

## There's hope for labour funds

LATER-STAGE FUNDS CARRY LESS RISK, BUT SECTOR STILL A GAMBLE

By Jonathan Chevreau

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It's been awhile since we looked at labour-sponsored investment funds – or retail venture capital, to use the new category name embraced by Morningstar Canada.

The last piece I wrote on the subject expressed my personal disillusionment with this asset class. However, a contact of colleague Barry Critchley prevailed upon me to take another look.

John Varghese is a managing partner with VentureLink Funds. "Sounds familiar," I thought, checking my investment statements. Sure enough, one of his funds – VentureLink Financial Services – is in my own portfolio. Better yet, I realized, it's actually up since I purchased it. The only other labour fund I own that's up is Front Street Energy Growth, which is really a "half labour fund" since it doesn't generate provincial tax credits.

So I agreed to meet with Varghese over a nice lunch, with Critchley picking up the tab. (Thanks, mate).

Before the water arrived, Varghese whipped out a chart titled Comparative Industry Returns. He didn't pretend returns were much to brag about for the asset class as a whole but wanted me to distinguish between early-stage venture capital funds and later-stage funds.

Many underachieving LSIFs have been early-stage funds like Canadian Medical Discoveries, which sports a minus 4.7% return over the 10 years ended Aug. 31. The worst LSIFs, like Triax Growth, no longer exist or have been assimilated.

However, LSIF rules don't require that they invest exclusively in ultra-early-stage ventures. The actual criteria for investee firms is a maximum of 500 employees, with at least 50% of those workers employed in Canada. As well, total firm assets can't exceed \$50-million.

This permits investing in less bleeding edge, more mundane businesses. Examples of "second-generation" LSIFs investing in such firms include the ROI (Return on Innovation) Fund, Vengrowth Traditional Industries and some funds in the VentureLink stable. These may not be pure equity funds but could use mezzanine debt: higher coupon debt with an equity "kicker."

The upside may be lower than early stage ventures that hit the proverbial grand slam but the risk in later-stage funds is also lower.

Sure enough, these funds – while no barnburners – have at least showed positive returns. As of Aug. 31, 2006, ROI Fund has a plus 3.3% three-year return, while Vengrowth Traditional Industries has a slightly positive 0.7% one-year return.

VentureLink Financial Services has a 5.1% return over three years and Diversified Income Fund is up 6.2%.

As of Dec. 31, 2005, returns for the 59 early-stage LSIFs were minus 12.3% over five years but only minus 0.7% for 10 years. The 14 later-stage funds were minus 6.5% over five years and minus 1% for 10 years. A third category, Balanced Venture Capital, is down 5.2% over five years but plus 4.2% over 10 years.

Naturally, Varghese wants the Ontario government to keep the program going, although the 15% provincial tax credit is scheduled to fall to 10% in the 2009 tax year and 5% in 2010. The 15% federal credit will remain intact and Varghese is optimistic Ontario may yet be persuaded to reverse course.

To the extent LSIF purchases are tax-driven in the first place, later-stage funds look more tempting. The disillusionment many investors feel over LSIFs is that many didn't even manage to break even, the minimal expectation when you view the real return as tax savings. Positive returns are a bonus.

This is where I part company with Varghese. He's pushing the public to stuff RRSPs with LSIFs but I've always believed products with such risk should be in non-registered portfolios, where losses can be used to offset capital gains elsewhere.

Like other LSIF execs, Varghese's marketing literature shows the net costs of LSIFs after both tax credits and the RRSP deduction any investment generates.

Thus, one piece shows that for someone in the top tax bracket, a \$5,000 LSIF purchase has an "after tax cost of investment" of just \$1,180. That's counting \$1,500 in the 30% LSIF tax credits and another \$2,320 in RRSP tax savings. But I don't think it's cricket to include RRSP "savings," which can as easily be generated with blue-chip stocks, quality equity mutual funds or government bonds.

As I remarked to Varghese, the Canadian market is 3% of the world's market cap so Canadian venture capital should only be a fraction of that in a properly diversified portfolio. Young investors with nothing but LSIFs in their RRSPs will end up with portfolios far from the optimum mix any good advisor would recommend.

To its credit, VentureLink also lists the disadvantages of LSIFs: MERs can be high, junior companies have more risk and probability of failure, and investors are locked into holding them for eight years (or must repay the credits).

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**VentureLink LP**

One Richmond Street W., Suite 701  
Toronto, Ontario M5H 3W4  
[www.venturelinkfunds.com](http://www.venturelinkfunds.com)

Phone 416 681 6676  
Toll Free 800 253 1043  
Fax 416 681 6661