# All bets are on

By ANDREW WAHL

## Hedge funds offer investors an alternate route to financial success

When you hear the term hedge fund, Long-Term Capital Management LP probably comes to mind. In the summer of 1998, as the Asian financial crisis spread and Russia defaulted on its debt, Greenwich, Conn.-based LTCM saw more than US$4 billion vanish in a matter of weeks. Carrying leverage of 100 times its assets, the fund made, among other missteps, some very bad bets on Russian bonds. And its imminent collapse sent an icy chill up the spine of an already weakened global financial system. To prevent further collateral damage to major American banks, the US Federal Reserve stepped in and organized a US$3.6-billion bailout. "Had the failure of LTCM triggered the seizing up of markets," Fed chairman Alan Greenspan said to the House Banking Committee in defense of the bailout, "substantial damage could have been inflicted on many market participants, including some not directly involved in the firm, and could have potentially impaired the economies of many nations, including our own."

Hardly a ringing endorsement of what hedge funds can do. LTCM's near-collapse entrenched a popular perception: that the mysterious backroom world of hedge funds is dangerous, and reserved for only the most wealthy and daring. The average Canadian mutual fund holder or online discount investor hears about LTCM and figures she has little use for such complex trading strategies, taking high-risk stakes in everything from bonds and derivatives to the direction of interest rates and currencies. But in fact, LTCM was never much of a poster child for the industry. And perceptions of hedge funds are changing. In the past year, a number of such funds have sprung up in Canada—and they're no longer just for the rich. Investment managers are finding ways to design products that convince securities regulators to let ordinary folks behind the red velvet rope. And once there, investors are finding that it's not such a scary place after all.

Hedge funds have been hidden from view in part because securities regulators have labeled them speculative investment vehicles suitable only for the sophisticated investor (read: wealthy). Investing in hedge funds is commonly a private placement (not on the public markets), so you need a minimum investment of as little as $25,000 in BC to as much as $150,000 in Ontario. (Even under the Ontario Securities Commission's proposed changes, which will remove minimum investment rules and come in line with regulations in the US, you'll qualify only by having at least $1 million in assetsor an annual income of $250,000.) Advertising efforts are restricted as well, but little would be gained by mass-market campaigns. Many hedge funds set minimum investment levels of more than $1 million, and they close to new investors when they reach a certain size that's optimum for their strategy (more on that later).

Ferenc Sanderson, director of research at industry watcher HedgeWorld.com, conservatively estimates that 5,000 hedge funds existed worldwide in 2000, worth US$450 billion to US$500 billion, up from US$25 billion to US$50 billion a decade earlier. Of those, 90% were managed by US-based fund managers, although about 50% of hedge funds are legally established in offshore tax havens. In Canada, where there are restrictive offshore tax rules and fewer people with the kind of wealth and temperament required for hedge funds, they are only just starting to generate much interest. Industry insiders estimate that five years ago, there were fewer than five hedge funds in Canada. Today, that number is more than 25—and growing quickly.

Some of them come from an unlikely source: traditional mutual fund companies. Mackenzie Financial Corp., CI Mutual Funds Inc. and Transamerica

Life Canada have each launched new products to tap into hedge strategies. "Fund companies are beginning to consider that perhaps their business is more investment management rather than purely mutual funds," says Jim Fraser, who was a leading advocate of the initiative inside Mackenzie, where he is senior vice-president of marketing. Mackenzie's approach, similar to others, is a "fund of funds": investors (those able to pony up $150,000 minimum) get a portion of a pool of about 18 hedge funds, which operate under a variety of different styles and are picked by specialists from a list of 2,500 credible managers. "Clients can do very well investing in hedge funds," says Fraser, "but it's really important that there be proper oversight and due diligence in finding managers. In packaging it together, the client is not exposed to single-manager risk."

most hedge funds are about. The universe of alternative investments (as they are officially labeled) is characterized by much smaller and less influential funds that are designed to control risk, not threaten the stability of capital markets. It's why they're nicknamed hedge in the first place: they are generally used to reduce volatility and shrink risk in a portfolio by providing a balance to other equity-based investments.

Hedge fund managers do this by using techniques mutual fund managers are not permitted. The latter generally diversify among asset classes such as stocks, bonds and cash, and spread out capital over many industry sectors and economic regions. While that's safer than betting it all on one stock, there's little that can be done against a broad market decline. At their most simple, that's what hedge funds do: remove, or at least reduce, the effect of the broad market on a portfolio.

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Other hedge funds have found ways of skirting private placement restrictions. Horizons Mondiale Hedge, managed by First Horizon Capital Corp. of Toronto, has a $5,000 minimum. Toronto-based Argentum Management & Research Corp. has three funds that use hedge fund techniques—Canadian Long/Short Equity Portfolio, US Market Neutral and Pooled Market Neutral—and got an exemption from the private placement rule. They each have minimum investments of just $500, and carry management expense ratios (MERs) that are competitive with the rest of the mutual fund industry. All are managed by Chabot Page Investment Counsel Inc. of Montreal, and they're performing well in this market climate. Year-to-date, the Canadian L/S is up 9.4%, US Market Neutral is up 9.6% and the Pooled Market Neutral is up 17.5%. The TSE 300, meanwhile, is down some 13%.

