

## **With pension funds cautious, managers look abroad for asset growth**

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This year, Canadian boutique Landry Morin Investment Managers will launch an offshore hedge fund for the first time since the firm's establishment in 2002. The Montreal-based firm will unveil the next generation of a long/short equity fund it has run since May 2003, marking a sea-change for the firm, which manages some CAD115m in assets.

"We've decided to go where the money is," says Nicolas Dang, an investment analyst at the company headed by Jean-Luc Landry and Richard Morin. "We continue to manage our expectations for local capital gathering due to the tough current market conditions."

These are difficult times for small and emerging funds. Institutions and rich individuals are staying away from turbulent markets, while funds of funds are waiting on the sidelines for credit issues to be resolved. At the same time, large institutions are either hoarding cash or are boosting allocations to their current managers.

While the sluggish fund-raising isn't Canada's problem alone, the circumstances are particularly tricky for start-ups here, because investors have increasingly embraced traditional equity investments that have so far generated handsome returns. The Toronto Stock Exchange's benchmark S&P/TSX Composite Index has gained around 8 per cent this year, compared with a 6 per cent decline for the S&P 500 in the US. Meanwhile, the multi-billion-dollar institutions have preferred private equity, infrastructure and real estate to local hedge funds.

Still, Canada's hedge funds have a fighting chance on various other fronts, with offshore business apparently one of the more significant ones. For example, Landry Morin plans to establish a Cayman-domiciled version of its Landry Morin Long/Short Momentum Fund and will target investors in Europe and elsewhere. Other managers are flocking to Asia, Europe and the Middle East in search of new capital. While the offshore fund market is still a nascent one for Canadian players, it is billed as a key future growth driver.

"Things are changing quickly here," says Garvin Deokiesingh, an associate partner at the Toronto office of accounting and audit firm Deloitte, who notes that in the past local

managers launched offshore funds only after amassing a long track record. No longer: “We’re seeing new managers start onshore and offshore funds at the same time. They aren’t waiting for their history to catch up with them.”

Also emerging from Canadian institutions are 130/30 funds, which are popular in the local marketplace and represent a total of around CAD1bn in assets under management. A number of firms keen to jump on the long/short bandwagon but weren’t ready to go all the way are going down the 130/30 route.

“130/30 reflects a changing landscape of alpha seekers,” says Srikanth Iyer, a portfolio manager and senior vice-president with the systems-driven team at Guardian Capital, one of the leaders in this field. “It has the risk/reward components that speak to it as being more of a hybrid than just a pure equity or hedge fund.” The systems-driven team has emerged from Guardian’s quantitative group running traditional investments and manages CAD100m for five institutional investors in its 130/30 portfolio, which was incubated in April last year.

Also pushing hard into the market is TD Asset Management, part of home-grown brokerage TD Securities and ultimately of the Toronto-Dominion banking group. The asset manager currently runs CAD50m in three 130/30 funds and has plans to launch two more vehicles this year.

Jean Masson, its head of quantitative research in Montreal, says clients have begun to realise they can extract more alpha for the same equity risk via a 130/30 fund, but they are taking their time to warm up to the strategy. “We’re talking to investors, but aren’t seeing the cheques yet,” he says. “We expect to be taken more seriously as we build a track record for the strategy.” Masson, the main quantitative professional behind the programme, adds that TD Asset Management’s portable alpha line, launched three years ago, is now gaining traction.

Another hotbed of activity is hedge fund replication, according to Pierre Saint-Laurent, president of consultancy AssetCounsel. “There’s cutting edge work being done on it in Montreal, which is becoming a big base for [replication],” he says, arguing that it could eventually become a means for pension funds to extract hedge fund performance without having to jump through the risk assessment and fee hurdles associated with direct hedge fund investments.

Meanwhile, Arrow Hedge Partners’ debut incubation fund has raised the hopes of start-up managers. The CAD1bn Toronto manager launched the Accelerator Fund in February with its partner Marret Asset Management and has CAD150m to back domestic emerging managers. “It’s an extension of the work we’ve done on early-stage managers for a long time,” says Arrow Hedge’s chief executive Jim McGovern. “There had been a noticeable lack of seeders in Canada, which provided the opportunity.”

