

CANADA TIP SHEET: Hillsdale Answers Diversification Issue

By Ben Dummett of DOW JONES NEWSWIRES

TORONTO -(Dow Jones)- With globalization making it harder for equity investors to benefit from diversifying their holdings geographically, a new market-neutral fund tries to offer a complementary alternative. In the past, investors could reasonably expect to protect their wealth by relying largely on a portfolio of Canadian, U.S., European and emerging-market equities, betting against all of these equity markets moving in unison.

However, increasingly this strategy falls short of the desired effect, reflecting the trend towards globalization in such areas as cross-border mergers and acquisitions activity, said Chris Guthrie, manager of the C\$19 million Hillsdale Canadian Market Neutral Equity fund. To support this view, Guthrie points out that the performance of the Toronto Stock Exchange 300 composite index is 90% correlated with the U.S. Standard & Poor's 500-stock index and 75% correlated with major European and Asian markets. "It is more and more difficult to put together a balanced portfolio - a non-correlated portfolio - using traditional asset classes," the portfolio manager said. In response, Hillsdale Investment Management Inc. last week launched the Canadian Market Neutral fund, using C\$19 million of seed capital from some institutional investors, to complement an investor's existing portfolio.

The fund's performance is neutral in that its performance doesn't correlate with the TSE 300. In addition, the portfolio of long and short positions is structured to be "extremely negatively correlated," Guthrie said. Shorting a stock involves making a bet that the price will fall. Going long means investing in a stock on the assumption that it will rise.

Seeks 20% Return In Good Year

The fund's return depends on the manager's ability to create a gap between the performance of the long and short positions. The fund should post a return about 5% in a bad year and perhaps 20% in a good year, regardless of what the TSE 300 does in any given year, Guthrie said. This means that, although the manager works to match certain factors to achieve neutrality, he also seeks spreads in other factors to generate returns. For instance, of the fund's short holdings, the manager is currently paying on average a price-to-earnings multiple of 20 times, but on the long side the manager is paying an average multiple of 15 times. At the same time, the earnings of the companies the manager has shorted are falling on average about 60% annualized, while the profits of the fund's long positions are growing about 45% annualized.

Under this scenario, the manager is expecting the average price-earnings multiple of the short positions to fall as the stock prices of the short positions decline, and the average price-earnings multiple of the long holdings should rise as the corresponding stock prices increase. "So hopefully, our longs go to 20 times earnings and our shorts (fall) to 15 times earnings and our fund has made 40%," Guthrie said.

The manager uses quantitative analysts to review the fund weekly in order to make sure the fund's neutrality and spread criteria remain intact. Some of the fund's long positions include Aur Resources Inc. (T.AUR), a mining company, gold company Placer Dome Inc. (PDG), PanCanadian Energy Corp. (PCX), an oil and gas producer, forest-products company West Fraser Timber Co. (T.WFT), Potash Corp. of Saskatchewan (POT), a fertilizer producer, and graphics chip manufacturer ATI Technologies Inc. (ATYT). The manager's short positions include Falconbridge Ltd. (T.FL), Barrick Gold Corp. (ABX), Nexen Inc. (NXY), Domtar Inc. (DTC), Agrium Inc. (AGU) and Zarlink Semiconductor Inc. (ZL).

In addition to seeking neutrality, Guthrie also aims to fix the fund's risk exposure to resemble that of bonds. To accomplish this goal, the fund has a reasonably large number of long and short holdings to avoid too much concentration. For example, the fund holds 40 long positions and 40 short positions.

In addition, the long and short holdings are diversified across a range of sectors. The fund also neutralizes, or matches on the short and long side, the fund's exposure to value and growth stocks, dividend yields, capital structures and other "important risk-creating factors," Guthrie said.

Company Web Site: <http://www.hillsdaleinv.com/>