It all likely sounds rather intriguing, as any new opportunity for the average investor always is. But if you invest in a hedge fund, just what are you getting into?

The drama that engulfed LTCM in 1998 was, in fact, the antithesis of what

The first hedge fund is credited to scholar Alfred Winslow Jones who, as an associate editor of Fortune magazine in 1949, wrote a story about Wall Street forecasting. Several months later he established an investment partnership and a fund that used two key speculative tools that buy-and-hold mutual funds can't: short selling and leverage. Short selling is borrowing a stock in order to sell it, in hopes of buying a replacement at a lower price—betting that the price will drop. Leveraging is borrowing money to invest and hoping to make more money than the interest you'll have to include with the principal repayment. Used exclusively, both techniques come with the much higher risk of losses—bet wrong, and you lose much more than your initial investment. But combined with buying long, the techniques can be effective in negating the direction of the market.

This is how Christopher Guthrie does it. As CEO and founding partner of **Hillsdale Investment Management Inc.**, he's been running hedge funds for six years out of the attic in his midtown Toronto house. Prior to that he spent nine years designing quantitative trading models for institutions such as pension funds. He's used that knowledge to come up with extensive databases that are his window on the financial markets. Hillsdale, which has four managers in Toronto, offers six funds (three US and three Canadian) worth a total of $50 million. They break down, one per country, into three categories: straight equity funds, market neutral funds and aggressive hedge funds.

Market neutral is the classic hedge play: take equal amounts of long and short positions. This neutralizes any market volatility and is intended to make the fund completely uncorrelated with the market indices. (For example, if the TSE 300 is down 10%, a market-neutral fund can just as likely be up.) How does Guthrie make money in his hedge funds? By reinvesting short-sell proceeds in money market instruments, and by carefully choosing the right stocks to buy long and the right ones to sell short. In a rising market, good long buys will rise more than the general market, and good short sells will rise less, yielding a net profit within the hedge. It works in a declining market, too: good long buys will fall less than the market, and the right short-sells will fall more—offsetting the longs' losses and, again, leaving a net profit.

The end result is a fund that won't ever make as much as a raging bull market but won't get mauled by a bear market, either. Volatility is cut to bond-like levels, and Guthrie targets a 10% to 15% annual gain. "You get a lower return, but you get much lower volatility," he says. "Successful hedge funds are all about risk control. If you're just looking at returns, it's hard to tell a good hedge fund."

Guthrie's aggressive hedge funds work along the same lines. But instead of investing equally long and short, he uses leverage to get a boost. These funds usually are about 180% long and 120% short, for a net of about 60% long, which is still lower risk than a 100%-long mutual fund. Their return objectives are 20% to 25% per year, and they have slightly more volatility than the market-neutral funds. "It's designed for high-net-worth individuals who still want to grow capital and don't mind how bumpy the ride is," explains Guthrie, "so long as you don't lose them money over six months or a year." He points to the recent performance of his aggressive hedge fund against the TSE 300 index: since last August, Guthrie's fund is up 8%, while the index is down 26%— still much worse than his fund's deepest trough of 13% between December and February. "You're still affected by the market going down," says Guthrie. "You're just hoping to keep the draws to a minimum."

In both cases, the trick is to pick the right stocks to get returns as well as control risk—and that's where Guthrie gets coy. He relies on his complex quantitative models, which track dozens of variables and factors, some of which he's spent years perfecting, and reviews each week. "Unto themselves, the factors are quite simple," says Guthrie. "The value is in finding the factors and then putting them together to make a predictable return expectation."

That is common in the world of hedge funds, where every manager has a secret strategy to exploit some inefficiency they perceive in the market. It's one reason funds may close themselves: the larger you get, the easier it is for the rest of the market to watch a manager's strategy in action and destroy that first-mover advantage. Small hedge funds are simply nimbler than billion-dollar behemoths, and often more able to expertly deploy a strategy. They don't all just play the long/short game, either. One common tactic is takeover arbitrage: betting one company will buy another and estimating the effects such a move will have on the stock prices. In some cases, so-called hedge funds don't hedge at all, but really just leverage or try to time the market with opportunistic short selling.

And this is where the risk of hedge funds comes in: what if that manager is wrong? What if he doesn't stick to his trading style? What if he gets so caught up in his own hubris, he blows it all—like LTCM? Ultimately, it's caveat emptor. You have to place a lot of trust with a manager and his abilities, since so much of what he does is proprietary and therefore kept secret. One standard practice of most hedge funds is supposed to dampen worries: managers usually have almost all their own money invested, too.

Still, hedge funds are generally expensive propositions. The minimums are high and may represent a large portion of your savings. When considering what hedge funds can do for you, that's where you have to start—with your own portfolio and how much risk you're exposed to now. In this kind of market, it should at least make you think twice.