

Canadian shorts

Lower liquidity, tough markets no match for Hillsdale long/short fund

By M. Corey Goldman

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Vital Statistics

Assets under mgt	C\$150 million
Cdn Aggressive Hedged	C\$107 million
Minimum investment	C\$150,000
Registration	Ontario Securities Commission
Domicile	Ontario
Redemptions	Quarterly
Fee structure	
Management fee	2%
Incentive fee	20%
Auditor	Deloitte & Touche

One of the ironic things about Canada is that it's such a big small country. While boasting the second-largest land mass in the world, its entire population is the same as California's.

Likewise its financial markets. Although robust and sophisticated, Canada's equity and fixed income markets are about one-tenth the size of those in the US, with some sectors like financials consisting of only a handful of companies.

That means finding good shorts and applying strategies that normally take advantage of liquid markets can be slightly more challenging. Systems may point to shorting or buying a stock or slapping a weight cap on a trade based on market conditions, but there may not be as many obvious counter trades to offset risk and volatility.

Not so for Arun Kaul, a portfolio manager with Toronto-based Hillsdale Investment Management. Kaul and partner Christopher Guthrie have proven there is a science to finding and extracting value in the long/short department north of the 49th parallel.

"A lot of people in the US tend to focus on regions, but no one looks at Canada as a separate region in the Americas," says Kaul. "It's nice from our perspective because there are many inefficiencies here to take advantage of, and a few still to be discovered."

Their numbers show it. The firm's flagship Hillsdale Canadian Aggressive Equity Hedge fund had a 23.6% return for the 12 months ended December 31. In the past five years, the fund has produced a compound annualized return of 17%, compared with 3.6% for the S&P/TSX.

Canadian Aggressive, launched on January 31, 2000, is a long/short fund that uses leverage—approximately 85 cents (Canadian) short and C\$1.40 long for each C\$1 in assets, according to the company.

Its objective is to invest a minimum of 80% of its assets in Canadian exchange-traded companies that have a market capitalization of at least C\$100 million. No single long or short position exceeds 5% of the fund's assets.

Fundamental value

Kaul and Guthrie's secret is their statistical methodology, which through hundreds of different variables whittles down to a short list of approximately 40 company names on the long and short sides that are constantly readjusted based on alpha forecasts and their risk contribution to the overall portfolio.

The factors include everything from technical analysis of a particular stock price to numbers that quantify sentimental or even emotional factors at work in the equity market: short-selling and volatility, among others.

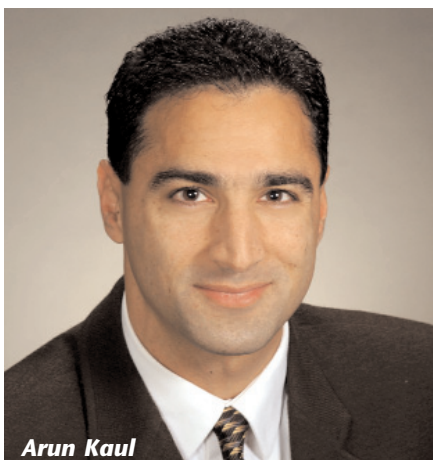
The methodology generates a number that tells the managers the fundamental value of a company, which they constantly monitor and adjust to determine how much that company should be weighted within the portfolio.

"It's a very disciplined approach we've developed over the past 17 years," says Kaul.

He says he and Guthrie came into the hedge fund business from an "irregular background"—the consulting side. In

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Arun Kaul

the early 1990s, Kaul helped provide portfolio analysis, factor modeling and other services for Canadian plan sponsors, pension funds, mutual funds and money management firms.

By the mid-1990s, he recognized that not a lot of people were running shops in Canada that traded systematically or quantitatively. "So we decided to leave and do something most in the industry weren't doing."

He and Guthrie began experimenting with factor models, adding the long/short side to their approach as they went along. Their approach worked in part because of the Canadian trading environment. Hillsdale's database comprises approximately 800 Canadian names.

Finding natural offsets

"In Canada, it's more difficult to find natural offsets to some of the names because the market is not as broad a market as in the US, particularly if you're trying to control volatility," says Kaul. "We're trying not to be one stock dependent."

Hillsdale certainly manages. Kaul points to Research in Motion as a prime example.

