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FP Questions & Answers

Rally's end brings good outlook for hedging

BOB THOMPSON

Chris Guthrie, Arun Kaul and their team at **Hillsdale Investment Management Inc.** have been responsible for some eyepopping returns over the years with their non-traditional approach to money management. Last week, Bob Thompson had a talk with Arun Kaul, portfolio manager and chief operating officer. Hillsdale uses a quantitative investment method, which has posted about a 20% annualized return over the past 10 years on the Hillsdale Canadian Performance Equity Fund, and about 16% annualized on the Hillsdale Canadian Aggressive Hedged Equity Fund since inception six years ago.

Q *What is your stock-picking process?*
A We would look at price factors, risk factors, macro factors, expectational factors and all factors that drive stock prices in our opinion. It is quantitative with a fundamental bias.

Q *How do your funds complement existing funds?*
A The hedged [funds] have been designed specifically to complement traditional [funds], in that we try to target a low correlation with other [funds]. When we started running hedged products, we ran the long and short portfolios on a screen and for us the key point was to make sure we make a profit on the spread between our long and shorts. In other words, if the market falls 10%, we might expect our shorts to fall 15%, and our longs to fall 8%, giving us a return of 7%, and vice versa.

Q *What was your biggest mistake in the fund, especially on the short side?*
A Our biggest mistake was probably shorting a stock called Rambus, during the tech boom. It went from $20 to $40, and then up from $40 to $60. We were

definitely wrong. We cut back our position as the stock rose, for risk-control purposes.

Q *Can you discuss the inefficiencies in the Canadian market that you can exploit versus the U.S. market?*
A Yes, hedge fund assets in Canada, as a ratio of mutual fund assets, are about 1%, whereas in the U.S. that ratio is about 5% to 6%. This means that there are not a lot of hedge funds in Canada seeking to exploit market inefficiencies. Secondly, you don't see as great of a development of execution technologies [or program trading] in Canada, and third there is not a lot of liquidity in the names in Canada, which can create opportunities.

Q *Any names of stocks you have owned or shorted that would help us to understand your discipline?*
A Sure, we went long Research in Motion in December, 2003, at under $20. Main drivers were a turnaround in earnings and reasonable valuation. As it ran and its volatility increased, we trimmed back the name all the way up to $110 in late 2004, when it peaked with around a 4% weight in the portfolio. We trimmed back toward 2% and sold in April, 2005, in the mid $80s. It ranged between a 1% and a 4% weight throughout. Later in the spring of 2005, we went short around the mid 90s. We ignored the court case all the way through. It was not a determining factor in our model, nor did we trade around it.

Q *Since we have had three years of great returns where long-only funds would have done well, do you think a hedged approach is prudent going forward?*
A Good question, we are cautious and the reason is that there has been multiple expansion over the past three years. Therefore, in the future the market has to go up based on earnings growth instead of multiple expansion. So it is a good time to have a hedged approach going forward, within a specific risk framework.

Q *How much money can you effectively manage in Canada?*
A We can manage $700-million to $800-million on the Canadian side and we have been pretty firm on that over the last three years. For the Performance Fund, capacity is about $100-million and it is pretty close to being closed to new investors.

Q *Can you comment on mutual fund returns versus a non-traditional approach such as what you do?*
A We are paid to perform, as there is a management fee as well as a performance fee. Mutual funds are much more related to asset gathering, as compensation is based on a fee that depends on the assets managed. This means that in Canada there are definite constraints on how big we can get and still perform well. This is why we will cap a fund. When you look at most large mutual funds in Canada, they tend to underperform because they simply run out of places to put their money. It is also true of hedge funds if they become too large.

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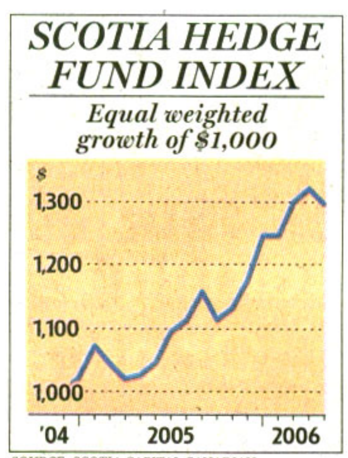

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