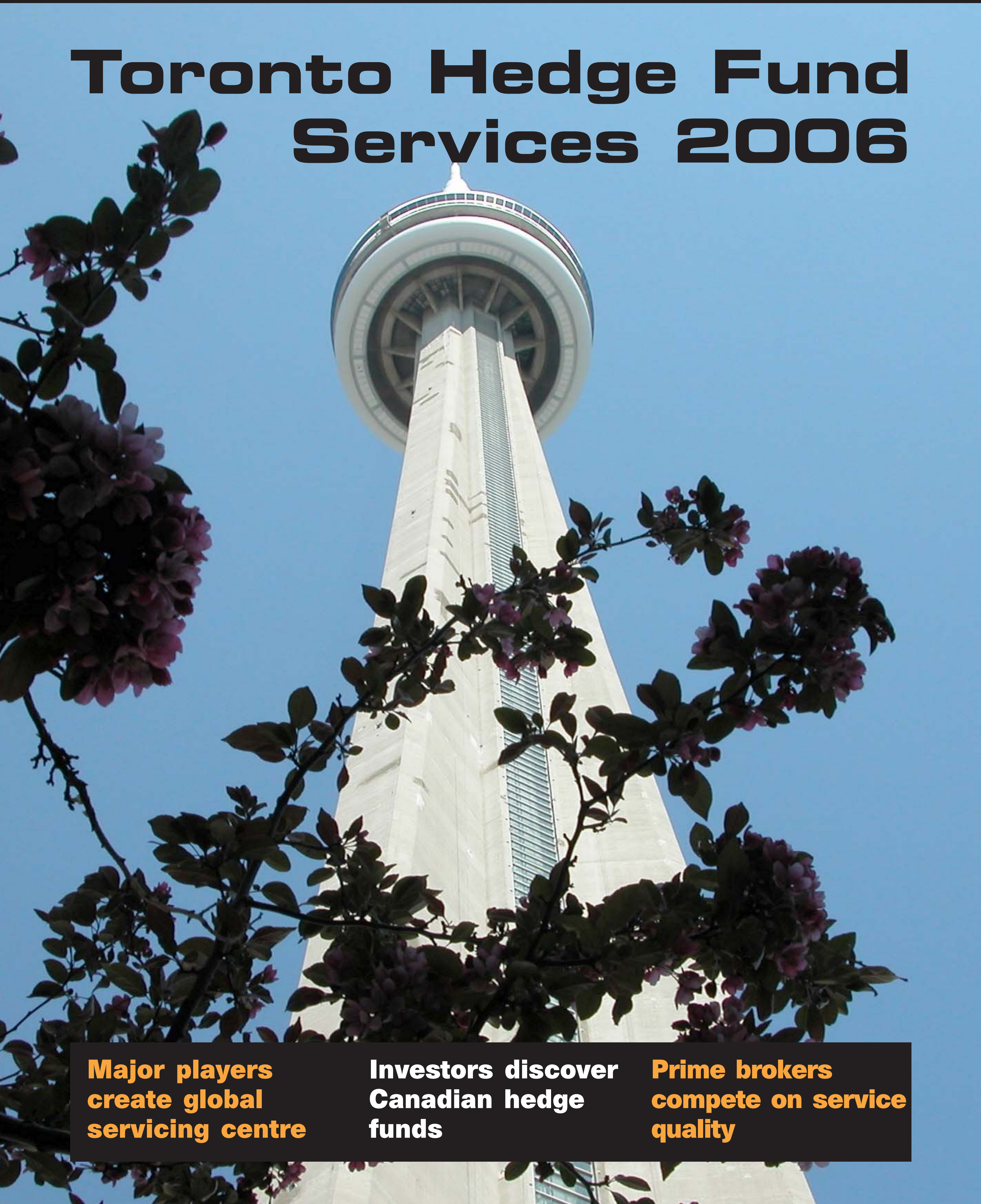
hedgeweek special report
www.hedgeweek.com
Apr 2006

Toronto Hedge Fund Services 2006



Major players create global servicing centre

Investors discover Canadian hedge funds

Prime brokers compete on service quality

James L. McGovern, President of Arrow Hedge Partners Inc and Chairman of AIMA Canada

Hedge funds market poised for tremendous growth

The Canadian capital markets have been extremely vibrant over the past few years, as global economic growth has led the international investment community to "discover" the investment potential of Canada.

