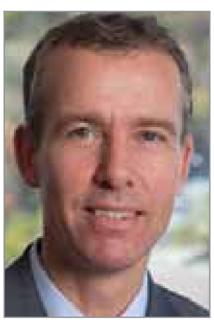
An Interview with John Liddy

John Liddy, lead Portfolio Manager of the Formula Growth Hedge Fund, discusses their investment philosophy and strategies.



John Liddy MBA
Co-Chief Investment Officer
and Executive Vice President
Formula Growth

FORMULA GROWTH LIMITED

CHW **Why don't you start with a quick overview of Formula Growth Ltd.?**

John Liddy This year is actually our 50th anniversary. Formula Growth was founded in 1960 by someone generally considered the dean of growth stock investing in Canada, John Dobson. He started the original Formula Growth Fund with ten individuals who each put up $10,000 at $9 per unit. Today these units are worth over $3,000, and the original $10,000 is worth over $3 million. The S&P's total return over the last 50 years has compounded at just over 9% and we have compounded at just over 12% net of fees. John Dobson decided that they would invest anywhere other than Canada to diversify away from the resource and bank stocks that dominated the Canadian stock market then as they still do today. Essentially they said, "Let's find growth stocks somewhere else in the world". Initially the obvious place to look was in the United States. At various times the group invested elsewhere around the world but eventually settled on the United States markets in the late '70's. Our firm is now going back to its roots and we've launched a new global long/short fund that will focus mainly on Asia Pacific and North America. We're quite excited about this new product and the additional research capabilities we're building in-house with a new hire to cover the Asia-Pacific region and with the signing of a Hong Kong based strategic partner. We're of the view that these new additions will foster synergies in our long/short stock picking and research process which should benefit the entire firm.

CHW **What was your motivation in starting the Formula Growth Hedge Fund?**

JL We had been discussing hedge fund strategies since the mid '90's. At the time the only game in town was long investing but volatility was on the rise and stocks were trading at high valuation levels. Retrospectively we were a bit late to the game after the market crash of 2000-01 but we felt we had to add new tools to our portfolio management toolbox in order to succeed going forward. A long/short strategy fit that bill perfectly. We've compounded at close to 28% since inception of the Hedge Fund in 2002 which is a good indication that we have effectively used these new tools.

CHW **How would you categorize your overall investment philosophy?**

JL We're bottom-up investors with a growth orientation. Our philosophy could be called GARP but we are a catalyst driven investor. We make our living from a lack of correlation between our stocks and the market over the medium term. Positive and negative earnings performances in addition to M&A activity are excellent examples of uncorrelated value surfacing. We spend a great deal of time looking for and doing fundamental research on companies where we hope to surface positive catalysts to exploit on the long side and negative on the short.

CHW **What gives your investing its edge and what differentiates your approach from that of other peer firms?**

JL We have a definite knowledge edge because of our long history and the amount of built-up knowledge we have in-house. Our archive contains over 3,000 companies we have followed at different points in the cycle. Some of these companies and industries we've been following for many decades now. This gives us the opportunity to quickly get up to speed on a story and decide if an investment is worth it or not. Successful investing also requires patience. Some of the best investment opportunities come by only once per decade or even in a lifetime.

CHW **With so many options in the stock market, how do you even start to look at companies and how do you buy and sell stocks?**

JL There are about 7,000 or 8,000 public companies in the US. Probably half are not really investable as they are penny stocks, companies losing lots money or micro caps so that leaves about 4,000 US listed stocks that are potentially investable. Every year, our team will have reviewed about 2,000 files which are kept internally. We reject roughly 5 out 6 ideas that we review, investing in the best 300 or so during the year and holding about 75 at any given moment. We expect to make money on about 2/3 of our ideas, and try to minimize the hit from our losers. We're quite strict with maintaining our price targets and not leaving capital at risk for the last few percentage points. The risk and return trade-off doesn't work if you have too much invested in something that only has 3 to 5% left.

CHW **Does the volatility in the market change the way you look at investing and how you invest?**

JL Although we pay close attention to risk and volatility, it hasn't changed how we invest and manage our portfolios. Much of the extremity in day-to-day markets has also been clustered at month ends this past summer, possibly as a result of long and short stops being triggered. Ironically, as more players become concerned with month end marks, the volatility of these marks grows. This leaves individual stocks subject to large month end swings, with little fundamental change in the stories.

CHW **Your portfolio is typically exposed directionally to the long side, is there a reason for this?**

JL Our longs and shorts are driven by earnings growth, and for most of the economic cycle, corporate earnings are up. We tend to be longer at the start and in the middle of the economic cycle and less long as the cycle rolls over. During the last cycle for example our net long exposure peaked in the low 80's in 2003, and hit its low in the high teens in mid 2008 just before the recession began.

CHW **How has your short book performed, has the environment been conducive to successful short investing?**

JL We have done well historically on the short side, making moderate profits most years and more substantial profits in the recession years. In 2008, the shorts added over 18% to our return, helping us to contain the overall capital loss in the fund to just over 15%. We expect to continue to make money on the short side with a patient bottoms-up approach and comfort with stocks from many different sectors. As long as earnings remain cyclical and most investors chase stocks up and down, there will be plenty of short candidates out there.

CHW **You have offices in Montreal & NY, are there plans to open a Toronto office?**

JL We originally moved to NY in order to increase the flow of corporate directors and officers coming through our doors. Effectively, the move was based on putting research resources where we were conducting the majority of our investments. We've recently entered into a strategic partnership with a Hong Kong investor to provide us "on the ground" coverage for our global fund. Although we could possibly cover Canada quite well from Montreal, we may in the future begin investing more in Canada so a Toronto office could be a thoughtful addition in our future.

John Liddy *is Co-Chief Investment Officer and Executive Vice President of Formula Growth. He is also the primary portfolio manager of the Formula Growth Hedge Fund. A graduate of Waterloo and York Universities, he joined Formula Growth in 1995 after four years as a growth stock analyst in Toronto. Mr. Liddy is currently based out of our New York office.*

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