

Is it time to boost clients' hedge fund investments?

After a lousy year, conditions favourable to better hedge fund returns may be showing up in the markets

■ BY CATHERINE HARRIS

This hasn't been a good year for most hedge funds. Of the 105 alternative strategy funds in Morningstar Inc.'s database, only 28 had returns greater than 4.3% in the first nine months of this year; 54 were in negative territory.

One reason may be that hedge managers are finding it difficult to identify stocks to sell short. Another concern is that the hedge fund space is becoming too crowded, making ideas hard to come by. A third problem: the three market conditions that make for hedging opportunities — volatility, a definite market trend and low correlation among stocks and sectors — have been absent so far this year.

However, the last problem may be about to change. Hedge fund managers believe those three conditions will return shortly, presenting greater opportunities to short some stocks and go long on others, thereby creating the potential to gain on both ends.

"The market has been so focused on macro issues — such as the U.S. presidential election, China, oil prices and terrorism — that investors aren't thinking about winners and losers," says Jim McGovern, president of Arrow Hedge Partners Inc. in Toronto.

It's ironic that these macro risks have posed problems for hedge funds, which are designed to minimize the downside impact should any of these risks create serious difficulties for the global economy and financial markets. But with the U.S. election over, McGovern thinks the environment will improve.

Miklos Nagy, president and CEO of Toronto-based Quadrex Asset Management Inc., which launched its first hedge fund this past summer, agrees. He thinks there will be more direction and volatility and less correlation in 2005 than in 2004.

"We know the policies of George W. Bush," says Nagy. He expects the U.S. dollar to continue its slide in the next couple of years and thinks there could be serious problems financing both the war on terrorism and the U.S.'s huge fiscal deficit. It may be hard to keep the economy going, he says.

As for the hedge fund space becoming too crowded, industry players acknowledge that if there's too much money chasing too few opportunities, returns are likely to be squeezed. And some hedge managers have, indeed, had problems finding shorting ideas.

The problem is greater for hedge funds that rely on statistical analysis. With little volatility, high correlation and no trends, their computer programs aren't identifying as many possibilities. "Lots of long/short funds that are usually in the 80%-long/40%-short range might be 60%/20% with 20% cash today," says McGovern.

A notable exception is Toronto-based **Hillsdale Investment Management Inc.**, which uses a statistical approach and has still outperformed. "We don't subscribe to the view that there can be no opportunities," says Arun Kaul, portfolio manager at Hillsdale. "We are having no difficulty finding good shorts."

Indeed, Kaul says, today's environment is better for finding shorting opportunities than in the late 1990s or even last year, when the bull market was strong. He suspects the hedge managers' ability to find shorts

depends on the methodology. Hillsdale looks at the longs and shorts together, which provides a better relative value spread.

That strategy is reflected in the return of Hillsdale Canadian Aggressive Hedge Fund, a long/short fund which uses more longs than shorts and requires a \$150,000 minimum investment. It had a 15.7% return for the 10 months ended Oct. 31. The similar Hillsdale U.S. Aggressive Hedged Equity Fund (\$50,000 minimum), which was affected by the high Canadian dollar, was down 3.6%, however. The firm's aggressive equity funds are at typical short exposures — using leverage, they sit 90¢ short/\$1.40 long for each \$1 of assets.

In the U.S., the picture is a little different. Over the past few years, more funds have begun competing in the absolute-return or market-neutral arenas, which is compressing returns. "If there are excess funds in the space, they borrow from each other," Kaul says, which can result in problems when managers want to get out of short positions. He thinks compression in Canada is still several years away.

Generally, hedge managers don't think the current situation is a permanent problem in Canada, although there is concern that a shortage of opportunities may be developing in the U.S., which is relevant to Canadian investors in that many Canadian hedge products invest in the U.S.

Hillsdale's fully invested Canadian Market-Neutral Equity fund (\$50,000 minimum) hasn't fared well recently. With as much money in shorts as longs, it had a 2.2% return for the 10 months.