In particular, our resource- and commodity- related equities have been in demand, but so too have our government bonds and our Canadian dollar – affectionately known as the "loonie".

It may surprise some to know that the Toronto Stock Exchange is the seventh largest exchange in the world with over $1.5 trillion in market capitalisation. It boasts more than 50 per cent of the world's listed mining companies and has the highest number of oil and gas listings globally.

That said, well over 50 per cent of our market cap is not resource-based, offering hedge fund managers the benefits of diversification into sectors such as financial services, communicators and technology. Additionally, more than 50 per cent of our companies are considered small to mid cap (C$50-C$500 million in size), offering a good trade-off between liquidity and informational inefficiencies to exploit.

Our debt and currency markets have also been in demand. The Montreal Exchange provides equity, debt, interest rate and index derivatives as means to both leverage and hedge investment activity. There's certainly a great deal of life north of the 49th parallel!

The Canadian hedge fund market has grown dramatically over the past five years. From barely a few dozen single manager funds in 1999, there are now some 150 hedge funds in operation, and capital has swelled from C$1.3 billion to more than C$6 billion during that time. There is a broad range of strategies available, but the bulk of the capital is opportunistic in nature, with long/short equity strategies being the dominant category.

In general, performance has been very strong. In addition, there are a number of large funds of funds operators in Canada that each manage in excess of $1 billion – much of this institutionally focused. In aggregate, there is well over C$15 billion allocated to hedge funds in Canada.

The majority of hedge fund capital is managed from Toronto. All the major Canadian banks offer prime brokerage services, and there is a very deep and reliable group of service providers including major accounting, legal and administration organisations. Canada has a sound legal and regulatory infrastructure with registration required for all managers. Securities regulation however is somewhat burdened by a provincial (rather than federal) system. The Ontario Securities Commission is considered the leading regulatory watchdog in the country.

The Canadian hedge fund market is poised for tremendous growth going forward. Alternatives generally make up only a small percentage of private client portfolios, but that is starting to change.

International investors, in search of exposure to new sources of alpha and beta, have been markedly increasing their exposure to Canadian hedge funds, albeit from a low starting base. All of this comes at an opportune time as more talent enters the industry and substantial capacity is available. ■

James L. McGovern

Global investment made in Toronto

By Jennifer Wood and Mark Purdy

Arrow Hedge Partners Inc. is an investment management company founded in 1999, specialising in providing hedged fund of funds strategies to high net worth investors worldwide, and from uniquely regional perspectives. Arrow Hedge is headquartered in Toronto, with its research team covering the Canadian, US, Latin American and Asian markets. Based in Geneva, Sarah Caygill provides additional research coverage from a distinctively European vantage point.

In addition to its strong global research coverage, Arrow Hedge has adopted an investment process that has capitalised on some of the most innovative and dynamic developments in alternative investments: early stage managers and strategies. Investing in early stage managers and strategies represents the core to Arrow's approach.

Arrow Hedge firmly believes that early stage managers are most compelling due to their competitive return profiles relative to their more established peer groups. Additionally, early stage managers have tremendous advantages in focusing on niche markets and investment styles.

For example, early stage managers have much more flexibility in managing smaller pools of capital, enabling greater tactical movement in to and out of their positions. This, in turn, is especially critical to Arrow's asset allocation decision-making as early stage platforms provide a means to prudently scale into underlying investments.

As well, the early stage focus also represents a more efficient method – hence longer-term allocations – in deploying capital, as Arrow's investments are able to grow alongside the underlying manager's assets.

This focus on early stage investing has also compounded the importance of thorough and rigorous due diligence on all underlying investments. The due diligence process is perpetual and designed to capture the dynamics of our managers' investment as well as business or organisational development.

Additionally, Arrow utilises a number of proprietary risk tools for determining individual and aggregate level exposures and has supplemented these with solutions from Bear Measurisk, enabling more robust risk monitoring and measurement.

