

Hedge Funds Rebounding

Better due diligence makes Canada fertile investment ground

BY MARK NOBLE

Mention Portus and Norshield and investors may recoil at the very mention of hedge funds. Hedge fund specialists, however, are convinced that the investment vehicle plays an important role in a portfolio, provided advisors understand how they work and conduct proper due diligence.

Hedge funds and alternatives are intended to produce an absolute return regardless of what happens in the market. This should allow steady gains to outperform over the long term against the ups and downs of particular market benchmarks.

Yet, these moderate gains can make them a difficult sell, notes Gordon Kim, an advisor with Aon Consulting. In a bull market, where most standard Canadian equity mutual funds have big returns, hedge funds just aren't that appealing.

"Too many people go into hedge funds expecting double-digit returns," Kim says.

Kim also notes that hedge funds are more an art form than a science. Hedge funds focus heavily on the manager and absolute returns, so the standard bank research and market predictors used by mutual fund dealers do not always apply to determining the potential of a hedge fund. This makes it difficult for clients to understand what they're investing in.

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"I tell clients with a hedge fund you replace market risk with manager risk," says Mike Hayhoe, a Waterloo-based advisor with IPC securities. "I look for the best managers and the majority of those are in hedge funds."

Hayhoe says hedge funds attract the best managers and the compensation structure of hedge funds allows them to earn more money. He notes hedge funds can be very illiquid and require a long-term investment horizon to work their strategies.

Christopher Kruczynski from The Marchand-Kruczynski Group at Scotia McLeod says clients will understand risk if you relate it to financial risk they take every day. For example, Kruczynski says

clients should be comfortable to the concept of leverage considering that most take out a mortgage on their homes. He relates how a mortgage is a leveraged loan against a home, similar to how leverage can be used in investing; if advised properly it has relatively low risk.

Still, there's no getting around due diligence. Hedge funds are restricted to the accredited investor – clients with \$1 million in financial assets or an income of \$200,000. These rules have been bent if not broken. Portus used what appeared to be principal-protected notes to circumvent these rules and sell to non-accredited investors. There's no surefire way to ensure investors won't be taking on unnecessary risk without doing your homework, Kim says.

Kim says he always asks a prospective hedge fund manager how he defines risk. Risk is a relative term, and this gives him a sense of what types of risk that manager is going to be taking.

"You really don't want to handcuff these managers with too many rules," Kim says. "Regardless of regulation, I want to see risk management."

Alex Chapman, vice-president of Mintz Fund Services, provides third-party consulting to hedge funds. He says regulators are taking a closer look at hedge funds, which he feels will ultimately make the risk management assessment for advisors easier.

"In Canada, just to manage to assets, you need an ICPM, which is an investment council and portfolio manager. If you want to sell hedge funds to accredited investors in Ontario you need a limited market dealer registration," Chapman says. "The proposed National Instrument 31-103 will effectively create a new category called investment fund manager, which is something from the ICPM and market dealer registrations of today."

Under 31-103, hedge fund managers will have to have a minimum working capital of \$100,000 and will be required to take out a secured bond equivalent in value to 1% of assets under management.

These rules are likely timely, because according to hedge fund manager Allan Brown, a partner with Burlington Capital Management, there is a resurgence of

interest among retail investors in Canadian hedge funds. Brown also believes that an inefficient Canadian market is attracting hedge fund investment here.

This is good news, considering investors in Canada are able to take advantage of greater opportunities for short-term trading than what is available in the U.S., explains Brown.

In the U.S., more traders and deeper pools of capital have made the day-to-day trading spreads very narrow; in addition, Canadians can invest in the nation's resource sectors. This combination, however, has also attracted high levels of foreign investors to Canadian hedge funds.

