

In praise of 'evil-doers': It's too bad so many investors avoid hedge funds because of their lousy reputation. A lot of them are doing excellent work

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If we believe everything we are told, hedge funds are full of rebellious, anti-conformist cowboys -- smart alecks, who are too greedy, too impatient and simply too dangerous for the rest of us chumps who adhere to buy-and-hold investing.

Myriad examples are held up to support this idea. In the U.S., hedge-fund critics like to remind us of how the founders of Bayou Group lied about the fund's returns and even created a phony accounting firm to audit its results. Wood River Capital Management, meanwhile, collapsed after it allegedly violated the terms of its offering memorandum by taking a bad gamble on a single stock. In Canada, of course, Portus Alternative Asset Management Inc., a so-called fund of funds, is routinely cited as reason enough to avoid hedge funds altogether.

But it's a mistake to believe that these high-profile cases of fraud and deceit are the norm. In fact, if investors assume hedge funds are evil incarnate -- and therefore bad investments -- they're missing out. Even in Canada, where the hedge fund industry is small compared to the United States or Europe, there are several money managers doing extremely well for their clients. And they're doing so without being controversial or tawdry.

Take Elmwood Capital from Milton, Ont. Managed by Rick Serafini and Scott Coleman, it focusses on very small U.S. technology firms, the kinds of companies that mutual funds abandoned after the dot-com bust. Elmwood has produced a three-year compound annual return of nearly 30%, compared to 19.5% for the Nasdaq.

That's a great return. But there's more. Elmwood achieved this result while being open and upfront about its investments. In a recent note to clients, for example, the firm detailed its interest in a company called Genome Health, which has developed a test for early-stage breast cancer. Bucking the hedge-fund stereotype, Elmwood was explicit about the risks of putting money in the company. Genome may profit from a potentially huge market, the firm said, but it also warned that the U.S. medical system won't pay for Genome's expensive test. Such candour is hardly the behaviour one would expect from a fund that's trying to operate in shrouds of secrecy.

Likewise, investors should take notice of funds such

as Goodwood Inc. Based in Toronto, Goodwood has a history of buying stakes in struggling or undervalued companies and occasionally strong-arming management into making changes. To most people, this sounds like "activist" investing. But there's a lot more to it than just being tough. Goodwood looks hard for undervalued and unrecognized assets within companies that could be revived or sold. And when it finds the right opportunity, it's willing to load up on a stock and stick with a firm.

The style may be aggressive, but Goodwood's flagship fund has produced a 22.5% compounded annual return since its inception in 1996, net of fees, compared to 10.4% for the S&P/TSX Composite Index.

Furthermore, Goodwood doesn't hide information. It publishes performance numbers monthly, including risk measures and long and short positions by sector. It also discloses its top-five long-term investments to unitholders and regularly publishes detailed commentaries on its handful of concentrated holdings. It's not that Goodwood is motivated by any great sense of altruism. Transparency is simply good for business.

There are plenty of other examples of Canadian hedge funds doing solid work. The better ones are even attracting money from Europe and the U.S. Obviously, these hedge funds aren't magic bullets. But they present options for investors to diversify their portfolios instead of riding the ups and downs of equity markets in plain-vanilla mutual funds. The solid results delivered by Goodwood, Elmwood and many others prove that the blanket condemnation of hedge funds is not only tiresome, but also a disservice to investors.

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