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The long and the short of hedge funds

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In a climate where investment returns from most asset classes are likely to be modest and the stock market is expected to remain highly volatile, should investors consider hedge funds? Questions on people's minds range from the actual performance of these funds, in comparison with traditional stock portfolios, to the types of funds available to Canadian investors. Today, in the first instalment of a two-part Buy & Sell Roundtable on hedge funds, leading industry figures address these key questions, as posed by Buy & Sell columnist Sonita Horvitch. Tomorrow, the hedge-fund portfolio managers share their strategies and their longs and their shorts.

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Hedge funds are gaining in acceptance, says Robert Parnell, president of Tremont Investment Management Inc.

"There is increasing recognition that they are more conducive to successful active money-management than is traditional money management," he says.

After the severe bear market, institutions are realizing that when you give hedge fund managers greater lattitude and discretion, they can produce "excess returns or alpha," says Parnell.

His firm manages $200-million in assets and is part of Tremont Advisers, which has been in the hedge business for almost 20 years. The parent specializes in funds of funds and has assets under management of US$8.5-billion globally.

Jim McGovern, managing director and chief executive of Arrow Hedge Partners Inc. in Toronto, notes that the global hedge industry has grown dramatically, particularly in the last 10 years. Alternatives such as hedge-fund products, have, for the most part, generated steady rates of return, typically with low levels of volatility and with low correlation to stocks and bonds over the long haul and this has attracted investor attention.

A former mutual fund CEO, McGovern founded Arrow Hedge in December, 1999, to offer a range of fund of funds and single manager hedge funds. Arrow Hedge has $150-million under management.

There is a need for some caution at present, says Peter Puccetti, chief investment officer of Goodwood Inc., which is a long/short hedge-fund manager which manages some $170-million in assets. The long-run trend clearly favours hedge funds, he says. But so far this year you would have done better in most equity mutual funds, as long-only strategies that avoid shorting stocks have done well.

Puccetti, who co-founded Goodwood some six and a half years ago, says that investors are expecting the overall equity market to generate modest returns for a long time to come and "we agree with this."

But there can be periods, "maybe multi-year periods," where there are strong upward movements in stock prices and it could be difficult for many hedge funds to outperform during those periods.

Market-neutral hedge fund manager John Schmitz, president of SciVest Capital Management Inc., which manages $150-million, says that while the prospect of superior long-run returns are a key advantage of hedge funds, another major advantage is lower volatility.

"When you add hedge funds as an asset class to stocks and bonds and real estate and virtually anything else, you can lower the volatility risk of the overall portfolio," he says. The addition of a hedge-fund product, will, he predicts, be a strategic asset-allocation decision in almost everyone's portfolio -- retail, pension funds and high net-worth individuals.

It must be remembered, says David Fawcett, founder and partner in Epic Capital Management Inc., which is another long/short manager, that there is a significant alignment of the hedge-fund manager with the portfolio's returns, perhaps more so than is the case with traditional fund managers.

"Hedge-fund managers make money from performance," says Fawcett, whose firm is two and a half years old and has assets under management of $50-million.

Warren Irwin, president of Rosseau Asset Management Ltd. expands on this.

"In the case of myself and many of the managers around this table, you will find that the bulk of our net worth is in our hedge funds," he says. This certainly aligns the interest of the manager with the investor more closely, he says. "We are joined at the hip."

As special situations hedge fund manager, Rosseau Asset Management which has $50-million under management, looks to maximize returns, while taking prudent risk/return bets in a concentrated portfolio, says Irwin. "In our particular strategy, we try not to get too fussed whether the market is going up or down." Irwin founded Rosseau in June 1998.

Q: What is the background to the hedge fund industry?

McGovern: If you go back to the origins of hedge funds in 1949 with Alfred Winslow Jones, most of the money was from high net worth investors looking to protect their wealth from the vagaries of the equity market. These investors wanted more than to put their money in treasury bills and other low risk securities, so they looked for alternatives, which included hedge funds.

This industry went through fits and starts through the '50s and '60s. It grew quite rapidly in the '60s, but collapsed in the 1969-70 bear market period. This is because hedge fund managers who supposedly hedged, actually did not. They were leveraged long managers [traditional money managers that added borrowed funds to the funds gathered from investors] and got caught in a vicious bear market. The '70s were more dominated by the macro hedge fund managers like George Soros, who placed big bets, for example, on currencies. That has given way through the late '80s and early 90s, to a more refined market place. In part, this is the result of the institutions investing money in this area.

