Annual Report

The Goodwood Fund
1999 Annual Report

To the Unitholders of The Goodwood Fund:

For the year ending December 31, 1999, The Goodwood Fund (the "Fund") returned 60.28% gross (or 50.05% net - after performance fee). The TSE 300 Total Return Index ("TRIN") rose 31.71% in the same period.

From October 31, 1996 (the commencement of the Fund's public operations) through to March 31, 2000, the Fund has returned 39.1% per annum gross (or 32.7% net) versus the TRIN's per annum return of 18.5%.

* In 1999 our long positions in the aggregate generated $1,846,924 in realized and unrealized net gains while our short positions produced realized and unrealized net losses of $308,463. These figures do not account for any interest and/or dividend income earned or paid out on our positions.

On December 31, 1999, the Fund distributed $2.35 per unit, which was the manager's year-end estimate of net capital gains, dividends, and interest income after providing for management, operating and performance fees paid during the year. This amount was automatically reinvested on your behalf in additional units (at the post-distribution NAV per unit of $11.44).

The Fund's 1999 audited financial statements and a copy of the portfolio as of March 31, 2000 are attached for your review.

As unanimously approved by the unitholders, Rabin Puccetti & Partners Inc. ("Rabin Puccetti") became the managers of the Fund on November 25, 1999. However, Peter Puccetti, as President and Partner of Rabin Puccetti, remains the Fund's portfolio manager.

* Note that the indicated rates of return are the historical total returns over the periods noted, including changes in unit value and reinvestment of all distributions. These indicated rates of return do not take into account any redemption charges that may have been payable by redeeming unitholders, which would have reduced the returns of redeeming unitholders in certain circumstances. Please refer to the Offering Memorandum for details concerning the redemption fee schedule of the Fund. In addition, note that performance data represents past performance and is not necessarily indicative of future performance.

Investment Philosophy: Portfolio Composition

During 1999, the Fund averaged a 94.1% invested position (i.e., long positions plus short sale positions as a percentage of the Fund's equity). At one extreme, the Fund was 133.4% invested (98.8% long and 34.6% short). At the other extreme, 47.7% invested (43.1% long and 4.6% short).

Our net market exposure (i.e., longs minus shorts as a percentage of Fund equity) has averaged 66.6% in 1999. Thus, on average during 1999 the Fund has had only two thirds of its capital exposed to a downward market move.

As at March 31, 2000, the Fund is 115.0% invested. This is composed of 101.6% in long ideas and 13.4% in short positions, leaving an 88.2% net market exposure.

While the Fund does not have a formal target ratio of percentage invested and percentage allocated to longs versus shorts, effort is made to maintain some balance of longs and shorts (with a preference for long ideas) and to not be highly leveraged.

Investment Philosophy versus Current Market Reality:

Investment fads come and go periodically as it is in the market's nature to swing between greed and fear. A tremendous rally in Canadian small capitalization oil and gas shares took place in 1991. In the 1980's "portfolio insurance" was the fad (subsequently debunked in October 1987). However, nothing compares to the technology mania of the last few years (in particular 1999). The amount of "overnight wealth" created by promising technology companies (primarily tied to the Internet) and the speed with which this wealth was created exceeded even unreasonable expectations. While one must recognize and give due credit to the vast opportunities that are being created by the Internet and by huge improvements in the speed and quality of communication, one must also be aware that ultimately the economics and profitability of a business will determine it's equity value.

The rich history of manias features a few recurring themes: 1. Manias exceed expectations on the upswing, 2. Manias exceed expectations on the downturn and, 3. The downturn portion occurs over a much shorter time frame than the upswing. In fact, as this Annual Report is being written, the technology/Internet/day trader mania may have already entered it's downturn portion since the Nasdaq Index has already dropped as much as 34% from its 2000 peak (albeit after having risen 86.1% in 1999!). Our assumption is that the speed with which this mania has made billionaires out of some young technology geniuses will be exceeded by the speed with which some portion of this great wealth is lost.

The important issue vis a vis managing the Fund's portfolio has been to not get thrown headlong into a style of investing that I am not experienced in nor comfortable with. While the Fund did invest in some technology issues we did so with some confidence as these stocks were trading at substantially discounted prices relative to prospective earnings and asset value. In other words, the Fund's exposure to the technology mania was handled in a common sense, risk averse manner.

