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Behind Heathbridge's great trades? Guts

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The challenge was to find portfolio managers who brought distinction upon themselves and added to their clients' wealth during the financial crisis. Enter Heathbridge Capital Management.

Money managers don't have many opportunities to distinguish themselves. The past year is one of those rare periods that can separate talent from mediocrity. (I say "can" because you can never take chance completely out of the equation.)

The stock market was flat in the year ended Sept. 30. Heathbridge's clients are up 14 per cent over the same period. The median equity mutual fund return, meanwhile, is down a bit more than the market. Over 10 years, Heathbridge is up 7.4 per cent versus 5.7 per cent for mutual funds. (Heathbridge doesn't run funds; it manages individual accounts.)

So, we want to know the firm's secret. Vice-president Richard Tattersall shared a few of the firm's winning trades and the thinking behind them. The most interesting one involved Thomson Reuters, (TRI-T33.22-0.71-2.09%) the company born of the marriage between the Canadian and British information companies.

After the merger, shares of the company continued trading on the London, New York and Toronto stock exchanges. But the London-listed shares, while having the same economic interest in the company, were not exchangeable into normal stock. These shares traded at a steep discount of 20 per cent to the North American ones. In a world where arbitrage is possible, that shouldn't happen.

Mr. Tattersall explains that the discount was the result of two forces. First, arbitrage desks at dealers were stripped of their capital because of the financial crisis and therefore couldn't short sell the stock in North America while buying in Britain, which would normally close the gap. (A short sale occurs when the seller borrows stock from a brokerage, and sells it, expecting the price to fall. If it does, the seller will buy stock at the lower price to replace the stock that was borrowed.)

The second reason was that European analysts were bearish on the stock because Reuters had been a dog. Heathbridge, which owned Thomson in its portfolios, sold the stock in North America and bought the London variety.

Mr. Tattersall and his partners figured that eventually, that gap would close. They were right; Thomson exchanged the stock for regular shares. The stock went up 40 per cent. Plus, it paid a 5-per-cent dividend. It's nice to make 65 points on a top-drawer blue chip.

Heathbridge also played the financial sector well, selling most of its bank stocks in mid-2006 – "a little early" Mr. Tattersall acknowledges. The crew didn't like the risks the banks were taking with their balance sheets, even Toronto-Dominion Bank, (TD-T62.380.210.34%) their favourite (Heathbridge only buys one stock per sector). They sold the rest of their TD shares last fall at $68. They bought the stock back in the subsequent equity offering at $39.

With respect to U.S. financial services companies, Heathbridge's bet was Wells Fargo (WFC-N27.46-0.93-3.28%) . They picked up the stock last fall in the $20s (U.S.), then watched it drop to $8 in March as the markets plummeted and fears of nationalization mounted. Yet Mr. Tattersall and his partners, Robert Richards and Rupel Ruparelia, reasoned that the bank's fee-based earnings, from its commercial real estate, insurance brokerages and mutual fund business, were not properly understood. The bank had ventured into these businesses through acquisitions, resulting in a lot of goodwill on the balance sheet. Government stress tests, meanwhile, didn't consider goodwill a real asset, even though in this case it was. The bank also enjoyed huge retail interest rate spreads – a big driver of earnings.

What did they do? Bought more. The stock today? $28.

"If shoes or milk are on sale, you buy more. When stocks are on sale, people panic," Mr. Tattersall says.

That phenomenon was also evident in gold shares, which last fall fell between 50 and 90 per cent, although gold was down only 20 per cent. That didn't make sense, so the team bought Barrick Gold (ABX-T37.04-1.34-3.49%) enthusiastically at $25 (Canadian). It's $40 today.

Ask Mr. Tattersall to sum up the firm's philosophy and he loosely quotes legendary investor Warren Buffett: "Extraordinary investors don't require extraordinary intelligence, they require extraordinary discipline."

I'd add to this that they require extraordinary due diligence and intestinal fortitude.

There's another quality that makes companies like Heathbridge more attractive than mutual funds. Heathbridge is an investment counsel; it doesn't pool funds, it manages separate accounts, although they have largely similar portfolios.

This is more tax efficient. When you buy into a mutual fund, you can end up paying taxes on gains you didn't benefit from. For example, if a fund sells a big winner the day after you buy in, you'll get a tax bill (if it's outside your RRSP) even though you didn't benefit.

The bigger problem is the flow of money. Successful funds tend to attract a lot of new cash. Often, the manager wants to maintain his portfolio weightings, meaning as his fund grows, he may end up using that money to buy more of stocks that have gone up a lot. That's often a recipe for disaster.

The only downside to investment counsel firms like Heathbridge? You need a few hundred thousand to become a client. Makes you want to work hard.

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