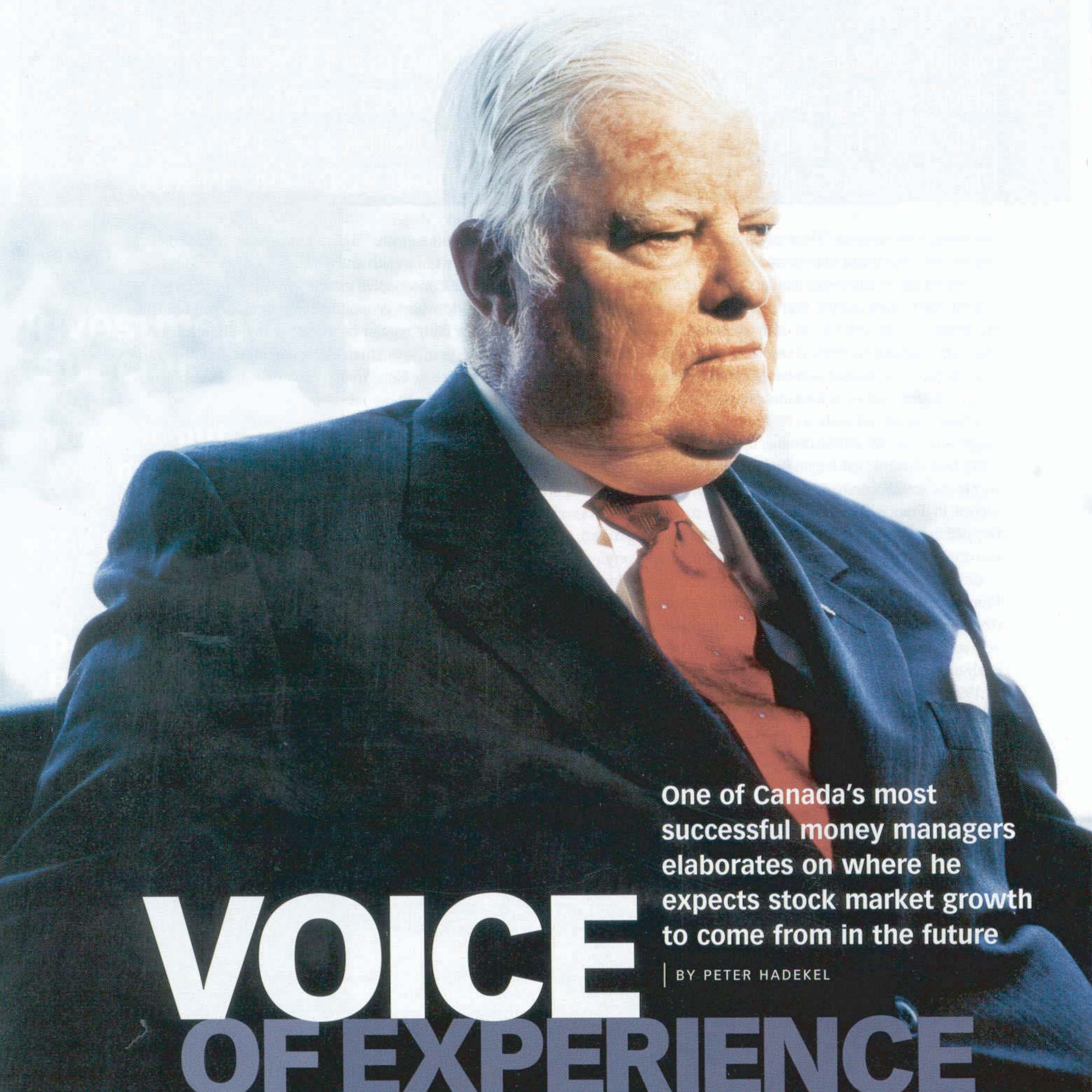

VOICE OF EXPERIENCE

One of Canada's most successful money managers elaborates on where he expects stock market growth to come from in the future

BY PETER HADEKEL

AFTER THREE YEARS OF DIFFICULT FINANCIAL MARKETS, these are trying times for many investors. Their faith in the bedrock principles of investing has been shaken; many aren't sure where to turn next. Do the classic rules of investing still apply? Can investors today expect the same kind of returns from the stock market as they have seen over the last 30 or 40 years? Is it still true that, over the long term, stocks will outperform other asset classes?

After more than 40 years in the business, Montreal-based mutual fund manager John Dobson has earned a reputation as one of North America's most successful investors and a legend in the industry. In 1960, he raised a modest sum from friends and family to start a closed-end investment fund called Formula Growth Fund, specializing in small, U.S.-listed stocks. What's happened since then is nothing short of remarkable: a compound annual average return of 15 per cent over the last 42 years, compared to a return of 7.1 on the Dow-Jones Industrial Average. The fund's unit value has soared from $9 in 1960 to some $2,900 by June of this year.