The investment model constructed by Arrow's research and investment management team is expressed through specific fund of funds portfolios, which are designed to suit different investment objectives and investor demands. These fund of funds are at the centre of Arrow's business model and are constantly monitored and re-balanced.

Arrow manages two flagship fund of funds for its Canadian investors, one a multi-strategy product, which encompasses a broad spectrum of investment styles including equity hedge, relative value, event driven and global macro, the other a dedicated global equity long/short strategy. Arrow has mirrored this approach to its offshore investors as well through its Compass and Voyageur funds.

The success of both the onshore and offshore products is a testament to Arrow's unique global research coverage and focused investment process. Since inception, all funds have met their risk-return objectives and have outperformed their respective industry peer groups. ■

Jennifer Wood is a research analyst and a member of the investment committee and Mark Purdy is chief investment officer with Arrow Hedge Partners in Toronto.

p15 characteristics and valuation are, or vice versa."

Arrow Hedge is well placed to assess the relative qualities of Canadian managers and their counterparts abroad because the firm offers investors funds of funds and selected single manager funds drawn from both groups. Says director of research Keith Tomlinson: "We visit managers globally, so we don't have to put any money in Canada, but we find excellent hedge funds here, so about a third of our number of allocations are to Canadian managers."

Adds chief investment officer Mark Purdy: "The increased demand globally for Canadian hedge fund managers probably has a lot to do with the returns being produced by oil and energy, but another important factor is that, very much like in the UK, almost all managers are registered with their respective provincial securities commission. That means there's a very good legal framework to operate within, on top of the advantages of a highly educated workforce and five big banks that provide good channels for distribution."

The high degree of regulation and the importance of bank distribution reflect the specific characteristics of a market in which retail sales of hedge products in the form of principal-protected notes accounted for around 25 per cent of all investment with Canadian managers, including offshore funds, funds of funds and managed accounts for pension schemes, at the end of 2004.

According to Lionel deMercado, managing director and global head of equity finance with prime broker TD Securities, the range of strategies followed by Canadian managers is broadly comparable with those in other markets and include notably equity long/short, long-only, convertible arbitrage and risk arbitrage as well as fixed-income strategies.

Among individual funds, he says, there are a substantial number with assets of between C$20m and C$100m, rather fewer in the "bulge bracket" of C$500m-C$1bn, and a handful with between C$1bn and C$2bn. DeMercado estimates that the industry now probably has more than 200 single manager funds and total assets of around C$18bn, including funds of funds but not managed accounts.

Arrow Hedge chief executive Jim McGovern, who also founded and heads the Canadian chapter of the Alternative Investment Management Association, argues that on the institutional investment side there is a sharp dichotomy between the attitudes of the biggest pension funds, some of which are experienced and enthusiastic investors in hedge funds and other alternative asset classes, and smaller schemes that he says are still reluctant to take the plunge.

He says: "The big government pension plans and some corporate plans are very strong in terms of knowledge and acceptance of alternatives in general. Five or six very substantial plans are big buyers of alternatives across the board and have long incorporated them into their investment policy. However, the smaller endowment and pension schemes are not as keen on hedge funds."

One of the big hitters in the market is the Ontario Teachers' Pension Plan, which has attracted headlines in recent weeks for its forays into the private equity market and is one of the biggest allocators to hedge fund managers. Says Purdy: "One advantage of Toronto from an allocator's standpoint is that you've got the Ontario Teachers' Plan up the road which has 150 hedge fund managers. You often get a lot of managers coming up here from New York and London or even Asia looking for capital."

Managers and service providers agree that two high-profile hedge fund collapses last year have resulted in a hiccup for the industry, although there is less consensus of how long the impact will be felt. Norshield, once one of Canada's largest fund of funds managers with C$1bn in assets in mid-2004, collapsed into receivership last June, leaving investors as much as C$500m out of pocket.

Portus Alternative Asset Management was placed in bankruptcy on March 24, just over a year after the firm had its licence withdrawn by the Ontario Securities Commission following allegations of sales to unauthorised investors and failure to follow the firm's stated investment policy. However, the firm's 26,000-odd investors are likely to get much of their money back after the court-appointed receiver KPMG said it had now recovered all but C$17.6m of the nearly C$800m placed in the Portus funds.

