

COMING OF Age

The Canadian Hedge Fund Experience.

BY LES MARTON AND NICOLA RAY SMITH

Canada is forging a new reputation for itself on the international investment scene—a growing hedge fund presence. Global interest in hedge funds has been building for a number of years and, as a leading producer of many of the world’s most critical commodities, it is no surprise that global investors are looking to benefit from Canadian hedge fund managers’ home advantage in resources. However, there is more to the growth than just resources. Canada boasts a rapidly developing pool of investment talent, well-developed investment infrastructure, a stable regulatory environment and a remarkably less crowded investment community. To date, this growth has been driven more by Canadian high net worth investors and global institutions. This article will provide a snapshot of the Canadian hedge fund landscape using current data.

According to a report published by *Absolute Return* in 1999, Canada was home to less than 50 single-manager hedge funds and only a handful of fund of hedge funds, comprising a total of approximately \$2.5 billion. Today, analysts generally agree that the Canadian industry is now managing close to \$30 billion across over 200 funds. This 12-fold growth rate over the period is significant relative to the fourfold rate in total assets under management for the global hedge fund industry (bearing in mind of course that the global industry is now thought to be more than US\$2 trillion across over 9,000 funds).

Comprehensive data across the entire Canadian hedge fund industry is not publicly available and is difficult

to source. As a proxy, it is helpful to examine broad characteristics of the Scotia Capital Canadian Hedge Fund Performance Index. Although it does not include funds with less than \$15 million in capital or a track record less than one year, the data is a useful view of what the more established section of the industry looks like. The size of the Canadian manager hedge fund industry (excluding fund of funds) is currently estimated at \$9 billion, and roughly 70% of this capital is represented in the index (44 funds across 10 different hedge fund strategies). Tables 1 and 2 provide summary information on constituents reporting to the index and similar statistics for the global industry.

Notably, both the comparative size and track record lengths of Canadian versus global hedge fund managers on a proportionate basis are not that different. However, bear in mind that the differential in the absolute number of larger, more seasoned funds is dramatic when comparing the global hedge fund industry with its more modest Canadian counterpart. In addition, one can observe the significantly more concentrated strategies pursued within the Canadian hedge fund manager universe.

INVESTOR BASE

According to a 2006 study published in *Global Custodian*, high net worth individuals/family offices and fund managers/employees are by far the predominant sources of capital for Canadian hedge funds, representing nearly 70% of hedge fund net assets.¹ The global industry, at approximately 41%, is much less dependent on these two sources of capital. Within the global investor

community, institutional allocators, which include fund of funds, pensions, banks and endowments/foundations, are generally more seasoned hedge fund investors and comprise more than 52% of the overall investor pool. It is interesting to note that even relatively small percentage increases in allocation ratios to hedge funds within the global institutional investment community represent enormous growth opportunities for the hedge fund industry overall.²

Institutions currently are thought to comprise a much smaller proportion (26%) of the Canadian hedge fund pie. Importantly, very little of this institutional interest appears to be driven by Canadian institutional investors. Certainly the relative size of the much smaller Canadian endowment/foundation segment, which has long been a major investor in hedge funds and other alternative strategies, is a factor in this imbalance. However, other than a few significant Canadian-based fund of funds and a handful of large sophisticated pension plans, the Canadian institutional investment community as a whole has not yet embraced the hedge fund concept. The reasons for this are not clear, but some well-publicized hedge fund-related scandals within the Canadian fund of funds industry have resulted in understandable career risk management stances on the part of some institutional fiduciaries. For those institutions that are investing in the space, the allure of global managers often tends to overshadow the efforts of homegrown hedge fund players. Instead, growing interest in Canadian-based hedge fund managers is expected to be driven more by international institutional allocators.

The reason for this heightened global interest appears to be twofold. Firstly, there is the focused beta argument. The economic prosperity that Canada has seen in recent years has resulted in the strengthening of the Canadian dollar and growth in the resource and energy sectors. Consequently, Canadian hedge funds have launched a series of niche funds in these sectors which have garnered significant interest from global investors. Many of them view Canadian funds as an opportunity to gain hedged exposure to a resource-rich market through talented and experienced local managers on their home turf. When viewed as a portion of a larger global portfolio, such focused beta exposure offers compelling return and diversification potential. We shall see whether the recent Canadian market downturn dampen some of this interest.

The second factor behind the increased global interest

in Canadian hedge fund managers is that sophisticated global investors are constantly on the hunt for less-covered, more untapped opportunities. Canadian markets are much less crowded than those in the U.S. and Europe, offering what many consider to be unique opportunities within a stable and mature market that still has enough inefficiency to generate strong returns. Although many managers are following a focused hedged equity strategy in their own backyard, there are many talented Canadian managers with wider product and market mandates who offer funds with compelling risk-return propositions as well.