Furthermore, we coupled our long "cheap" technology exposure with a bearish short position on technology. Through most of 1999 and continuing into this year, the Fund has been short the NASDAQ Index (through the NASDAQ 100 Trust series - a proxy for the NASDAQ Index) and short the "dot.com" phenomenon (through the Internet Holders Receipts - a Merrill Lynch created basket of twenty internet companies that trades on NASDAQ). Again, these short positions, along with our short position in the "TIP's" (a proxy for the TSE 35 Index) and more recently in the "XIU's" (a proxy for the TSE/S&P 60 Index - which replaced the TIP's), actually cost us quite a bit in 1999 and early 2000.

Expectations and Rate of Return:

To avoid any potential misunderstandings, we want to stress to you that we have no idea what the Fund's rate of return in any one-year period may be. Stock investing does not lend itself to accurate predictions of returns. What should be expected is to earn a return over the long run that is above the risk free rate of return (the risk free rate of return is commonly defined as the return of treasury bills issued by the Federal Government) thus justifying the extra risk incurred.

Our hope is to average 20% plus per annum, not every year - just average, which, if it is achieved, will be a mix of good years and bad years. And, to be clear, we are shooting for a good year in 2000 and every other year.

The Fund's "Core" Positions:

The Fund's core positions each typically account for 10% or more of the Fund's portfolio. A core position is one in which we have a high conviction level and are prepared to wait for some time for the stock price to catch up with fair value.

The following discussion of the Fund's core positions includes estimates of future results and target prices that are, except where otherwise indicated, based on my analysis of publicly available information respecting such companies. There can be no assurance that such results will be obtained or that the market value of such securities will approximate their target prices.

Future Shop Ltd. ("FSS") - common shares:

Future Shop is the largest retailer of computer and consumer electronic products in Canada. The Company is also a major retailer of appliances, music and video software. The company operates 83 retail superstores and 5 Computer City computer superstores serving retail customers, corporations and government agencies.

FSS management made an all too familiar mistake in Canadian retailing - they ventured South of the border, hoping to repeat their domestic success in the much more competitive US retailing market (reminiscent of Canadian Tire's ill-fated "Whites Stores"). Well, to say it was a flop would be too generous. FSS was losing more money in the US than the Company was making in Canada despite having a substantially greater number of stores in Canada. After some serious thumb sucking, management finally made the decision to abandon their US operation. Approximately $80.3 million was reserved simply to provide for the costs of this exit!

Leaving the US gave the Fund a terrific opportunity to buy the remaining assets, namely the Canadian retailing operation, for a very favorable price as most investors were justifiably worried that perhaps FSS wouldn't be able to cope with the financial strain of winding down their US operations. Our analysis suggests otherwise. When the proceeds of the spring 1999 equity financing are factored in (of which 57.9% was purchased by management) FSS clearly has the capacity to deal with the US setback. Importantly, a Canada only FSS is in superb position to reap outsized profits from its National presence and unparalleled Canadian buying power.

Adding further to our confidence in FSS's earnings outlook has been the recent string of strong year over year "same store" sales growth. This yardstick, which relates only to stores that have been open for one year or more, measures current sales performance versus sales in the year ago period. Beginning in October 1999 FSS began reporting double-digit growth rates in this important metric as follows; October (1999), +12%; November, +10%; December, +14%; January (2000), +22%; February, +21%; March, +23%; and, April, +28%! Furthermore, this growth has been driven by the newfound pervasiveness of digital products, which should carry much better gross margins for FSS than their traditional product lines. A reasonable estimate of FSS's current earnings power is $3.00 plus per share (after a lighter than normal tax rate due to some tax loss carryforwards). In fact, with the recent increase in year over year same store sales, FSS could be running at a substantially higher rate. This year, fiscal 2001 (the year ending March 31, 2001), will be the first year not marred by the US experiment and thus will be investor's first chance to see the status of the Canadian operations on a stand-alone basis.

While the stock has already doubled from our cost, there is much more upside as the investment community at large begins to understand the company's inherent earnings power. The US comparables (Best Buy, Circuit City and Tandy) trade for 28X to 38X earnings. To be conservative and in light of the Canadian markets' historical pattern and FSS's relative illiquidity, we have assumed that FSS will trade at a discount relative to the US comparables. Yet, potential earnings of $3.00 combined with just a 15X multiple yields a price target of $45.00, materially ahead of FSS's current share price.

Canadian Medical Laboratories Limited ("CLC") - common shares:

CLC is a healthcare company, providing laboratory testing services in Ontario and pharmaceutical research services throughout North America.