Q: Time for the portfolio managers around the table to talk about their strategies and their returns. Let us start with the long/short strategy.

Puccetti: At Goodwood, we have a net long bias approach to picking stocks, which means we tend to be more long than short. Although in the six-and-a-half year history of the fund, there have been a couple of periods where our shorts and our long positions have been equal. Our discipline is very much bottom up value driven. We are looking for triggers within a company that could result in a material revaluation of the share price. It is more similar to Warren's special situations fund than John's market neutral approach. With a net long bias, it is tougher for us to do well when the market is down sharply, because you are fighting that tide. The Goodwood fund originally started on October 31, 1996. We look to do 20% or better per annum, net of fees over a reasonable time frame. So far we have done a little bit in excess of that. Our main fund has grown at about 21% net of all fees per annum compound for about six and a half years v. an S&P/TSX composite index that has grown by 4.5% to

5% per annum. During that period, there have been at least five major market selloffs. We have been up substantially four out of five of those times. For the most recent period, that was not the case.

Fawcett: Epic Capital is also in long/short equity hedge fund management focusing on Canadian investments. We also use a bottom up value style and use intensive company and industry fundamental analysis. We are looking superior risk-adjusted returns. We are trying to return 15% to 20% net to investors. Epic has been in business for two-and-a-half years, we are up 72% net to investors. On an annualized basis, we have returned 20% to 25%.We look to concentrate our portfolio, with some 20 to 25 positions, where we want our stocks to matter. Capital preservation is important to us. In the 30 months we have been in business, we have only had one down month and it was a modest decline.

Q: John, please explain to us what a market neutral equity manager does?

Schmitz: The objective is to totally insulate our returns from what is going on in the equity markets. Whether they are going up or down, it should not matter to our returns. We do that by being totally neutral on our longs v. our shorts. If we are $100 long, we are $100 short. We tend to balance our long and short positions in industries, sectors and countries. We view risk management as our key goal. We hold more than 370 positions, with no position representing more than 2% of the fund.

We are fundamental stock pickers using quantitative analysis and computer modelling. We are trying to pick stocks on the long side of the portfolio that outperform those on the short side of the portfolio in an up market and in a down market, thereby producing a spread return between our longs and our shorts.

In order to deliver a true market neutral portfolio and covering thousands of stocks as we do, the only way to do it is to harness the power of computers and high quality data bases that are available. We launched our core SciVest retail fund on May 1, 2001, and through April 30, 2003, we had a compound annual return net to investors of 15.3% per annum. We produced that return with an annualized volatility that is less than half that of the S&P 500 index over that time period. We hope over the long-term to deliver annual returns in the 13% to 16% net to investor range with volatility that is significant less than the S&P 500 Index.

Q: What about special situations management, Warren?

Irwin: I have been in special situations management for eight years. In June of 1998, I started Rosseau Asset Management Ltd., and we have some good successes. We have just under a five-year track record. Our average compound rate of return is about 30% per annum. What is neat about the group around this table, such as Peter, is that a number of us have gone through some pretty hairy markets in 1999, 2000, 2001 and 2002 through the crazy run up in 1999, the two crashes in the Nasdaq index, Sept. 11, 2001 and the big stock market meltdown last summer.

We are fundamental analysts who focus on special situations such as corporate bankruptcies, restructurings, breakups, liquidations. Within these situations, we invest across the capital structure of the company. Sometimes we get substantial risk-adjusted returns, by buying the debt instead of the common stock. Given the amount of research we do, we keep it concentrated around our 15 best ideas. We do, from time to time, to keep some shorts to shelter us in certain industries.

Q: What are the other strategies that fall under the hedge fund banner?

Parnell: The Canadian hedge fund industry is very long/short equity driven at this relatively nascent stage in its evolution, but globally the industry is more diverse and complex and includes things like macro hedge funds, convertible arbitrage, mergers and acquisitions, mortgage backed securities and fixed income arbitrage. Tremont's approach is to recognize that when you put those strategies together, you can significantly reduce the risk of a hedge fund portfolio.

McGovern: There are as many styles as there are hedge fund managers. Peter, as a long/short manager, approaches his portfolio quite differently from David who also employs this strategy. Hedge funds can use leverage quite differently, there are different levels of portfolio concentration and they focus on different geographic emphasis. Some may use derivatives.

