Alpha: Canada's Other Natural Resource

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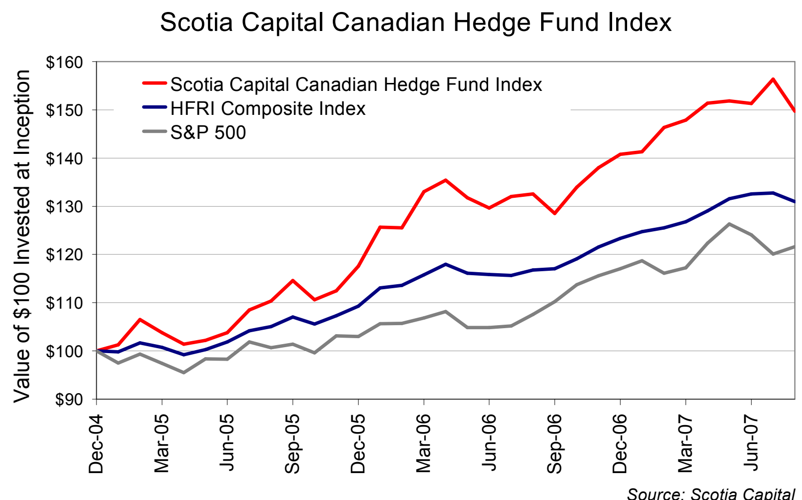
When European explorers first came to Canada, they were awestruck by this nation's vast natural resources. From timber, farmland and gold to oil, natural gas, and water, Canada is abundant with natural resources about which most nations dream. But its newest export may force the world to reassess its traditional view of the country's export sector. Canada has quietly become one of the world's hottest new hedge fund markets.

Since its inception in January 2005, the Scotia Capital Canadian Hedge Fund Index, a widely-quoted barometer of the performance of Canadian hedge funds has increased at a rate of 18% per annum (vs. 6% for the HFRI Index). What makes this feat even more impressive, however, is that the Scotia Capital Canadian Hedge Fund Index had a Sharpe ratio of approximately 1.5 (vs. 0.5 for the HFRI) over this period.

While demand for Canada's natural resources has certainly helped, the Scotia Capital Index has also significantly outperformed Canadian equity markets – beating the S&P/TSX by nearly 150 basis points per annum with 10% less volatility.

During this time, assets have also grown substantially. Many foreign investors have added Toronto, Montreal and Vancouver to their research itineraries and domestic investors have become more comfortable with alternative asset classes. According to research firm Investor Economics, Canadian hedge funds now manage well over US$35 billion and Canadian institutions have invested over US$20 billion in both domestic and foreign hedge funds.

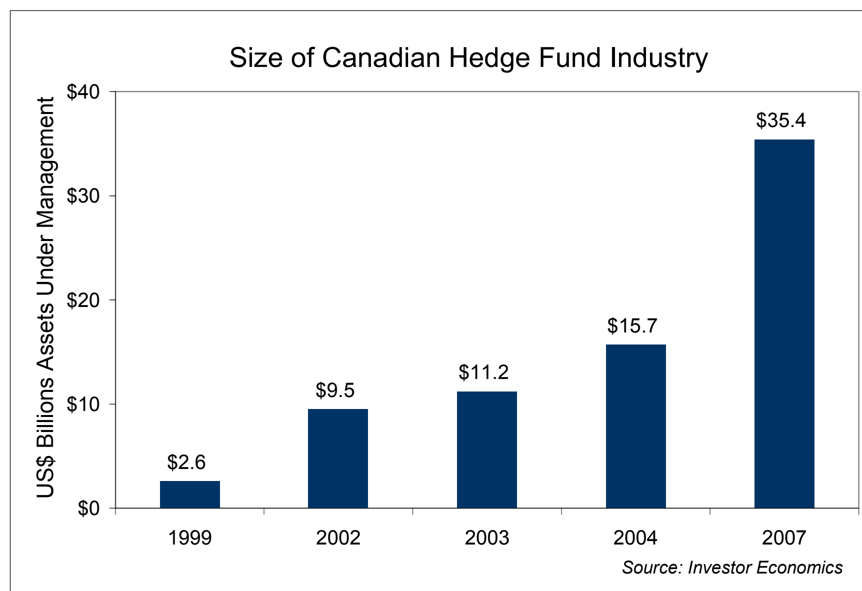
Many Canadian hedge fund managers contend that Canada's well regulated and liquid capital markets remain somewhat informationally inefficient creating the ideal conditions for managing a hedge fund. Equity hedge strategies with their idiosyncratic risk profiles tend to dominate, providing extensive opportunities for diversification. But Canada is also home to several arbitrage strategies (merger, statistical, convertible, credit) and a number of quantitative funds.