CLC is a familiar name for the Fund. It was our largest position going back to 1997. Our original cost was in the $6 per share range and beginning in early 1999 the stock began to move upwards sharply. It eventually reached a high of $24.60. We sold the bulk of our position between $9.35 and $24.50 per share but we have since reestablished it at an average of $15.10 per share.

Our renewed interest in CLC was spurred on by MDS Health Group Limited's ("MDS") recent acquisition of Phoenix International Life Science's Inc. (a leading Canadian pharmaceutical research firm). Arguably, there is now a scarcity value accruing to CLC, as it is one of only two Canadian publicly traded lab/pharmaceutical research firms (the other one being MDS). While in and of itself this is not a reason to own the stock, I think it does add to the potential for a decent valuation being placed on the stock later on.

The CLC we now own is significantly stronger than the one that we originally bought. Earnings for the fiscal year ending September 30, 2000 should come in at approximately $1.75 per share (implying an 8.6X P/E multiple at our cost) versus $0.40 per share in fiscal 1997. As well, while the lab portion of CLC's business continues to be the primary earnings engine of the company, progress continues to be made in enlarging CLC's high growth, pharmaceutical research business.

Management owns almost 50% of CLC and as a result has taken a cautious approach to growing the pharmaceutical research business. The average investor, particularly in the momentum driven times that we live in, would probably not approve of this cautious approach. However, I very much like this approach as I think it reflects Management's substantial acquisition experience (from growing their lab operations) and lessens the risk of a major mistake being committed. In fact, CLC's management ability to "step on the accelerator" at the right time has been impressive (e.g., the Med-Chem Health Care Ltd. acquisition of last year which resulted in a doubling of CLC's lab business).

My target price of $30 places a multiple of 15X on going forward earnings of $2.00 per share. Further comfort can be drawn from the fact that CLC's operations are non-cyclical - rare in a Canadian perspective.

VERSUS Technologies Inc. ("V") - common shares:

VERSUS Technologies Inc. ("Versus") develops, distributes and provides access to electronic securities trading services and related products for both retail and institutional investors through its electronic trading network (the "Network"). The company's institutional business provides institutional investors and investment dealers throughout North America with electronic trade execution products and services, as well as specialized information management, trading and analysis tools. Versus' retail business is marketed exclusively in Canada under the E*TRADE Canada name, as a service of VERSUS Brokerage Services Inc., and delivers online investing services through its branded Internet site.

Versus has three identifiable assets; 1. Substantial cash net of debt (somewhat offset by the Company's "cash burn rate" due to current operational losses), 2. The institutional trading business and, 3. The retail online business (E*TRADE Canada).

Versus' institutional business enjoys a dominant market position in Canada as virtually every Canadian institutional investor/dealer operates a Versus machine. In the fiscal year ended September 30, 1999 the Versus Network accounted for approximately 12% of the combined volume of The Montreal Exchange and The Toronto Stock Exchange. The bulk of this volume came from other dealers and institutions using the Versus Network as an effective means to execute some portion of their trading needs (i.e., making use of the technology platform).

Versus' institutional business does face the prospect of additional competitive pressures coming when current regulatory practice is overhauled. My position is that Versus' strong Canadian presence and inexpensive share price makes the Company a potential takeover candidate. In the meantime, Versus is getting stronger through adding "content" to it's machines (i.e., information that traders and investors will find useful - witness the recent acquisition of Fairvest Securities Limited a provider of corporate governance research). Substantial upside exists in Versus' institutional business. To the extent that it's Network remains the main alternative trading system in use in Canada, substantial upside exists in Versus' institutional business.

However, the "sexiest" part of Versus' business has to be it's retail business as the potential exists for a massive increase in the number of clients. Evidence of this potential was shown in the quarterly results for the period ending March 31, 2000, as E*TRADE Canada's accounts grew by a staggering 76% in just three months (to 37,241 accounts as at March 31, 2000). In the same time frame client assets reached approximately $1 billion up from $605 million as of December 31, 1999.

Of course with stocks, relative certainty is rewarded with a relatively high valuation and since Versus has been trading at a relatively cheap valuation you can draw the correct conclusion that there are concerns about Versus. The chief concern has to do with the issue of profitability or more specifically, the lack thereof. Versus is spending much more money on advertising, marketing and systems development that it currently generates in revenue and thus the Company is operating at a loss. The quarter ending March 31, 2000 featured a net loss of approximately $4.0 million. These losses have weighed on the stock price.