Parnell: In our fund of funds approach, we look at the big economic picture and then choose the strategy. That is typically true of fund of funds managers. Once we have made the strategy allocation, then we look within the strategy and identify from several hundred managers, one or two who we think do well in their category. For example, we manage the Mackenzie Alternative Strategies Fund which is diversified fund of funds. The portfolio has done well over the last number of years because we have kept our long/short equity exposure less than might typically be the case historically. We have emphasized the global macro strategy, this is a very flexible style. We also allocated significant money to managers of distressed securities, that have lower credit ratings than junk bonds. These funds have been up 22% in the past six months. We also direct the management of a strategy focus portfolio, the Mackenzie Long/Short Equity Fund. This is still a multi-manager portfolio.

Q: Time to talk about the performance of the fund of funds managers.

McGovern: We run a series of single manager hedge funds, too, that are represented here today -- Goodwood and Epic. They have both stated their returns. There are others we have on offer. Our two fund of funds which this have reached their required number of managers are our Arrow Global Long Short Fund which has eight managers and our Arrow Multi Strategy Fund has about 20 managers. So far the Long/ Short Fund is up slightly for the year and the Multi Strategy Fund is up about 3%.

Parnell: Of the three funds we manage in Canada, the Mackenzie Alternative Strategies Fund, which has been around two-and-a-half years, and is up about 4% annualized and cumulative about 10% in a U.S. equity market which is down 30% over that period. The Mackenzie Long/Short Equity Fund, which is intended to be a little more aggressive, has been down slightly since inception, which is about a year-and-a-half. It is down 3.6% annualized, again in a market that is down double digits since the launch of the fund. We also run the Tremont Capital Opportunity Trust (TTun/TSX) which is just coming up to its first month of valuation.

Q: Rob, please tell us about Tremont's index.

Parnell: In association with Credit Suisse First Boston, Tremont has developed the CSFB/Tremont Hedge Fund index, the only major asset weighted index for the global industry. Its long term performance has been modest double digits 10% to 11% annualized over the past slightly more than nine years.

The volatility of the strategies comprising that index has been substantially lower than that of conventional equity indexes. Last year is a good example. In a horrendous bear market, the overall hedge fund industry was up about 3% net. There are subsectors in this index for the different strategies. The long/short strategy has produced about 12% net per annum over nine years. Global macro strategies are a little higher than that at 14%, but generally with more risk than some of the other arbitrage and market neutral strategies. When you asset weight the returns, the returns are not as strong as some other indices might lead you to believe, but it is still a compelling story.

McGovern: On the long/short strategy, the HFRI index from the start of 1992 to the end of April has generated a compound annual return of 16% to 17%. The HFRI index is produced by Chicago-based Hedge Fund Research Inc. The volatility is a little higher than some of other strategies because of the net long bias, nevertheless it is much lower than the market. So you are getting a pretty good return from these long/short funds and a lower risk. Last year, the long/short index was down 6%, with a net long bias you can lose money in any given year, but relative to the market the overall performance is still good.

Q: Are hedge funds only for the wealthy investors and institutions?

McGovern: Our view is that a fund of funds or any individual hedge fund is suitable for any investor. If you are going to buy a multi-strategy fund, you are looking for treasury bills plus a percentage above that, typically it is an additional 4% to 7% over T-bills.

In Arrow Hedge's open end trusts, there is a $25,000 minimum, which is high relative to the minimums for most mutual funds, but you also have to be an accredited investor. You have to have $1-million of liquid net worth or be making $200,000 a year and be able to prove this. What has happened is that a lot of structured products have been introduced for smaller investors. We are currently offering Arrow Multi-Strategy Notes with a minimum of $5,000.

Investors are guaranteed a principal repayment backed by BNP Paribas (Canada), wholly owned by BNP Paribas, SA in France. It is a note that has for its return stream the return from our multi-strategy fund. The note has a life of eight years and liquidity on a monthly basis, so people can redeem it.

Parnell: The Mackenzie Alternative Strategies Fund and the Mackenzie Long/Short Equity Fund target high net worth investors. They are private placements and the minimums are $150,000, unless you are accredited. If you are accredited, then the minimum here is $25,000. We wish that we could structure our products for retail investors, but regulations do not currently permit it. The only qualification that an investor should have in order to invest in a hedge fund product, is a tolerance for risk, appropriate for the investment.

Q: Peter, what are your minimums for your hedge funds?

Puccetti: The Goodwood hedge fund minimum is $150,000, unless you are an accredited investor. This accredited investor rule says that if you make $200,000 a year, or you and your spouse combined make $300,000 a year and/or you have a net worth outside of your principal home of $1-million, this is for an Ontario resident, then you can invest just $25,000 in a private placement that would otherwise require a $150,000 minimum. The irony is that the only people who qualify for accredited investors, are the people who can afford to give us $150,000.