As a recent entrant into the global hedge fund industry, Canadian proprietary trading desks and asset management firms are also replete with traders and analysts ready to launch new hedge funds. This pent up demand seems likely to drive a steady stream of new fund launches in the coming years.

Many of the world's largest administrators and service providers also see Canada as an ideal base to service the western hemisphere. Toronto's established financial sector and deep labour pool has earned it the moniker "The Dublin of North America".

Outstanding returns, strong asset growth, a skilled talent pool, and well regulated capital markets are poised to continue the growth of Canada's newest export sector; its hedge fund industry.



Industry Size and Demographics

According to the latest industry data as provided by Investor Economics, Canadian hedge funds now manage over US$35 billion of assets in a variety of strategies. Single-manager hedge funds manage approximately US$20 billion or 56% of that amount. Fund of hedge funds managed a further US$12 billion or 33% and the remaining US$4 billion (11%) is thought to exist in the form of managed accounts. In total, Canada is home to approximately 260 hedge funds and funds of funds (80% single manager and 20% funds of funds). These funds are managed by a total of 125 different firms.

Canadian hedge fund managers have been targeted by offshore investors over the past several years. To meet this growing demand, many Canadian managers have opened offshore and US-domiciled versions of their funds. Currently, single-strategy hedge funds manage approximately US$5 billion, or a quarter of their assets in the form of these offshore funds, and nearly half of Canadian funds of funds assets are managed in offshore funds.

As is the case globally, assets tend to be concentrated in the largest Canadian hedge funds. A 2007 study of 35 Canadian hedge funds conducted by National Bank Correspondent Network (NBCN), the prime brokerage arm of Canada's National Bank, revealed that only 63% of Canadian hedge fund sponsors managed over $100 million (vs. 77% globally).

These findings not only show that Canadian hedge fund companies are smaller than their global peers, but also that fewer large managers of traditional funds have added hedge funds to their existing suite of offerings. Recent anecdotal evidence suggests this is rapidly changing as long-only fund managers launch new long/short funds.

Research by NBCN also shows that Canada has disproportionably fewer hedge funds that are ten years of age or older. According to the firm, 17% of Canadian hedge funds were launched prior to 1997 (vs. nearly a third globally).

However a review of the constituents in the Scotia Capital Canadian Hedge Fund Index, a widely quoted benchmark of Canadian hedge fund performance, suggests that 72% of Canadian hedge funds are over 3 years old (vs. only 60% globally).

This apparent inconsistency may be a result of a lack of new fund launches in Canada over the past three years (due largely to the strength of Canada's stock market and therefore its long-only fund industry). Had Canada seen the type of explosive growth experienced by the global hedge fund community over the past three years, older funds would have undoubtedly comprised a smaller proportion of all hedge funds in the Scotia Capital Index.

The Canadian Capital Markets: World leaders in several sectors

Institutional investors will find not only skilled managers in Canada, but also a capital market that is ripe for hedge fund investment strategies.

The Toronto Stock Exchange – Canada's largest – lists companies with a collective market capitalization of approximately US$2 trillion. This makes Canada the 7th largest equity market in the world.

The fixed income markets are primarily government issues and the trading is dominated by the Canadian banks. This explains why there have been few fixed income arbitrage funds in the past. However, developing credit and credit derivative markets have provided fodder for a new breed of Canadian fixed income manager.

When compared to the NYSE, the Toronto Stock Exchange (TSX) has a bias toward the energy, financial services, materials and telecommunications sectors (which collectively make up nearly 80% of the market).

- **Energy:** Canada is home to the second largest oil reserves in the world (after Saudi Arabia),
- **Financials:** protective regulation has nurtured a highly profitable banking sector,
- **Materials:** 60% of the world's listed mining companies are on the TSX,
- **Telecom:** Canada is home to global telecom players such as Research in Motion, Nortel, and BCE.

Although Canada is the United States' largest trading partner, the correlation between the two countries' equity indexes is relatively low. A recent study by State Street finds that the 5, 3 and 1 year correlations between the S&P/TSX Composite Index and the S&P 500 are only 0.77, 0.61 and 0.64 respectively.

Market inefficiencies make Canada fertile grounds for hedge funds

Despite the fact that the Canadian market is sometimes cited as a place to make directional bets on the energy and resources sectors, its true value to hedge fund managers lies in its apparent informational inefficiency – providing those managers with a definable "edge" vs. their global peers.

