branded products. So when Maple Leaf Foods (MFI/TSX) announced in its annual report that it started to shift its product mix from white label goods to a branded line, McElvaine scooped up a significant amount of shares in the latter half of 2006, believing that that the firm will also experience the same financial windfall. This story hasn't completely played out yet, but the stock is up 31.1% over the last twelve months.

One thing we dislike about this fund is its fee structure. The fund charges a base management fee of 0.4% and then 25% of annual performance that exceeds the meagre hurdle rate of the 91-day treasusy bill. Most performance fees are calculated on any performance above a reasonable benchmark. In this case we think a broad equity index would be more appropriate. Furthermore, the fund doesn't employ a traditional high watermark. Unfortunately, all this can translate into steep costs for this otherwise outstanding offering.

Morningstar Rating
★★★
(as of 31 Jul 07)

Strategy
The manager attempts to achieve long-term capital appreciation by investing primarily in Canadian securities that are trading significantly below their estimated intrinsic value. When assessing a security, the manager determines the difference between its intrinsic value and market price. In addition, he identifies the business risks associated with an investment and determines whether management's interests are aligned with those of shareholders. While the manager invests primarily in stocks, he has engaged in alternative strategies such as risk arbitrage, derivatives and rights offerings. The manager has sat on a number executive boards as a director/trustee in order to fully evaluate the underlying fundamentals of a business and its industry.

Management
Tim McElvaine is the president and a director of McElvaine Investment Management Ltd. and of McElvaine Services Ltd. He joined Peter Cundill & Associates Ltd. in 1991 as vice president, research, and was employed by the Cundill group through March 2004, where he steadily assumed a greater role in investment management culminating in his position of chief investment officer from September 2000 to May 2003. McElvaine is a chartered accountant and holds a CFA charter.

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Of Note

- Management's general policy is to hedge foreign currency. For better or for worse, currency fluctuations will not affect performance.

- Because this fund is sold via offering memorandum rather than by prospectus, its minimum investment varies depending on the investor's province of residence.

- Value aficionados should definitely read McElvaine's past annual reports and newsletters at www.mcelvaine.com. These documents are chock full of informative and amusing commentaries on markets and investing.

About the Author

Jordan Benincasa is a fund analyst with Morningstar Canada. He holds LL.B and MBA degrees from the University of Windsor and a bachelor of environmental studies (honours) degree from York University. He is currently working toward his Chartered Financial Analyst designation.

Kudos

- According to McElvaine, a significant portion of his personal wealth is tied up in this offering. It's great to see managers eat their own cooking.

- McElvaine's board experience is a definite plus. There are very few managers who go to such lengths to understand the businesses and management teams they invest in.

- The fund boasts the best 10-year risk-adjusted return, measured by the Sharpe ratio, among all equity funds tracked by Morningstar.

Question Marks

- The fund's fee structure tarnishes an otherwise excellent offering.

- McElvaine is a one-man show. The loss of this manager would cause us to reconsider our opinion of the fund.