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What price institutional investment?

BY KEITH DAMSELL

TORONTO – It was billed as a debate, but what attendees ended up getting was a spirited crash-course in the hedge fund industry's growing pains.

Jim McGovern, managing director and chief executive officer of Arrow Hedge Partners Inc., was reluctantly drafted by the Alternative Investment Management Association to argue how large institutional investors in the asset class are hurting returns.

It was an awkward position for Mr. McGovern, who also serves as founding chairman of the Canadian chapter of AIMA. He courts institutional dollars that lend hedge funds credibility and has been one of Canada's most vocal defenders of the sector following the high-profile collapses of Portus Alternative Asset Management Inc. and Norshield Financial Group.

"Vast capital is hurting returns," he told a Toronto audience of about 100 investment professionals. The market collapse of the tech sector raised "terrifying" fears that institutions and pension funds may not be able to meet future obligations, he said.

Billions of dollars flooded in to hedge funds, a wealth of riches that left many fund managers risk-averse, willing to "avoid superior performance for fear of cracking the golden egg," Mr. McGovern said. "The elephants [institutional investors] are leaving very, very large footprints on the industry and creating a rather messy situation that will eventually have to be cleaned up."

Managers are less opportunistic and returns have suffered, he said. A year ago, major U.S. fixed-income hedge funds were hurt when corporate bonds of Ford Motor Co. and General Motors Corp. were cut to junk status, affecting $453-billion (U.S.) in obligations held by the two auto makers.

"Everybody is in the same damn trade. They have to be… because they can't do more profitable, smaller trades," Mr. McGovern said.

Chris Guthrie, chief executive officer and founding partner of Hillsdale Investment Management Inc., defended hedge fund investing by institutions, arguing that it's near impossible to link performance with a rise in investment dollars.

The collapse of the tech market left many hedge fund managers "on the wrong side of the trade," leading to a shift in risk tolerance and ultimately, a decline in returns, Mr. Guthrie said.

More importantly, hedge funds remain a tiny part of the institutional investment landscape, he said. Global hedge fund investment by institutions has soared from about $375-billion (U.S.) in 1998 to about $1.1-trillion in 2005, he added.

But the asset class's value as a percentage of the total market has remained relatively flat during the same period, climbing from 0.3 per cent to about 0.44 per cent. The overwhelming bulk of institutional dollars is held in equities, derivatives and debt securities.

"The elephant is merely a mouse. None of this is affecting hedge fund returns," Mr. Guthrie told the audience. In an interview following the debate, he added that "if you ask for lower risk, you will get lower performance . . . The beauty of hedge fund is they can match or meet an individual's or an institution's desired risk."

It's estimated Canada's hedge fund market is about $20-billion (Canadian), a fraction of the U.S. market. Only a handful of Canadian institutional investors, including Ontario Teachers Pension Plan and the Caisse de dépôt et placement du Québec, have significant investment in hedge funds.

Industry sources cite a series of factors behind the limited exposure, including strong Canadian equity returns, a Canadian hedge fund market still in its infancy, and limited due-diligence investment staff at Canada's pension funds.

Not surprisingly, the partisan crowd backed Mr. Guthrie and, by a show of hands, he was voted the winner of the debate. His prize was a bottle of wine. Mr. McGovern did not leave empty handed -- the consolation gift was a set of golf balls embossed with the Portus logo.