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ENERGY ISSUE

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3G Capital Management's Pavel Begun (left) and Cory Bailey

BY DAVID PETT

Mr. Nice Guys

Pavel Begun and Cory Bailey are building a kinder, gentler type of hedge fund

HEDGE FUNDS ARE usually pretty easy to spot. They are contrary by definition. Even though hedging should reduce the risk of an investment, hedge funds use riskier investment strategies, such as short-selling or trading on margin, to make big scores. In 2008, they were also the funds run by money managers who cowered in fear as the market collapse fuelled record redemptions.

Then there are hedge funds like 3G Capital Management LLC, run by managing partners Pavel Begun and Cory Bailey. They weren't as spooked by the meltdown. In fact, they embraced it as a buying opportunity. And while investor panic was making otherwise healthy companies look bad, 3G's performance was looking pretty nice. From the start of 2008, 3G has earned a 23.2% return from its relatively conservative plays, which compares nicely to its 14.5% annual average since it began in 2004.

Those numbers may not impress investors who pine for the glory days earlier this decade, when hedge funds used outsized strategies to generate outsized returns. But with markets still bruised by the crash — and investor appetite for risk more restrained than ever — even modest double-digit returns look appealing. And in producing them, Begun and Bailey may be helping to define a different form a hedge fund — one that's trades off extremes for security and careful risk management.

"From day one, our objective was to use common sense to generate high returns while assuming below-average risk," Begun says from his downtown Toronto office. In fact, that philosophy is so deeply ingrained, Begun and Bailey try to avoid the term "hedge fund," preferring to label their business a private-investment partnership. Fair enough. The main points of comparison are on

the surface. Like other hedge funds, 3G Capital Management requires a high minimum investment — $250,000 — and investors are charged management and performance fees. Typically, hedge funds charge a "2 and 20" fee, meaning a 2% annual management fee and 20% of any profits. 3G uses a similar model, but with lower costs. It charges 1.5% as well as a 20% incentive fee — but only if its portfolio returns more than 8%.

But the similarities end there. While traditional hedge funds will head off to pursue exotic investment strategies, 3G has been buckling down to business as a conservative money manager, albeit a souped-up one, using a strategy originally envisioned by Begun almost a decade ago.

Begun, a native of Belarus who was educated in the U.S., met Bailey, a native of Missouri, in September 2001 when both were working at Fiduciary Asset Management LLC in St. Louis. "Neither of us wanted to work for somebody else," Begun says. "Cory said he wanted to do real estate and showed me the numbers. I wanted to get into the value investing business, and showed him my numbers. Then Cory said, 'To hell with real estate.'" 3G opened its doors three years later and now boasts more than $50 million worth of assets under management.

With offices in Toronto and St. Louis, Begun and Bailey have built a strong global-client base, managing capital in Canada, the U.S., as well as continental Europe and the United Kingdom.

While not entirely unique among their peers, 3G focuses on making picky long-term conservative investments, not unlike more famous investors such as Warren Buffett and Benjamin Graham, the creator of value investing. For example, the company owns a significant holding in Wells Fargo, the well-known U.S. bank that was hit hard during the crisis despite its strong fundamentals. Similarly, 3G is bullish on Bingraee Co. Ltd., a South Korean dairy producer that has "zero debt, great margins, great management and is really cheap."

Because 3G looks to hold its investments for three to five years, the firm avoids using borrowed funds and shorting stock, the hallmark trade among hedge funds. On average, the firm carries a net cash position of about 14%. It also limits redemptions to once a year and reports returns biannually, compared to most hedge funds that report and allow redemptions on a monthly basis.

"Last year, when people were worried about the world ending, we didn't receive one redemption request. In fact, we had some clients add to their investment," Bailey says. "This investor base allows us to focus on the long term and not on monthly numbers, which is the reason we continue to outperform 99% of all mutual-fund money managers."

Despite 3G's success, Begun doesn't expect other funds to start emulating its strategy or to try to move into its less risky niche. The primary goal of many hedge funds is to always get bigger returns in the hopes of attracting even bigger investments. To do that, money managers are under pressure to achieve short-term gains. If they don't, clients will walk at their first opportunity.

"Last year, when people feared the world was ending, we didn't receive redemption requests. Some clients added to their investments"

That, Begun and Bailey believe, is ultimately a losing strategy, especially when the market turns sour. "Anytime you do well in times of crisis, it gets noticed," Begun says. "But if you can regularly demonstrate that your performance is superior to mutual fund and hedge fund competition, it will attract assets." In the end, they say, it's about consistent performance. Nothing else matters. **FP**

Street Talk

Green check-up

Trends emerging on clean-economy front

THIS MONTH, TWO TAKES ON GREEN THEMES. FIRST UP, A REALITY CHECK ON CARBON EMISSIONS — AND THE INVESTMENT OPPORTUNITIES THESE EFFORTS MAY PROVIDE. NEXT, BRACE YOURSELF FOR A BOOM IN HYBRID CARS

> CARBON REALITIES How far do we need to cut greenhouse-gas emissions to reach climate-change targets? More than we think, according to a recent report from UBS. The problem: rapid growth in India and China and their reliance on coal-fired electricity generation. According to UBS's calculations, even if India and China maintain their emissions at 2006 levels, the rest of the world will need to cut emissions by 84% to meet the widely suggested target of reducing emissions to half of 1990 levels by 2050.

Even if reduction targets look increasingly difficult to achieve, UBS notes that they are creating investment opportunities in renewable energy. Hybrid electric cars will be a space to watch, as autos account for 16% of direct emissions. The UBS report also mentions Energias de Portugal, Iberdrola, Vestas, and Applied Materials, noting that they are the world's largest hydro, solar and wind-equipment technology companies.

> MORE HYBRID HITS Evidence of steeper-than-expected battery price declines may soon push hybrid electric cars deep into the mainstream, Duestsche Banke writes in a recent report. Based on its discussions with industry experts, Deutsche says that the price of lithium-ion batteries will likely fall by 25% and 50% over the next five and 10 years, respectively. If these projections bear out, that should lead to increased sales as payback times on purchases decreases. That's the good news. Deustsche also warns increasing competition may raise concerns about the profitability of battery producers. — *Jonathan Ratner*