Although a majority of the Canadian equity market falls into the aforementioned sectors, each with their own factor betas, Canadian stocks still exhibit a relatively low cross correlation (compared to the S&P 500 and MSCI EAFE Indexes). This high dispersion of returns is fertile ground for those hedge funds that can exploit any information advantage.

Studies have shown that Canadian equity markets do not always perfectly reflect all available information. For example, academics have found that momentum plays a statistically significant role in Canadian equity prices. A 2003 academic study revealed consistent annual returns for Canadian stocks that were not explained by volatility alone. This study also found that the Canadian market did not accurately price value stocks.

A 2004 study backed-up this finding, concluding that inefficiencies in the Canadian equity market were particularly apparent in stocks with low analyst coverage.

Some in the industry point to the fact that the average short interest in an S&P/TSX component is less than the average short interest in an S&P 500 component. Research suggests that a higher short interest allows stocks to respond more quickly to news (and conversely, that lower short interest prevents immediate price responses). This further supports the notion that bargains can often be found on Canadian markets and conversely, that short positions can be "pressed" on the way down.

Notwithstanding the generally good liquidity of the Canadian equity market, smaller companies may sometimes appear to be less liquid than they are. Canadian hedge fund managers often cite their ability to find buyers for blocks of small cap stock by appointment and with relatively little discount. They ascribe this to Toronto's relatively close-knit asset management community.

From a long/short core, a variety of strategies are emerging

Canada's capital markets are generally not considered to be deep or liquid enough to support large numbers of arbitrage strategies (e.g. statistical arbitrage, capital structure arbitrage, convertible arbitrage). As a result, most Canadian-domiciled single manager hedge funds can be characterized as "long/short equity".

The Scotia Capital Canadian Hedge Fund Index is composed mainly of long/short funds (60% of its 44 funds). Investor Economics' survey of the broader single-manager hedge fund industry (155 funds) found that 79% of funds pursue an "opportunistic" investment strategy. And according to Earl Bederman, CEO of Investor Economics, most of the "opportunities" pursued by these funds are of the long/short equity variety.

This may be due to the large proportion of Canadian hedge fund managers that hail from Canada's large mutual fund sector (vs. from proprietary trading desks as is so common in the US and Europe). It is often said that the prototypical Canadian hedge fund manager is a former mutual fund manager using short-selling and leverage to extend their security selections. However, as Canadian capital markets mature, quantitative strategies such as capital structure arbitrage, merger arbitrage and convertible arbitrage are expected to grow considerably.

Institutional Investment: Early movers cashing in

Globally, over half of all investments in hedge funds are made by institutional investors. However, NBCN reports that only 26% of the assets of the hedge funds in their study are from institutional investors.

This comes as no surprise to Canadian hedge fund managers who say that most of this institutional investment comes from non-Canadian institutions – particularly funds of funds. Too little of it, they say, comes from domestic institutional end investors.

Domestic Institutions

Explanations for the industry's shortage of domestic institutional investors vary. In the United States, foundations (particularly university endowments) have traditionally made up a large portion of hedge fund investors. But due to its smaller size and its history of publicly funding its universities, Canada simply does not have as many of these types of institutions.

Several Canadian funds of funds have established funds comprised solely of Canadian managers – giving investors more direct access to "Canadian alpha".

Banks and insurance companies are conspicuously absent from the registries of Canadian hedge funds. NBCN released a study in early 2007 showing that while global hedge fund allocations from these types of institutions amounted to 11% of assets, Canadian bank and insurance companies represented a negligible portion of the industry.

Foreign Institutions

International investors find that Canada is home to a large number of funds that have not yet achieved international recognition. Many investors unfamiliar with Canada are surprised to learn that meeting these managers face-to-face is a relatively simple task. The flight from New York to Toronto is only 15 minutes longer than the well traveled path from New York to Boston (and Toronto is also served by hourly flights).

There are clearly enough funds to make such a trip worthwhile for almost any institutional investor. But many Canadian funds are too small to actively solicit non-Canadian capital. Many smaller Canadian managers are reluctant to launch offshore versions of their funds until they receive an initial commitment from investors. This chicken-and-egg problem is currently being addressed collectively through organized capital introduction events in Canada, the US and Europe (and through AIMA Canada's advocacy at events such as the Global Absolute Return Congress).

Finding that US hedge funds have been well "picked-over", several US and offshore institutional investors have recently taken an interest in Canadian funds. Most of these investors have been funds-of-funds seeking diversification and access to Canada's unique alpha sources.