Over the course of a year, the maker of the famed Blackberry saw its stock whipsaw several times with moves of as much as 30–50% in each direction over a few months. "We took profits and cut back on that position as its price and contribution to volatility in the portfolio was rising," because there weren't a lot of natural offsets to the stock's moves, says Kaul.

"We typically won't let one position ride

Hillsdale Asset Mgt Inc

PERFORMANCE HISTORY

January 2000 – December 2004

Aggressive Hedged	Hillsdale Canadian Long/Short Equity Fund	CISDM Submedian	S&P/TSX
Return (%)			
Annual comp rate	17.04	8.50	3.59
2000	33.40	16.37	7.41
2001	6.38	5.50	(12.58)
2002	(1.14)	2.88	(12.45)
2003	26.70	9.98	26.74
2004	23.56	6.86	14.47
Risk (%)			
Annual std dev	15.23	8.12	16.55
Semideviation	9.32	4.29	12.40
Maximum decline	(18.99)	(7.37)	(43.21)
Return/Risk			
Sharpe Ratio	0.89	0.67	0.01
Correlation with Benchmarks			
S&P/TSX	0.52		
Canadian T-Bills	0.00		
Lehman Bond Index	0.00		
CISDM Trader Index	(0.12)		

forever because it throws off the risk of the fund. We very actively control exposure to volatility."

Other times, a factor prompts Kaul or Guthrie to send orders to their trading desk to buy or sell a stock—or hold off.

"We constantly monitor the factors themselves for robustness and decay depending on market conditions," says Kaul, noting that earnings surprises have not worked in the US for the past two years, but are now beginning to pick up again.

Overall, Hillsdale's portfolio consists of companies invested in a variety of sectors, including industrials, materials, health care, technology, energy, financials and consumer products and services. The firm limits its exposure to 20% of any one sector.

A rough patch

It hasn't been totally smooth sailing for Hillsdale. The firm suffered a loss in the middle of 2002.

This was partly due to the lack of a shorter-term trading focus and partly to missing factors that Kaul says might have picked up on the additional volatility prominent in the markets that year.

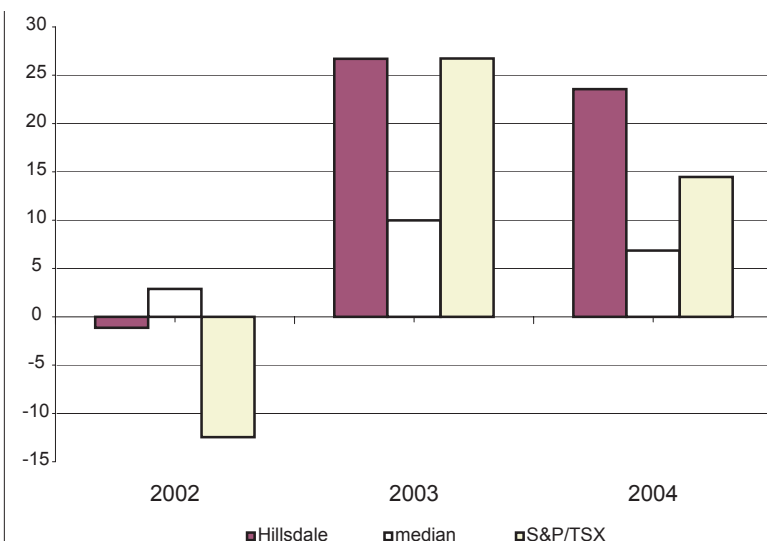
To compensate, the group added more trading and risk-oriented factors that now help it respond better to short-term volatility and trade more nimbly.

For the future, Kaul sees lots of opportunities in Canada, thanks to inefficiencies that still exist and a very low penetration of hedge funds relative to the US and elsewhere.

The markets in general and stock fundamentals in particular are also looking good, owing to Canada's economic position, which currently appears stronger relative to the US than it has in more than a decade.

The current differential between return on equity in Canada versus the US is less

Hillsdale vs median vs S&P/TSX



than 1%, its lowest since 1989. Less exposure to the burst tech bubble and stronger fundamentals including a balanced budget also make Canada attractive, says Kaul.

That's partly why he and Guthrie plan to launch an offshore version of the fund in the second quarter of this year.

"We're always trailing behind the US in terms of profit growth, but Canada has been doing better," says Kaul. "We think it's a story offshore investors will be interested in." ■

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