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Introduction

The year drawing to a close has represented a very successful year for Tidd Capital and its clients. Not only has our performance been quite satisfactory, but there has been a steady inflow of new capital from clients throughout the year. I appreciate the continued trust that clients have put in my firm to manage their assets, and I enjoy the opportunity to try and grow those assets.

In light of these business developments, starting on January 1, 2007 the minimum size for new accounts at Tidd Capital will be raised from $25,000 to $50,000. Existing accounts of less than $50,000 will be retained and managed in exactly the same way as they have been in the past -- as always, all previous commitments will continue to be honored. However, clients with smaller accounts should consider adding to those accounts to bring them up to the new minimum, if possible. Note that Tidd Capital fees start to decrease on a percentage basis once the assets under management for a client reach $100,000.

My goal from the inception of Tidd Capital has been to attract not just any clients, but the right kind of clients. I find that the best way to do this is by describing my investment philosophy in these newsletters, and obtaining new clients primarily through referrals. Almost all new accounts this year were obtained from referrals from existing clients. If you believe that your family, friends, or colleagues could benefit from Tidd Capital investment services, please mention it to them.

I am also seeking to affiliate Tidd Capital with other financial firms to provide complimentary services to their clients. If you think your CPA, financial advisor, estate planner, or wealth management firm would be interested in having Tidd Capital provide investment services to their clients, I would like to talk with them.

Fading Amaranth (or, hedge funds that don't hedge)

You may have read something in the news about the meltdown at the large hedge fund named Amaranth Advisors. The name, ironically, comes from a Greek word meaning "never fading". Amaranth lost approximately 65% of its value -- about $6 billion -- in about one week. I guess that isn't a "fade" exactly, more like a "collapse".

These astonishing losses were achieved by just a few traders at Amaranth, making highly leveraged bets that natural gas prices would **increase**. Unfortunately, those prices **fell** precipitously, and Amaranth lost big. Amaranth had 360 employees, 7 offices worldwide, and assets approaching $9 billion, yet they were "effectively in the hands of a 32-year old trader", according to one industry veteran. Amaranth had billed itself as a "multiple-strategy hedge fund" with a "risk management infrastructure", two claims that seem specious today.

In fact, the way that Amaranth was embracing these huge risks, it would be a misnomer to call it a "hedge fund" -- clearly, it wasn't hedging. Hedge funds were originally conceived as "market neutral" funds, for example those that would go both long and short stocks, with the goal of maintaining steady gains in any market environment. But these days, with the explosion of "hedge" funds managing tens of billions of dollars, most hedge funds don't hedge, and are far riskier than other investment vehicles. The funds embrace risk rather than hedge it, but the term "risk fund" will never become popular, so they continue to call themselves "hedge funds".

Warren Buffett has called hedge funds "a compensation structure dressed up as an industry". This refers to the lavish compensation structures charged by hedge funds, which usually include 20% to 30% of profits plus a management fee of 1% to 3%. With this structure, hedge fund employees get not only a hefty guaranteed income, but a percentage of the fund's profits as well. But perhaps most importantly, they often suffer no penalties at all if there are losses. In this case, the 32 year old trader many say was responsible for wiping out the fund reportedly earned between $75 and $100 million in previous years before causing the fund to lose more than $6 billion. After delivering these losses to clients, he will most likely keep his outsized compensation from previous years, without experiencing any of the losses himself.

This allows me to point out a major difference between hedge funds like Amaranth and accounts at Tidd Capital -- not only is my own money invested along side that of Tidd Capital clients, but so is my family's -- my wife, kids, brothers, a family trust, mother-in-law, aunt, etc. If I made a mistake like Amaranth Advisors, and wiped out 65% of our value, let's just say that things would be a little uncomfortable around the next Thanksgiving dinner table.

There is an anecdote to the Amaranth story that is particularly relevant to Tidd Capital clients. Aside from the natural gas trading, Amaranth also held significant positions in the stocks of companies worldwide. As big as they were, when they had a position, it was usually a large one. It turns out that Amaranth held 15% of Cinram, a Canadian DVD replication business. Cinram has been a holding of Tidd Capital since November of 2004. When Amaranth got into trouble, it announced that it might have to sell its position in Cinram suddenly to raise cash to pay off its other claims.

When 15% of the shares of a company need to be sold in a hurry, the price of the stock usually falls, because there aren't enough buyers to offset the selling volume. That is exactly what happened with Cinram, the stock fell about 10% in a short time. However, I continue to believe that Cinram the company is doing quite well, as worldwide demand for DVD's remains very strong, and Cinram's capital structure is well suited for delivering substantial free cash flow to shareholders. They are also headed into their seasonally strongest quarter, the fourth, when a lot of DVD's are sold.

So this was a classic example of the stock moving completely out of step with the business. With the stock at depressed prices, I have been buying more shares while they are "on sale". This situation demonstrates that markets are not always efficient -- sometimes, a stock moves for reasons that have nothing to do with the business, and this can mean an opportunity for the attentive investor.

"Wealth creation" companies

Investing legend Marty Whitman uses the term "wealth creation companies" to describe companies whose business is to create or compound wealth. This may seem like a truism, but most companies provide only a specific product or service -- Coke sells soft drinks, USG sells wallboard, etc. The successful companies do so profitably, and the most successful grow over time, but their operational focus is relatively narrow. The analytical focus of these conventional companies is revenue growth, margins, competitive advantage, cash flow, etc.