Market-neutral funds usually have lower returns than long-bias long/shorts because markets normally rise, providing greater returns on the long side. Hillsdale's targeted return on the market-neutral fund is return on cash plus four percentage points; on the aggressive long-bias funds, the goal is the relevant market index plus six to seven percentage points.

Another manager who sees no shortage of opportunities for shorting is Colin Stewart, portfolio co-manager of a number of funds at J.C. Clark Ltd. in Toronto. The firm uses fundamental analysis to find companies that are overpriced or likely to have deteriorating earnings. This kind of value approach widens the universe of possible shorts, compared with the statistical-based approach.

J.C. Clark also takes a longer perspective than many. "Identifying a deteriorating company or very high valuation is not the same as it working short-term. We don't worry if a stock goes up in the next month because we expect it to deteriorate over the next two years," says Stewart.

Stewart maintains shorting is easier in Canada because so few are doing it. And although it's more difficult in the U.S., "we are still finding it manageable," he says. "In Canada, there's not a significant amount of research being done on shorting opportunities, while a lot of firms have popped up in the U.S."

J.C. Clark's Loyalist Trust, a Canadian long/short fund, has done well this year, up 10.6% for the nine months ended Sept. 30.

However, its Preservation Trust, a Canadian and U.S. long/short, is down 1.4% for the same period. The latter was affected by the higher C\$, which lowers returns when translated from U.S\$. In addition, the Canadian markets have outperformed those in the U.S., resulting in less upside for U.S. longs. Both funds — which are currently closed to new investors — require an initial \$2-million minimum investment. There is a good chance Loyalist Trust will reopen this year, however, and be available through selected small private-client firms for a \$150,000 minimum, says Chris Holt, director of business development.

BluMont Capital Corp., also of Toronto, hasn't done that well, either, although not for want of shorting ideas, says John Szucs, who works with Veronika Hirsch on the funds she manages.

BluMont looks at new trends to find shorting opportunities, says Szucs. It is currently focusing on companies that are negatively affected by the high C\$ and/or high resources prices but can't pass on higher costs to customers. One example is Cinram International Inc., the Toronto-based manufacturer of CDs and DVDs, whose costs have risen sharply because of the high prices for oil, a key ingredient in the plastic used in discs and packaging.

Earnings per share in the second quarter were 25¢ a share vs the expected 42¢, and the stock price fell 23% the day the financial report was released.

Another is CFM Corp., the Toronto-based manufacturer of home products and related accessories. The company has been affected by both the high C\$ and the increased cost of steel. Then there's soft drink maker Cott Corp. of Toronto, which is exposed to the rise in aluminum prices for its packaging costs.

The approach requires "hands on research," Szucs says. Only when BluMont has a fundamental view of a stock would it look at statistical data "to see if we like the way the trades are shaping up."

BluMont Hirsch Long/Short was up only 2.8% for the nine months ended Sept. 30, while BluMont Market-Neutral was down 10.1%. Both have a \$150,000 minimum investment. On the other hand, BluMont Strategic Partners Hedge, a long/short fund with a \$5,000 minimum, was up 7.6%. It is managed by six managers, including J.C. Clark and Hillsdale as well as Hirsch.

The 12 Arrow funds for which Morningstar has year-to-date returns haven't done well this year. The highest returns for the 10 months ended Oct. 31 were 5.0% for Arrow Enso Global and 6.3% for Arrow WF Asia. Of the others, two were down 1%-2% in the same period; two were up marginally; and six posted returns of 2%-3%.

Although long/short funds account for about half of all hedge funds, there are many other kinds of hedge strategies. Most of them have suffered in the current environment, says McGovern. The only strategies that are producing good returns at the moment are distressed securities (that is, investing in companies in deep trouble that have turnaround potential) and credit arbitrage (shorting a stock while holding long positions in the company's convertible bonds). **IE**