GLOBE AND MAIL REPORT ON BUSINESS COVER STORY

Report on Business

Canada's junior oil and gas companies had become the forgotten children of the energy world. Shunned after the implosion of the energy trusts, things got worse – low gas prices, rising costs and uncertainty about royalties. That was so 2007. This year, oil and gas prices have soared, making new technologies more viable and sending a rush of juniors to once untouchable lands.

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Globe Investor

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The news this week that a bunch of hedge fund managers raked in billions of dollars last year did little to burnish the image of an industry facing calls for tougher oversight of its often opaque practices.

At a time when ordinary investors were getting pummelled, the credit markets were freezing up, Bear Stearns was rushing headlong toward oblivion and institutions were paying a heavy price for their plunge into so-called alternative investments like mortgage-backed securities, the top 50 hedge fund players pocketed a cool $29-billion (U.S.).

The king of the hill was a shrewd Wall Street trader named John Paulson, who took home $3.7-billion for his all-in bet that subprime mortgages and the investment vehicles in which they were bundled would crumble to dust. Many of the others on the list, compiled by Institutional Investor's Alpha magazine, made their pile from commodities.

Thanks to what has been called the biggest hedge fund coup ever, Mr. Paulson's firm more than quadrupled its assets to $28-billion and attracted retired Fed chief Alan Greenspan, who apparently still needs work, as an exclusive adviser.

No one is turning into a hedge fund zillionaire in Canada, where the industry is still of the cottage kind. But these are still good times to be in the business, despite a spate of losses suffered by funds of almost every stripe.

That's the optimistic word from John Schmitz, who ranks as one of the Canadian industry's grizzled veterans with a decade under his belt. He freely acknowledges that life has been difficult in recent years for his sort of quantitative investment approach. That is, until last year when the market started to dip and dive and recovered in fits and starts.

“I tend to do better the worse it is for everyone else out there,” says the founder and CEO of SciVest Capital Management. “I'm feeling pretty good these days because I think these [conditions] are going to last not just for a couple of quarters but a couple of years. We've got a great economic environment to pick stocks in, and most of my competitors don't exist any more.”

Hedge funds and their aggressive managers in pursuit of monster billion-dollar scores have been linked to some of the worst global market excesses, including last August's stunning equity collapse. They have even been fingered for the sharp rise in oil prices (as well as other commodities), which analysts estimate would be as much as 40 per cent lower if the speculators pulled out.

You won't find Mr. Schmitz swimming in commodity or derivatives pools. He operates largely in the hedge fund space known as market neutral equity, which means he plays a much more conservative game than many industry heavyweights.

“If you take big risks and you win, you get paid well,” he says. “If you don't like taking big risks, like me, a great year is probably the high teens in terms of returns. I'll never do a 30-per-cent year.”

Indeed, there was a time when even 1 per cent would have been welcome. That was back in 2004, when his neutral equity fund plunged 11.8 per cent, ending several years of healthy returns.

Mr. Schmitz relies on computer models to eke out modest returns from acquiring stocks that slightly outperform the market and selling short stocks that slightly underperform in the same industry and market. What the market as a whole does is irrelevant. But the larger the spreads between the long and short picks, the better he does.

This strategy requires a certain amount of volatility and plenty of diversification to prosper. When volatility plunged to historic lows during the height of the bull market between 2004 and 2006 – and euphoria trumped rationality – he and other market neutralists suffered badly.

One of his remedies was to reduce the heavy dependence of his core fund on U.S. stocks. He now trades in the 14 biggest equity markets in the developed world.

A conservative hedge fund manager sounds like an oxymoron in an industry known for people making huge wagers with other people's money. But the true purpose of hedging is to reduce risk, which is where Mr. Schmitz comes in.

People don't fully grasp how a conservative hedge fund can lower overall portfolio risk. “This is an education issue,” he says. “And unfortunately the most influential teacher is real life financial pain – and I think this teacher is starting to give her lesson.”

What Mr. Schmitz offers certainly isn't sexy, but it's what hedge funds are supposed to be doing – manage risk and produce conservative returns in markets good and bad.

Brian Milner