This stands as one of the best records in the business, but don't try to get in on the action. Formula Growth is not marketed for sale and you can't buy a piece of it unless a unitholder wants to sell to you. Dobson describes it as "a little club" with about 800 investors and assets of roughly $600 million.

Like everyone else, the fund has stumbled in recent years: it had flat results in 2001, a 30 per cent loss in 2002, and was breaking even in the first half of this year due to weakness in the U.S. dollar. Dobson describes the market's fall as "the worst situation in all my lifetime. We've never before had three years of the markets going down this much. It's been disastrous." But Formula Growth has survived and prospered after previous rough patches in the market. "[Markets] went down 30 per cent two years in a row in '73 and '74 and that was pretty bad." From the early 1960s to the early 1980s, stock market performance in the United States was essentially flat but "our smaller growth stocks grew when the whole market didn't."

His faith in his formula for growth remains unshaken: buying small to mid-size companies with lots of potential and holding on to them as they grow. As well, he continues to believe that the same human emotions rule the market. The point of greatest risk is euphoria, the point of maximum opportunity is despondency. On that score, he sees plenty of opportunity these days.

At the age of 75, Dobson has stepped back from day-to-day responsibilities but remains chairman of Formula Growth, while continuing to impart his investment philosophy to the fund's managers with an almost missionary zeal. "We look for companies where the earnings are going to grow by 20 per cent," he explains. "That's where the name Formula comes in. That's what we started looking for in 1960 and the core has always been the same."

Randy Kelly, Formula Growth's president, has absorbed Dobson's lessons well. "John taught me a long time ago the power of compounding. If you can move the needle in a small company doing $200 million in sales, you can watch it go to 300 and 500 and 700 million. We've seen it time and time again. If that company has good managers, and they bring that growth to the bottom line and can finance their growth, those will be good stocks. "That's what John is very good at: keeping the discipline of this firm on small-cap growth stocks. It's simple math. Small companies can double and quadruple quicker than big ones."

Formula Growth bats about .300 in its investment portfolio. For every 10 stocks it buys, only three will be hits. But those winners typically return enough that the fund can beat the market. Success stories in the last year or two have included stocks such as Rent A Centre Inc., which rents home appliances to customers with poor credit records, and Talk America Holdings, a company breaking into local telephony in the U.S.

"One thing John firmly believes is that this business is a numbers business," says Kelly. "If you buy 10 stocks, it's very hard to know which ones are going to win; they all seem good. Typically, out of 10, we get three very good ones, three neutral and maybe four where we just want to shoot ourselves." But as long as the managers remain patient and stick to their plan, this pattern has proven very profitable for Formula Growth. It's a long game, and there may be five-year periods when the portfolio won't do so well. But Dobson's focus has paid off.

He learned the power of compounding at an early age. From the time he was a baby, his father put $100 a year into stocks for him. He graduated from McGill University, then attended Harvard Business School and worked for an engineering firm before trying his hand at investment management.

From the start, Dobson wanted to avoid the ups and downs of Canada's cyclical economy. When demand for natural resources booms, cyclical stocks do well but when commodities fall out of favour, so do many underlying stocks. Investors face a serious problem of market timing with cyclicals: when to buy and when to sell. So Dobson looked south of the border, with its go-go economy. "You can buy a lot of stocks in the States that can grow every year, so you're removing the problem of timing," he says. "If you buy a growth stock, and you're wrong, you might not make money for a year, but then it gets going again."

It's not a game for the faint of heart or the inexperienced. Small stocks are volatile and carry as much risk as they do rewards. But small companies typically offer many attractions: they are nimble and unbureaucratic, innovative in their products and focused on their customers. When their owners and managers take a significant equity stake in these businesses, they have real incentive to succeed. The half-dozen fund managers at Formula Growth are each on the road in the U.S. about 60 or 70 days a year, checking out new opportunities and monitoring the stocks they hold.

If you ask him about the future, Dobson will tell you that the investing environment has changed in the wake of the technology collapse and the accounting scandals south of the border. There are more rules to contend with. There are a lot more players in the game than when he started, so competition has intensified. But the fundamental things that drive small stocks upwards have not changed. "Money will come into these companies and they will go up," he says with religious faith. "Now, will we see results like we saw over the last 10 years, when companies were able to print money and get away with all sorts of things? No. The returns will be less than they were, but still bigger than big caps, and they will beat every other asset class." ■

FORMULA GROWTH FUND SPECIALIZES IN SMALL, U.S.-LISTED STOCKS. IT HAS HAD A COMPOUND ANNUAL AVERAGE RETURN OF 15% OVER THE LAST 42 YEARS, COMPARED TO 7.1% FOR THE DOW. THE FUND'S UNIT VALUE HAS SOARED FROM $9 IN 1960 TO SOME $2,900 IN JUNE OF THIS YEAR.

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