THE RETURNS

The Canadian hedge fund industry has posted respectable returns over the last few years. The high correlation between index returns and the S&P TSX highlights the predominant long-biased equity theme that has characterized much of the single-manager hedge fund industry in Canada. Notably, 60% of fund assets reporting to Scotia Capital’s index report a hedged or long-short equity strategy. Given the bullish sentiment that has characterized Canadian equity markets for the last few years, it is not surprising that Canadian managers have been able to take advantage of this. We shall see whether the recent Canadian market downturn

HEDGE FUND SIZE Table 1

	Canada	Global*
\$10-24M	4.76%**	18.65%
\$25-99M	19.05%	34.40%
\$100-199M	47.62%	14.85%
\$200-499M	26.19%	14.47%
\$500-999M	2.38%	7.78%
\$1.0B+	0.00%	9.85%

* * Global data source: Hedge Fund Research.
 ** Criteria for inclusion in the Scotia Capital Canadian Hedge Fund Performance Index include AUM greater than C\$15 million, as such a significant component of this demographic is not included in Scotia Capital’s data.

LENGTH OF TRACK RECORD Table 2

	Canada	Global*
< 1 year	Not available**	7.54%
1 to < 2 yrs	11.90%	14.47%
2 to < 3 yrs	14.29%	15.98%
3 to < 5 yrs	30.95%	24.31%
5 to < 7 yrs	16.67%	13.95%
> 7 years	26.19%	23.75%

* Global data source: Hedge Fund Research.
 ** Criteria for inclusion in the Scotia Capital Canadian Hedge Fund Performance Index include a track

Les Marton is managing director, hedge fund execution group, Scotia Capital Inc.; Nicola Ray Smith is associate director, hedge fund execution group, Scotia Capital Inc.

dampens some of this interest.

In comparing Canadian returns to global returns, the Canadian hedge fund industry has shown great strength over the last few years. We compared the Scotia Capital Canadian Hedge Fund Performance Index to other global indices. Notably, the increased level of return has been achieved with a higher amount of volatility relative to global counterparts, as seen in Table 3. The higher volatility of Canadian managers has been difficult to reconcile for more conservative investors, particularly those considering initial forays into the hedge fund industry. With experienced hedge fund investors, however, the focused beta offered by Canadian managers has garnered significant interest, as discussed above.

LOOKING AHEAD

While the Canadian market will always represent a small component of a much larger global industry, it will likely continue to remain a compelling niche opportunity for global investors. Increased attention from sophisticated hedge fund investors, both global and domestic, combined with the ongoing rise of the global hedge fund industry will no doubt move more Canadian managers to become more institutionalized and thus continue to attract further capital. At the same time, although Canada already has one of the most highly regulated hedge fund environments globally, reforms set to take place by the end of 2007 could increase investor confidence without introducing a prohibitive effect on the ability of hedge fund managers to generate returns.

Increased asset flows into Canadian hedge funds will of course place strain on Canadian managers' ability to continue to outperform in some of their current niches. We will more than likely see an increase in market efficiency as more players join the quest for returns, removing some existing arbitrage opportunities and quickening market response. Sourcing the managers best able to rise to the challenge of such competition in a maturing environment will be increasingly important for investors.

In Canada, some trail-blazing hedge fund investors are taking advantage of the attractive returns and diversification that Canadian hedge fund exposure can add to a global hedge fund portfolio. Many more are taking a conservative wait-and-see approach. Some

“When the Canadian equity market inevitably turns, as could be the case right now, Canadian managers will be given the opportunity to deliver on the traditional hedge fund promise.”

RISK AND RETURNS OF SCOTIA CAPITAL CANADIAN HEDGE FUND PERFORMANCE INDEX VS. INDICES DEC. 2004-MAY 2007

Table 3

	Annualized Compound ROI	Annualized Volatility
SC CDN HF Asset Weighted	19.10%	9.51%
SC CDN HF Equal Weighted	16.57%	8.65%
Barclays Hedge Fund Index	12.64%	4.36%
CS/Tremont Hedge Fund Index	12.51%	3.93%
Hennessee Hedge Fund	11.73%	4.16%
HFRI Fund Weighted Composite Index	12.45%	4.29%
MSCI Hedge Fund Composite Index - Asset Weighted	9.95%	3.90%
MSCI Hedge Fund Composite Index - Equal Weighted	10.01%	4.15%

analysts feel that the bull run enjoyed by resource-intensive Canadian resource markets may be nearing its cyclical peak and this may well test investors seeking only the focused beta returns offered by some Canadian hedge fund managers. In the end, the test for Canadian hedge fund managers may well be their ongoing ability to find unique and compelling trading ideas, irrespective of market direction. ■

ENDNOTES

1. *Global Custodian* - Winter 2006.
2. Recent studies estimate that global pension funds currently manage assets in the tens of trillions and could by 2008 account for half of all hedge fund inflows. The SEC estimates that only \$72 billion in pension fund assets are invested in hedge funds today. However, concerns over capacity constraints within some niche-based hedge fund strategies may limit overall industry growth, irrespective of growing institutional demand.