High net-worth investment: Piling into Canadian hedge funds

An accommodating regulatory environment and the aforementioned institutional hesitation have made high net worth individuals the dominant investors in Canadian hedge funds. According to HFR, 41% of global investors in hedge funds can be defined as "high net worth individuals". By contrast, NBCN says that as much as 70% of the assets managed by Canadian hedge funds can be categorized as such.

While banks have opted not to invest their own capital in Canadian hedge funds, they remain the dominant distribution channel for high net worth assets in Canada. Much of the assets placed into Canadian hedge funds by high net worth investors pass through personal financial advisors at Canada's major financial institutions.

The remaining high net worth assets are commonly sourced directly by each hedge fund manager. Due to the challenges faced by these managers in raising assets internally, many fundraising drives experience challenges moving beyond the “friends and family” stage. In fact, NBCN says that while 8% of global hedge fund assets are sourced directly from managers and employees, a massive 25% of Canadian hedge fund assets come from these investors.

Some of the world’s most comprehensive regulation

All asset managers in Canada must be registered with their provincial securities regulator, regardless of the number of investors, size of assets, or investment strategy. The four key provincial regulators are all favorably predisposed to hedge funds.

In addition, The Bank of Canada has also shown its clear understanding of the role of hedge funds in the Canadian financial system. The Deputy Governor of the Canada told a 2005 hedge fund industry gathering:

> *“…it’s useful to note that the largely positive influence of hedge funds stems from their sophistication, their size, the diversity of their objectives and strategies, and the instruments they use. Hedge funds add to the depth and liquidity of Canadian financial markets.”*

Today, regulators are actively soliciting industry feedback on proposed new rules aimed to help the Canadian hedge fund industry achieve a broader level of acceptance. One rule, for example, will make registration contingent on proficiency thresholds and capital requirements. AIMA Canada is taking a leadership role by representing the needs of managers and investors in various regulatory forums.

The “Dublin of North America”

Canada has also become a key player in the global hedge fund administration business – earning Toronto the moniker “the Dublin of North America”.

During the 1980’s and early 1990’s, Toronto was home to the administration of several major US hedge funds. At the time, regulatory edicts in the United States forced US managers such as George Soros to locate administration outside of the US. Toronto, a short one hour flight from New York, was a natural choice.

Although these regulatory rules were relaxed in the mid-1990’s, Canada (particularly Toronto) remains the home to several of the world’s largest fund administrators. When UBS fund administration opened a large Toronto office in 2006, it proclaimed:

> *“Toronto is a leading financial services centre with a concentration of corporate headquarters as well as associated professional services. With a large pool of highly qualified financial and technical employees, the city offers many businesses the opportunity to grow effectively.”*

The Royal Bank of Canada's merger of its fund administration group with Belgium's Dexia Group in 2005 created another Toronto based global player in this sector.

And also that year, Citibank purchased Canada's largest fund administration business to create Citigroup Global Transaction Services (GTS) with nearly 1,000 employees.

Halifax, Nova Scotia, on Canada's East Coast, is relatively close to Bermuda. As a result, it has also attracted several leading Bermuda based fund administrators.

Taking a global leadership role in alternative investments

In June 2007, Canadian institutional investors won both pension categories at Institutional Investor's annual Hedge Fund Industry Awards in New York City. The Ontario Teachers' Pension Plan (OTTP) won honours for the best public plan and forest products company Weyerhaeuser won for best corporate plan (Weyerhaeuser's pension is managed out of its Vancouver office).

This was another entry to the list of "firsts" for the OTPP. It has long been regarded as one of the world's largest pension investors in hedge funds, infrastructure and private equity. Recently, it led the world's largest-ever leveraged buyout (a US$50 billion buyout of Canada's BCE Inc.)

Canadian Alpha: An under-exploited resource

With hedge fund investors fanning out daily from hubs in New York, London, Geneva, and Tokyo, it is easy to conclude that the Canadian hedge fund industry is already well covered by institutional investors. However, Canada is often left under-exploited by virtue of its close proximity to a much larger pool of hedge funds in the US.

As a result, Canadian hedge funds represent one of the last great under-exploited hedge fund markets in the world. Canadian capital markets are large and well regulated. Yet certain inefficiencies create an environment where sophisticated managers can generate meaningful alpha. The Canadian hedge fund industry is mature and highly transparent. Yet Canadian hedge funds remain relatively un-covered by US and offshore investors. Canadian hedge funds' ability to exploit various unique alpha sources has attracted the interest of some of the world's most sophisticated global investors. Today, more and more institutional investors have added Toronto, Montreal and Vancouver to their research itineraries. Not doing so, it now appears, comes at significant risk.

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