

Canada's hedge funds draw Wall Street attention

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By Wojtek Dabrowski

TORONTO, June 14 (Reuters) - Canada's small but rapidly growing hedge-fund industry is attracting increased attention from large Wall Street investment houses and from foreign institutional investors who are impressed, in part, by the fund firms' expertise in oil and mining.

The foreign investors are hungry for exposure to what has until recently been a piping-hot commodities sector, but Wall Street banks also are seeking to expand their prime brokerage businesses by setting up relationships with existing Canadian hedge fund managers or by seeding new outfits.

"There's some very good investment talent here that is, just now, starting to get recognized internationally," said James McGovern, chief executive of Toronto-based Arrow Hedge Partners Inc., which manages more than C\$650 million (\$585.6 million). "I think we're going to see a lot of the growth in these managers come via international allocations over domestic allocations (of assets)."

Canada's hedge fund world is so young that no one knows exactly how big it is, but the Alternative Investment Management Association's Canadian chapter and other estimates put it roughly at C\$35 billion, and growing fast.

"I don't think it's a big leap of faith that in five years, this industry could double," said McGovern, who also chairs AIMA Canada.

Abroad, investors and bankers alike are taking notice.

John Motherwell, vice-president of institutional marketing at Hillsdale Investment Management Inc., a Toronto hedge fund firm that runs more than C\$300 million, says that attention is being reflected in the firm's client base.

Whereas a year ago, Hillsdale had one U.S. client, it now has five, he says. Where there were no European investors, there are now 10.

"Whether it's been driven by commodities, natural resources, the returns of the Canadian market and some managers up here, there's certainly a greater awareness of funds-of-funds and institutional investors towards Canada, no question," Motherwell said.

Wall Street senses opportunity and Morgan Stanley <MS.N> is considering seeding new hedge funds in Canada.

Also, the big houses are calling with prime-brokerage pitches and offers of introductions to large U.S. institutional investors. Others invite Canadian funds-of-funds -- or funds which invest in a group of hedge funds -- to meet with individual managers.

"So what we'll tend to do is get invited as a client to a Lehman Brothers or a Goldman Sachs capital introduction, with the hope that we might invest in one of the managers they're presenting," said Andrew Doman, chief operating officer at Abria Alternative Investments Inc., also in Toronto.

But even if Canada's hedge fund industry soon doubles to C\$70 billion, it would still be dwarfed by its trillion-dollar U.S. counterpart.

And while commodities -- oil, gas and metals -- may be drawing new capital into Canadian hedge funds, the idyllic climate could deteriorate if the current selloff in Canadian equity markets continues.

In recent weeks, the Toronto Stock Exchange's main index has given up all the gains it had made so far in 2006. Even though hedge funds are ideally supposed to make money in any market environment, McGovern concedes this may pose a problem.

"I suspect if we got a sustained downturn in the resource market, that would really hurt, simply because I think Canada -- even in the hedge-fund community -- is perceived as resource experts," he said. "Right now, it's a pretty popular thing to be investing in energy and mining."

(Additional reporting by Joe Giannone in New York)

(\$1=\$1.11 Canadian)