"If you go back in 2002 and 2003, there was nothing going on," recalls Brown. "There were hedge funds in Canada putting up phenomenal numbers [but they are] not getting any assets. Now, there is a lot of attention from overseas. People want to have exposure to energy and resources. The big hedge funds like the Sprott and Front Street, who are heavy in this area, are attracting lots of global investors."

This strong weighting towards the cyclical resource sector is exactly why Kruczynski would like to see a greater outflow of Canadian capital into foreign hedge funds. Investors are not getting the chance to diversify, which is core risk management strategy.

"These products we have in Canada are specific to Canadian market managers," he says. "There is not a lot to choose from. I would like to see Canadian investors have more access to global hedge funds."

Brown agrees. His fund has limited its long positions in the Canadian market, which, he says, has few opportunities outside resources, making risk diversification difficult. He has to look globally to offset Canadian market risk. His fund aims for annualized returns between 10 and 20%. Since its launch in early 2005, the fund has been able to meet this goal and has realized a total return of 36.9%.

The fund manager creates positions of paired companies in the same industry, where divergent performance is expected. Burlington takes a long position in the undervalued stock and a short position in the overvalued.

Man Investments Canada, a subsidiary of global alternative asset manager Man Investments, is also touting hedge fund diversification. It has launched a new series of deposit notes with CIBC, the CIBC Man IP 220 Deposit

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Notes, which have 100% of their principal guaranteed at maturity by CIBC. Man Investments is a publicly listed company.

The notes provide notional exposure to a global fund of hedge funds that combines the strategies of Man's AHL Diversified Programme and Glenwood Portfolio. Through the combination of AHL and Glenwood, investors gain exposure to 60 hedge fund managers who are invested in more than 100 global markets. The notes offer daily liquidity, meaning they can be redeemed at any time.

The collapse of Portus and subsequent regulatory and criminal probes have hurt the PPN market. Yet, Man Canada's CEO, Toreigh Stuart, believes Canadian investors have gotten over Portus. For those who still have reservations about hedge fund investing, CIBC brand recognition provides some reassurance. Stuart thinks the current spate of market volatility will be the key driver in sparking investor interest.

Stuart says over the 10-year period, avoiding the steep drops during volatility has allowed the portfolio to post returns of 386.9%, compared to a global equity

benchmark return of 96.7%.

"The major difference is making profits when markets are going down," Stuart says. "Recent and pronounced market volatility should, yet again, remind all investors that exposure to long-only investments may not fully achieve true portfolio diversification."

Chapman emphasizes advisors can also drastically minimize risk by choosing hedge funds that have their auditing conducted by independent parties.

"I think a lot of the times, it's perceived the hedge fund managers themselves do their own accounting, to get their own Net Asset Value, and calculate their own performance fees which are based on NAV," he says. "Having a third party do this is much better, because you get an extra level of independence. The advisory network should really look at who the service providers are as part of their due diligence. Make sure that they don't have the managers themselves calculating their fees and their own NAV." **AER**

October Cuts

Industry applauds Flaherty's tax proposals: good for affluent

BY MARK NOBLE

Last month's proposed tax cuts by the federal government are garnering positive reviews from the financial services industry. But the ghosts of last Halloween still linger.

Last year's economic statement by Finance Minister Jim Flaherty, in which he announced a substantial tax increase on income trusts, took the markets by surprise.

This year's commitment to expedite corporate and small business tax cuts, reduce the GST by one percentage point and increase the tax-free income threshold to more than \$10,000 is nothing earth-shattering but was nonetheless received with open arms by the industry.

The federal corporate tax rate

cut, which will see the corporate tax rate drop incrementally from 22.1% to 15% in 2012, is drawing particular praise.

Targeted and piecemeal tax cuts over time have made the tax system too complicated.

"This is a strong move that gives Canada a competitive tax advantage," says Nancy Hughes Anthony, president and CEO of the Canadian Bankers Association. "This will be noticed on the world stage, clearly putting the spotlight on Canada as a place to invest, do business, live and work."

Continued on page 8