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How Canadian hedge funds are outperforming the market - while U.S. counterparts crash

By John Shmuel

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Capricious markets have given nothing but headaches to investors the world over, but one group of financial wizards has made a virtue of all of this volatility: Canadian hedge fund managers.

This country's hedge funds have been strongly outperforming the broader market in the past year. The increased volatility has been embraced by managers, many of whom see their strategies perform better when the market is less predictable.

The recently released figures for the Scotiabank Canadian Hedge Fund Index Asset Weighted index shows hedge funds returned an average of 6.21 per cent in 2015, while the broader S&P/TSX Composite Index posted fell 11.09 per cent during the same period.

Canadian hedge funds are smaller and more nimble

Canada's success contrasts starkly with the situation in the United States, where a greater number of funds and more competition for investor cash, combined with weak returns, has led to a rash of closures. The HFRI Fund Weighted Composite index, which tracks hedge fund performance, closed down 0.85 per cent in 2015, only the fourth time since 1990 the index recorded a loss. Since 2009, U.S. hedge funds have trailed the S&P 500's performance every year by an average 10 percentage points.

While it can be hard to compare the two markets, given the different regulatory environments, fund managers say what is giving Canada an edge now is a more boutique market.

"Canadian hedge funds are smaller and more nimble," said Gary Ostoich, president of Spartan Fund Management Inc. in Toronto. There's also less competition and more opportunities for managers to stand out.

That is not to say Canada's hedge fund industry is not without its challenges. The small size of the industry can make it difficult for smaller funds to get capital - especially since hedge fund investing is limited to wealthy accredited investors, which make up only one per cent of the population.

For a while, Canadian hedge funds have also had to contend with American funds eating their lunch. Some of Canada's biggest investors, such as the $272 billion Canadian Pension Plan Investment Board, opt to allocate their money into U.S. hedge funds because there are more options and big name managers.

Unsurprisingly, in terms of dollars and cents, Canada's hedge fund industry is small compared to the U.S., even when the population difference is taken in account. Domestic hedge funds have about $35 billion in assets under management.

To put that in perspective, a single fund in the U.S. - the Bridgewater Associates' Pure Alpha II Fund - has roughly US$81 billion in assets. Canada's $35 billion AUM is divided up among roughly 140 hedge fund managers, and according to data from AIMA, 58 per cent of hedge funds have AUM of less than $100 million.

"What you do find in Canada is we're much smaller, relative to the U.S., as an industry, with a much smaller asset base," Ostoich said. "In the United States, you have quite a few hedge funds that are north of the $20 billion mark, whereas in the Canadian market I'm not aware of any that are over $3 billion."

But while the U.S. boasts big funds, last year they also boasted big losses. John A. Paulson's Paulson & Co., Bill Ackman's Pershing Square Capital Management and David Einhorn's Greenlight Capital saw some of their funds recording double-digit losses for the year.

The smaller, less competitive nature of the Canadian industry, combined with strong returns in 2015, means that new hedge funds are opening here, whereas closures and liquidations are a problem in the U.S.

"It's an interesting divorce because the story here is we're hearing in Canada is more and more funds coming out," said James Burron, chief operating officer of the Alternative Investment Management Association of Canada.

Latest data from HFR shows that the number of American hedge funds liquidated in the third quarter climbed to 257, a jump from from 200 in second quarter. That brought closures in the first nine months of 2015 to 674, compared with 661 in the first three quarters of 2014.

"[Liquidations rose] as investor risk tolerance fell sharply, and energy commodities and equities posted sharp declines, resulting in net capital outflows, wider performance dispersion and meaningful differentiation between hedge funds," said Kenneth Heinz, president of HFR, in a release.

In Canada, the lack of over-saturation of the market means new funds are opening as investors seek alternative investments to diversify. Hedge funds are naturally in demand because of their low correlation to the broader market, since they invest in a wider variety of assets and strategies, such as shorting, derivatives and currency moves.

"The market dynamics definitely have changed," said Jim McGovern, managing director and CEO of Arrow Capital Management Inc. in Toronto. "The more things go down and the more volatility associated in the market and the less correlation, generally speaking, is good for alternatives. But you have to marry the market opportunity with the manager skill, and that's where I think things have gotten better here."

Managers are hoping stronger returns keep attracting more funds, as performance hasn't always been a certainty. Canadian hedge funds sorely disappointed in 2012, when the asset-weighted Scotiabank Canadian Hedge Fund Index fell nearly five per cent. The Toronto Stock Exchange's S&P/TSX composite index in that year eked out a four per cent return.

There's also the issue of fees. Hedge funds typically charge two percent for management and they commonly tack on an additional 20 per cent performance fees when net asset value increases. And as liquidation shows in the U.S., those performance fees aren't returned when the fund loses out on its bets.

But the strong performance in recent years is garnering some attention. A study led by Peter Klein at Simon Fraser University entitled the The Canadian Hedge Fund Industry: Performance and Market Timing, found that that Canadian hedge funds have higher risk-adjusted performance relative to the global hedge fund indices.

McGovern of Arrow Capital is not surprised, saying that the hedge fund industry in Canada has become leaner and more efficient since the financial crisis.

"Overall, the level of quality and sophistication of the operators is much, much higher than its been in the past 10 years," he said.

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References

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