

Hedge Funds

All the benefits of the market

By Terry Josic and Toby Heaps

The hedge fund industry in the United States is estimated to be a US\$400 billion industry and is growing at about 20 per cent per year, with between 4,000 and 5,000 active hedge funds. According to Mark Valentine, Chairman at Thomson Kernaghan, a prominent Canadian hedge fund manager, the Canadian market for hedge funds is estimated at \$2 billion of which Thomson Kernaghan manages US\$120 million. The Canadian hedge fund industry may be far less established but Valentine thinks that could change: "there's no reason to believe it can't grow. In this market, there is no shortage of companies looking for capital,"

What's been holding the Canadian market back? One reason may be that investors don't fully understand the varying investment styles and mandates of the different funds, which can be complicated. Hedge fund managers can employ one of the widest range of investment strategies out there, including hedging against market downturns, investing in asset classes such as currencies or distressed securities, and utilizing return-enhancing tools such as leverage, derivatives, and arbitrage. A hedge fund can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.

Because of these wide parameters for management, hedge funds can differ widely. Investment returns, volatility and risk vary enormously among the different hedge fund strategies. Like mutual funds, hedge fund companies also offer menus that tailor to the investor's preferences, be they spicy or bland. As Chris Guthrie, President of **Hillsdale Investment Management** describes, "We have six funds designed for each specific investor's preferences. Our funds range from low to high risk with commensurate returns. Some funds are safe, and some not. Our best fund is Hillsdale Canadian Aggressive Hedge Fund running 35 percent return this year. When the TSE dropped 12 percent this year, our fund only lost 1 percent. And our lowest returning fund is Hillsdale LS American Equities fund running a 10 percent return this year."

The popular misconception is that all hedge funds are volatile; that they are all risky investments that have the potential to lose big bucks. Understandably, they have garnered a bad rap because of some high profile losses in the U.S. in recent years most recently the demise of one of the most prominent hedge fund in the U.S., Long Term Capital.

One of the key differences between a hedge fund and a mutual fund is that hedge funds managers can make leveraged investments — which can make them more risky. In other words, mutual fund companies cannot borrow money to invest while hedge funds can. If you invest \$100 in a mutual fund, you end up owning up to \$100 in assets, and you can't lose more than you invest; however, if you put \$100 into a hedge fund you can own up to \$150 to \$200 in assets, and that could turn into debt for you if prices head south. "If you're right, you can make more money in a hedge fund, but if you are wrong, then you blow up," says Doak.

In reality not all hedge funds are risky. The primary aim of some hedge funds is to reduce volatility and risk and to deliver positive returns under all market conditions. Academic research shows certain hedge funds, particularly those which are “market neutral” (positioned to make money regardless of whether the market rises or falls) have higher returns and lower overall risk than indexes such as the S&P500. Some funds, though, will be less market neutral than others. The bigger the bets they take, the bigger the associated risks.

“Some hedge funds are distinguished by their ability to offer more return for the same risk. With a hedge fund, you can short sell stocks,” comments Jim Doak, President of Enterprise Capital Management, “With our economy presently in hydraulics mode, old economy stocks are rising while new economy stocks are falling. There are considerable returns to be had by shorting new economy stocks and buying old economy stocks.”

Chris Guthrie suggests, “When you look for a fund to buy, it’s not the return over the last five years that should interest you, but rather it is the next five years that you really care about. And to get to that with some level of predictability you need a disciplined approach.” Guthrie believes the best way to do this is to use a quantitative approach – which incidentally, is Hillsdale’s calling card – to see which funds are stable over time and which are not. “I have great comfort with numbers and not so much with opinions,” says Guthrie.

One fund with a distinctive approach to the market is the Thomson Kernaghan hedge fund, which was established in 1996. It capitalizes on consistent pricing differences in the market to make money for investors. Manager Mark Valentine explains, “The core

strategy on our main hedge fund, which is a regulation D fund, is to find U.S. listed companies, and sometimes Asian listed companies, that are seeking capital and need to raise money, regardless of where it’s from. Our theory of providing that capital is a wholesale versus retail pricing formula.”

In other words, Thomson Kernaghan is in the position to buy stocks at wholesale prices and to sell them to the main market at the retail price, thus reaping the benefits of the spread, and passing those earnings on to investors.

Investors are sheltered from risk through what Ian McKinnon, Vice president and Director, at Thomson Kernaghan describes as the floating conversion rate, a contract made when a company approaches his firm for capital. “Through Thomson Kernaghan, a company obtains the capital they need in 2-3 months,” Valentine explains, “They pay 20 per cent in fees for lawyers, accountants and so on. We get a piece of paper that converts shares at a 20 per cent discount. When we convert out of this instrument, which we have purchased from the company, we get to buy it at a discount and sell it to the market.”

This arrangement provides a constant return of 20 per cent on a sliding scale exists as long as there is liquidity in the stock price. “We get all the upsides, which are passed on to our investors,” says Valentine.

Even though most people may associate hedge funds with a quick in-and-out approach, the real investment strategy for a hedge fund may be to buy and hold. Valentine’s fund has had a consistent performance for four years, and investors who have stayed the course have been rewarded. There have been rapid peaks, or flat performance, but overall it has gained in a market that has been a wild ride for investors during the

rise (and some may add the fall) of the New Economy. “We’re taking as many factors that we don’t control out of the equation,” says Valentine, and in this way they have been able to offer some insurance against market corrections.

But remember, hedge funds must be researched thoroughly before making an investment, especially because the minimum investment associated with them is often substantial – usually around \$150,000. One of Canada’s most accessible offerings is the @rgentum line of funds, some of which do have low minimum investments of \$500. Their pooled Market Neutral Portfolio (which has the higher price of entry) is a hedge product and shows a two-year return of -8.5 per cent, which won’t please too many investors. The fund takes short positions in some US stocks, and long positions in others, and proves that high-end products don’t always pay off.

The bottom line for investors is that hedge fund investors need to be sophisticated, in order for them to pick the right product, because the range of offerings is diverse and often complicated. Still, if you find a solid product, it could pay off, as many of these products utilize money management strategies that are otherwise only available to professional traders.

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