Management's philosophy is that the next few years in Canada represent a critical, once in a lifetime opportunity to build market share. Thus, Versus' focus has been on delivering account growth not on profitability. At some point in the not too distant future management expects that a confluence of account growth (accompanied by revenue growth) and cessation of excessive marketing expenses will lead to profitability.

Obviously we have committed the Fund to some expectation of profitability. Our opinion is derived from the following assumptions: 1. There will be strong growth in the number of online brokerage accounts in Canada over the next few years (some estimates suggest 2 to 3 million accounts in Canada within that time frame), 2. That Versus will garner some reasonable market share, say 10% (particularly as the leading Canadian, non-bank purveyor of online financial services), 3. That Versus' inexpensive operating platform (made low cost through the extensive use of empowering technology) will more than offset it's low commission rates and, iv. Online commission brokerage rates will stop declining as investors become less driven by low commission rates (In the case of a $10,000 trade, do you really care whether you pay $8 as opposed to $15) and more driven by other services and features (e.g., good service, quick and accurate execution, research, tax help, portfolio tracking bells and whistles, etc.).

Importantly, the Fund hasn't paid much for our opinion, as the market's current pricing of Versus assigns no value to the Company's retail business. In other words, Versus' cash plus a reasonable estimate of the worth of the institutional business total to an amount that is actually marginally greater than the share price. The Fund has thus bought into E*TRADE Canada, a business that has grown at 25.9% in the first quarter and 76% in the second quarter of fiscal 2000 respectively for a negative price!

Our risks are; i. Marketing expenses eat up all of Versus' financial resources (although management believes that the cash "burn" will soon subside), ii. The institutional business loses its substantial market share and, iii. When the spending on market share stops E*TRADE Canada still can't turn a profit.

Admittedly, a money losing, Web based Company is not what you have come to expect in the Fund's portfolio. But, we feel that we can make an exception here as Versus operates in the financial services arena (an area that we are more familiar with than say retailing) and we aren't paying for it's growth prospects. Also, the Company's substantial cash position (approximately $3.20 per share as at March 31, 2000) makes us more comfortable that it can execute on its business plan.

The lack of profits makes the valuation of Versus less than straightforward. One approach is to assign values to each operating group separately. Based on US comparables, Versus' institutional business could be valued at 2X revenue to 3.5X revenue, while E*TRADE Canada, if valued at the current mid-point of US comparables, could command a value of 4.7X revenue. Keep in mind that a company growing this rapidly makes forecasting much more speculative than it is in our other positions. Nonetheless, assuming $21 million of institutional revenue (equivalent to 46% growth in fiscal 2000 over fiscal 1999 - 22% and 70% growth was achieved in each of the first and second quarters) Versus' institutional business is worth between $3.50 and $6.13 per share. E*TRADE Canada's revenues for fiscal 2000 are assumed to amount to $31 million, approximately 300% growth as compared to fiscal 1999 (the first and second quarters of fiscal 2000 showed year over year revenue growth of 259% and 353% respectively). Thus, Versus' total value may be in the range of $18.79 to $21.42 per share (cash included).

Looking Forward:

As you know from past Annual Reports, we have been loath to make macro economic calls in the portfolio (taking the point of view that our opinion has the same chance of being right as the majority of the population say, 50/50). Nonetheless, the recent burst of the technology bubble may mean that the Fund can now cautiously short sell second tier, cash challenged Internet companies. We are on the "lookout" for such candidates but remain cognizant that these stocks are extremely volatile. Sporadic rallies (sometimes of great percentage magnitudes) must be expected thus making it difficult to maintain these positions with impunity. Our approach to shorting (which has been mostly successful in 1998 and mostly unsuccessful in 1999) has been to cover loss-making positions quickly. After all, the position can always be reestablished if, after some reflection, the short argument remains factually strong.

At the very least, the good news is that some analytical skill can now be brought to bear in our shorting activities. Shorting individual names in 1999 has been fraught with peril, as many of the potential short ideas have enjoyed quick upward moves in their share prices. In terms of lessening our overall long exposure I much prefer having good individual short ideas as opposed to the less discriminate basket or index approach taken in 1999.

On the long side new ideas are constantly coming into view across many different sectors. As always the focus will be on finding inexpensive, high quality situations that are not well followed or are misunderstood. When combined with dubious, expensively priced short positions, the portfolio is well equipped to deal with many market conditions.

Please call if you have any questions, thoughts or comments.

Peter Puccetti, CFA
Chairman & Chief Investment Officer