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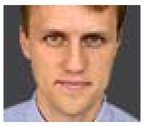
INVESTING

Riding Sprott's coattails is no sure bet



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No currency is more valuable on Bay Street than a good investment idea. The problem is they're hard to find, so a lot of people attempt a shortcut by buying what the smart money is buying. "Coattail investing," they call it.

Well, take a note, folks, because if you think you can easily follow what Eric Sprott and his band of money-makers are doing - you probably can't. That's because the insider-reporting rules in Canada contain a big loophole that's easy for fund managers to use. Retail investors, beware.

Whenever you hear Mr. Sprott's name these days, the word "Timminco" is usually not far behind, and this tale revolves around that one controversial investment. Sprott Asset Management is the second-largest owner of the silicon manufacturer, whose stock price rose 73-fold last year. That single bet helped Mr. Sprott's firm earn terrific performance fees, giving a major boost to his plans to go public.

The IPO was done in May and placed a tidy $1.5-billion market value on Sprott Inc., making Mr. Sprott a paper billionaire. He, in turn, publicly defended Timminco after short sellers questioned its claims that it had found the Holy Grail - an inexpensive method of making pure silicon, a key material for solar panels. On May 2, Sprott Asset Management filed a so-called alternative monthly report, or AMR, which revealed its 17-per-cent Timminco stake. That disclosure, along with a slew of positive announcements by the company, persuaded retail investors to climb on, and over the next five weeks Timminco shares went from about $19 to a peak of $34.50.

Alas, there's trouble in solar-powered paradise. Making silicon that's 99.999 per cent pure at a low cost is not easy. The company's much anticipated second-quarter numbers were a bust: It shipped just 221 tonnes of the stuff, well below the expected level of 300. Costs were high as well. Inventories went way up. Timminco's share price - well, it went in the opposite direction, and closed yesterday at $14.51. But do the Sprott acolytes still believe? Jean-François Tardif, a Sprott hedge fund manager, told The Globe on Tuesday that he still liked the Timminco story, but had sold most of the shares from his funds. "In our opinion, all this is real. Valuation is another thing, right?" he said. "I sold on the way up. I sold some in the low $20s, mid $20s, high $20s, and the $30s ... because my strategy is always to put the most money in my best idea in terms of risk-reward today."

On Bay Street, this triggered a round of head-scratching. Mr. Tardif's comments indicate he sold in May, June, or July. He sounded bullish on the Business News Network on July 15, however, telling the audience the stock "could easily go to $50 or $100 a share" if the company met it targets. More importantly, as the owner of more 10 per cent of Timminco, isn't Sprott supposed to disclose when it buys or sells shares? It has filed nothing on that since May 2.

That's where the loophole comes in. A passive fund manager, in this case Sprott, doesn't have to say anything if the change is less than 2.5 per cent (thus, with Timminco, it could trim its position to 14.6 per cent and stay silent). Seems reasonable enough. But even if the firm does break that threshold, it may not have to report anything for weeks under the loose rules for AMRs. Sprott could sell its entire Timminco stake today and not say anything until Sept. 10. Coattail investors wouldn't know what hit them.

For the record, that's not happening. Mr. Sprott says he's still a Timminco fan. "J.F. [Mr. Tardif] might have sold some - I don't even know what the number of shares was, quite frankly - but I have not sold," Mr. Sprott said yesterday. "So I obviously still believe in the technology and the opportunity. And we still own a very large piece of this company." He said didn't know exactly how much, but it wasn't far off 17 per cent.

"We've got a great company in this country, that's got a great product, that they sell at a very high margin ... if [the silicon-making process] functions properly, the margins would be quite exciting to everyone."

And if it doesn't? That's obvious. "If something's wrong, you have to try to extricate yourself if it's wrong," Mr. Sprott said. The man's track record on this score is astonishing. In addition to well-known winners, time and again Mr. Sprott and the firm have managed to escape from an investment in an overhyped small-cap stock with little harm to their reputation or performance.

In 2004, Mr. Sprott loved Ceramic Protection; the stock is down 92 per cent since the end of that year. That same year, he was a supporter of Taser International; it has plunged more than 80 per cent. He once touted the merits of Bennett Environmental. Two years later, after hitting $27, it crashed. Now it's 27 cents. Nautilus, another one-time Sprott favourite, also got destroyed. He knows when to buy, but also when to leave.

We don't know whether Timminco is all it claims to be. But if it's not, we're certain of two things. Eric Sprott will sell, and the average investor won't have a clue that he did until much later. Coattail riders should keep that in mind.