Wealth creation companies, on the other hand, may simultaneously be in more than one industry, and may change industries as they buy and sell businesses. The company can move in unexpected directions, and even change structure and financing on a regular basis. Warren Buffett's Berkshire Hathaway is an example, and currently sells everything from Dilly Bars to fractional interests in corporate jets, and recently made the surprise acquisition of a tool manufacturing company in Israel.

The analytical focus for these shape-shifting companies is not necessarily their current operations, which can change quickly. Rather, the focus is on the management team, in terms of their capabilities, incentives, shareholder orientation, and track record. The more nuanced analysis of their operations involves the total return delivered to shareholders, considering both the terms of the purchase and sale of each business operation. This analysis is more subjective, and the important points are not necessarily laid out on audited financial statements. Such analysis doesn't fit easily into the pigeonholes that most security analysts try to use, which gives an advantage to open-minded analysts that seek total return and are creative in how they achieve it.

Wealth creation companies often show up in Tidd Capital portfolios because I believe there are a lot of opportunities with these companies. They are often misunderstood, which provides good buying opportunities. The management teams of the successful companies are excellent investors in their own right, and it can be very beneficial to hitch our wagon to their efforts. I wanted to go into more detail about one such company below.

KHD Humboldt Wedag

This mellifluously named company has grown to be a major holding in Tidd Capital portfolios. Considering the somewhat obscure nature of the company, and the extremely outsized returns it has already provided, I thought I would give more background on the investment.

I had the extreme pleasure and privilege to attend a small investor luncheon in Manhattan in September, where I sat across the table from Michael Smith, Chairman of KHD Humboldt (and several other companies), and discussed his company for almost 3 hours. Aside from being extremely interesting and informative, it was an exciting opportunity for me to "talk shop" with one of my investing and business heroes.

Michael Smith has a long investment career that started with his takeover of a small REIT in the early 1980's. He used this company to fund investments and controlling interests in other companies, including mining, real estate, and merchant banking companies. His investment vehicles are characterized by international scope, strong shareholder orientation, limited tax liabilities, and complex financials. This combination has proven to be very profitable for shareholders, as well as fascinating for analysts.

I have been following Smith's various investment vehicles, both public and semi-public, for years. Most of the companies do not subscribe to the level of disclosure typical of large US corporations, since they are domiciled in foreign countries or have limited exposure on any stock exchange. Finding information about these companies is a fun challenge in itself, at one point I visited the SEC archives in Washington, DC to request paper documents dating back to the 1980's.

However, analyzing for dozens of hours does not necessarily mean that there is an opportunity to be found, and for a long time I sat on the sidelines and pored over these obscure financial documents, waiting for opportunity to knock. Finally in June 2005, one of Smith's prominent publicly-traded investment vehicles, then named MFC Bancorp, was trading at a price that seemed very attractive -- too attractive, in fact, considering Smith's acumen and track record. The stock was trading at a substantial discount to book value, a value which seemed to exclude the company's many positives.

Shortly after we invested in MFC Bancorp, they announced the acquisition of KHD Humboldt Wedag, an international cement engineering company. KHD was an international company in the midst of a brisk growth phase, as worldwide demand for cement and related services has been booming. Furthermore, KHD was poised to move its business out of the heavy assets of actual cement manufacture and delivery, and into more service-oriented businesses such as cement plant engineering.

True to form for a wealth creation vehicle, this acquisition came as a surprise to most analysts, including me -- however, the surprise was a most pleasant one. The hallmark of a successful wealth creation management team is pleasant surprises. While the specifics of each new investment are hard to predict, it is possible to predict that such investments will happen. In a moment, our investment in a successful merchant banking and finance company became an investment, at an extremely attractive price, in a booming international engineering company.

Starting with the completion of the acquisition, Michael Smith worked behind the scenes to greatly improve KHD's value to shareholders, by transforming the company into a services company that requires virtually no capital to operate, and produces a substantial amount of free cash flow.

During the investor luncheon, Smith outlined his brilliant strategy for maximizing value for shareholders, starting from KHD's successful business platform. The company's contracts were structured so that clients pay KHD up-front at each milestone, so KHD receives their funds before paying suppliers. This makes the business as a whole entirely self-funding and cash flow positive. Smith changed the company's financing from a government-guaranteed line of credit to an unsecured line of credit on much better terms, and the company is now able to borrow money at 8% but is paid 15% from clients. Leveraging the company's international platform, Smith has moved some operations and material sources to low-cost areas, to cut costs and increase margins. The company has been divesting itself of heavy assets (which, as Smith said, "only depreciate and rust"), turning the company into a streamlined engineering and finance company that can grow without any capital constraints.

The company is now not only much more profitable, but is significantly overcapitalized, with cash equal to more than 40% of its market value. This cash, under the control of Smith, is very likely to provide additional pleasant surprises to shareholders, and Smith is clearly on the hunt for new acquisitions. Thus, despite the more than 100% increase in share price since Tidd Capital began investing in the company, I believe the stock is still very much worth owning. I look forward to the next pleasant surprise that Smith sends our way.

Closing

I hope that this letter has given you a better understanding of my investment process. If you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

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