Parnell: This all means that if your entire net worth is $150,000, the regulations allow you to put every penny of it in a hedge fund private placement.

Q: Time to talk about fees and incentives.

Puccetti: My partner, Cameron MacDonald, and I have a large amount of our own money invested in the capital we run, so we have, like Warren, have considerable incentive to do well. The fees depend on which fund of ours you buy, but call it a 2% base fee, plus a performance fee equal to 20% of profits. In our original fund, it is 20% over 10%, so we have to do 10% a year net of the 2% management fee and then we get 20% of returns above the net 10%.

Fawcett: Our minimum is $150,000. Our fees are 2% of the asset under management and 20% of all performance.

Irwin: We should introduce the concept of the high-water mark clause. It is important for investors in hedge funds to know that when you pay a performance fee, the manager has to break through that unit value level on the upside, before the manager is paid a performance fee again. Our fees are a 2% flat fee on assets under management, a 20% performance fee, just like David's fund. We also have a high-water mark and our minimum investment is $500,000. Our target market is high net worth individuals as well as institutions. Our typical investor is a young individual, often an entrepreneur, who has made a lot of money and wants a bit more octane in his/her portfolio, is willing to handle a little more risk and have a longer-term horizon.The other high net worth group are older investors seeking a little more octane. They often give us a small amount of their total portfolio. Our product is not suitable for a core of anyone's portfolio.The institutions like us for the same reasons.

John: SciVest Capital's minimum is similar to everyone here. They are $150,000 in Ontario is not an accredited investor and $25,000 if accredited. Our fees for the retail products are 2.5% plus a 20% performance fees above Canadian three month T-bills, with a high-water mark.

Q: How do the fund of fund managers around this table, Jim and Rob, go about selecting fund managers and what are their fees?

Parnell: Fund of fund managers can charge another 1% or 2% on top of the fees charged by the portfolio managers. Some fund of funds managers have performance fees on top their base fees. Tremont does not.

McGovern: We have a small management fee overlaid on top of the individual hedge fund managers fees. We do the upfront work on the manager and then go into partnership with that manager and give them capital. In return for staying with them, the managers give us a rebate on the fees which we can pass on to our investors.

Parnell: We are more of a standard fund of funds. We are not forming partnerships with managers. We research the industry globally to allocate to both strategies and managers that we like. We try to be patient capital. But if our view changes on a strategy or of a manager, we have the independence to change to the portfolio.

Puccetti: We have not yet noted that one of the most substantial advantages that an investor in a hedge fund should look to vs a traditional mutual fund is the cap. For example,we have committed to our investors that we are not taking more than $300-million under management in our long/short fund. This means if we were at $300-million and had a year where we were up 50%, then we would pay out $150-million in profit to our unitholders. This cap keeps us nimble in the Canadian equity market which is relatively thin and gives us an advantage relative to some of the behemoth conventional Canadian equity mutual funds.

Fawcett: We are capped at $100-million for the same reasons. It gives us an advantage in the Canadian equity market vs funds trying to run-billions of dollars and gives us the opportunity to get more performance from the mid-to-small cap market where there is limited liquidity in these stocks.

Schmitz: Every hedge fund manager should have in mind some form of cap or capacity level. Most of our revenue comes from performance fees and if we become less nimble, then our performance goes down. This is different from the mutual fund community which gets paid 2.5 cents for every dollar under management every year. So a $10-billion fund is ten times as good as a $1-billion fund from its standpoint.

Irwin: I have a substantial amount of my net worth in the fund. There is no way that I will grow it beyond a level that I can earn very good returns.

Parnell: It is clear that when you take a manager out of the traditional game which is a volume business and put them in the performance game, which is the hedge fund business and you strongly motivate them with performance fees and they have a substantial amount of money in their funds, then suddenly the issue of caps, limiting assets under management is important. We like to see managers that are limiting their asset growth.

Q: We should talk about the regulation of the hedge fund industry in Canada.

Irwin: When we first started out, it was not clear whether or not we had to be registered with the OSC as an investment councillor/portfolio manager. We decided to go that route. . It has become clear that you have to be registered with the OSC, which has a number of hurdles to jump through. The players in Canada are subject to audits by the OSC. The regulatory framework in Canada is part of the reason why our hedge fund industry has not grown as fast as the United States. The OSC requires some

experience in managing money before you can start a hedge fund, it also favours designations like the Chartered Financial Analysts.

Puccetti: You can be registered either through the OSC or the Investment Dealers Association, but it is the same set of hoops.