So far, the hedge fund market has dodged bullets that have claimed fund casualties in the US and Europe, according to Martin Kovnats, a partner in the corporate finance practice at Toronto-based law firm Aird & Berlis. Canada is not facing a deflating housing bubble like the US, nor are its banks imploding, thanks to their conservative policies. Additionally, the

income-generating spigot of royalty trusts that were hugely popular with investors will be shutting down in 2010, which will put the CAD240bn of assets they currently manage in play.

Kovnats' colleague Sam Billard, a partner in Aird & Berlis's financial services group, says some of the big institutional funds remain interested in fixed-income investments because of their promise of a healthy monthly yield. However, fixed-income hedge funds could lure this rich pool of capital provided they demonstrate the ability to deliver positive returns in all market environments.

However, the Canadian equity market remains a formidable rival for investors' cash. The benchmark TSX index is back close to its record highs from last July, having first tumbled and then recovered amid the global credit crisis stemming from the battered US securitised products market.

"People don't need to look at alternatives when the broader market is performing so well," says Jeffrey Shaul, chief executive of Toronto-based Robson Capital Management. "We won't see a shift while main street keeps going up. What we need is a slightly down market that stays down. It's only then that people look at their portfolios and say to their brokers or advisors, 'What can I do about alternatives?'"

For institutions, some legacy issues persist. The industry still hasn't fully emerged from the impact of a series of high-profile blow-ups, notably Portus Alternative Asset Management and Norshield Financial Group in Canada and Amaranth Advisors in New York. These snared local pension scheme sponsors of all stripes, according to Montreal-based Marc Godin, managing director for Canada at bFinance, an international investment consultant that helps institutions select fund managers.

Even though Portus and Norshield got into trouble as long ago as 2005 and Amaranth collapsed in 2006, "hedge funds as a whole got bad publicity from these events," Godin says. As a result, Canadian pension plan sponsors remain underinvested in hedge funds even as global institutional investment in the sector has continued to rise.

"It's an open question as to how [hedge funds'] role will change over the next year or so," says Ian Russell, who heads the Investment Industry Association of Canada, a trade group. While they have played a significant role in the domestic capital markets, he argues, funds' access to capital will be restricted amid tightening of lending by banks, while their role in structured products such as collateralised debt obligations that are at the heart of the current credit crisis is set to diminish due to heightened regulatory oversight.

Regulators are already looking into the workings of hedge funds, and the Canadian Securities Administrators, a forum in which the 13 provincial securities regulators co-ordinate and harmonise regulation of the country's capital markets, is revamping the registration policy for hedge funds.

Canada already requires hedge funds to register with their local regulator, but they will face slightly higher scrutiny as a result of the new initiative. Its most significant consequences will

be that market participants such as broker-dealers that previously were excluded from the requirement now will have to register, and capital and insurance requirements will rise.

However, industry participants are sanguine about the changes. “The proposals aren’t a huge complication for most hedge funds,” says Patricia Koval, a partner at Toronto law firm Tory’s. “They definitely won’t result in any slowdown in people’s creativity.”

Arrow Hedge chief investment officer Mark Purdy concurs, saying: “These initiatives are in line with global standards. While they will make things a little bit tougher, there’s nothing in them that will have a major impact on existing hedge funds.”

Whether these initiatives will help draw in retail and institutional investors remains unclear, but the country’s maiden initial public offering of a hedge fund management firm, by Toronto’s Sprott Asset Management, is a promising start. Last month the firm, which has CAD7bn in assets under management, raised CAD200m via an IPO, joining the trend pioneered by international giants such as Fortress, Och-Ziff and GLG Partners.

But don’t expect the flood gates to open, cautions Summerwood Capital’s Phil Schmitt, who heads the local chapter of the London-based Alternative Investment Management Association, and who reckons that perhaps one other hedge fund manager may come to the market this year. “There’s a small chance that only one more [firm] is available,” he says. While the Sprott listing offers retail investors a chance to join the clubby world of hedge funds, it is too small for the larger institutions to partake.