DeMercado is relatively sanguine about the impact of the Norshield and Portus cases. He says: "Canada is no different from any other jurisdiction. There's always going to be the odd bad apple that's going to cloud the marketplace. All it does is to make the regulators take a closer look at the industry, and makes the big banks tread more cautiously when offering the product at a retail level."

Adds Mark Fieldhouse, director of technical sales and relationship for global products with RBC Dexia Investor Services: "The impact has been minimal as far as growth in the segment is concerned. As with any other investment vehicle, it just underlines that investors must complete proper due diligence and look at the providers with which the hedge fund is dealing. Are they getting risk management and prime brokerage services from a reputable institution? This is an important point with any type of investment."

McGovern believes that the scandals may have affected the industry in the short term, especially at the retail level, but it should be able to shrug them off over time. "The solid single manager funds and funds of funds have continued to take in capital from private clients, so for those that understand what's going on, it wasn't really a big issue. It affected more the pure retail market where they were using structured notes to distribute hedge funds to retail investors."

He argues that the inevitable calls for greater regulation of the industry are superfluous, since managers were already regulated more closely than by the new US rules introduced by the Securities and Exchange Commission in February. "Anyone managing money in this country and offering their services to the public has to be regulated, which covers continuous reporting disclosure regimes, capital requirements, proficiency requirements and so on. We're ahead of the US on a lot of issues."

According to Landry, one importance consequence of the scandals is that hedge funds have embraced a significantly higher degree of transparency. He says: "Setbacks such as Portus certainly impacted the marketing side for alternative products, although there still is an appetite for them. It's definitely impacted sales, and it will probably take a little while before sales of hedge funds in Canada continue their upward trend. There's a certain level of confidence that investors need to have restored.

"What you're seeing as a result of situations like Portus is that alternative products are elevating their level of disclosure to investors. Investors are moving toward the greater transparency offered by prospectus-based funds. This includes notably the history of the principals that are involved, to ensure that there isn't a risk that money will go offshore and never make it back. Managers who are not ready to face that kind of question will not get their product to market."

Landry argues that it may take more time before the market emerges from its current hiatus. "The market for domestic consumption of hedge fund products is in a lull, but that will ebb as things are clarified with Portus," he says. "Over the next year or so there will be growth, although it will be slower than in 2004. As people become aware of the increased transparency of these products, the market will start to rebound. It's just a matter of how easily confidence can be restored."

McGovern believes the rebound will be felt as early as this year. "We're going to see a surprising level of growth," he says. "There is a lot of international interest in the market, and at home the banks, who really are the drivers of financial services growth, will warm up to alternatives even more. In addition, we expect to get a bounce off Portus and Norshield as the problems fade from public attention, and some of the deferred investment from last year will start to come in. It should be a very good year." ■

Toronto joins the global hedge fund industry

By Simon Gray

Its skyscrapers and icy winters might seem at odds with the stereotypical image of an offshore hedge fund centre, but Toronto is building on a thriving domestic alternative investments market and a well-resourced financial infrastructure to provide a relatively inexpensive option for administering western hemisphere hedge fund managers, as the increasing interest of global service providers attests.

It may not boast the palm-lined beaches and sultry climate of the Cayman Islands, the sheer concentration of French restaurants of Luxembourg or the pubs of Dublin's Temple Bar, but Toronto is emerging as an alternative to the hedge fund servicing centres clustered in the offshore jurisdictions in and around the Caribbean and in Europe.

The new focus on Toronto is being boosted by a variety of factors: the existence of a burgeoning hedge fund manager industry centred on Canada's financial capital that is also attracting attention abroad, a well-established administration sector catering to traditional long only funds, a low cost base compared with many other hedge fund servicing centres, and the ready availability of well-educated and experienced staff.

Toronto has a long-standing tradition of hedge fund administration, including State Street's servicing of the Soros funds, dating back to the days when funds that wanted to escape the ambit of US taxation had to satisfy the authorities of their adherence to the so-called "10 commandments" specifying administrative and marketing functions that had to be carried out wholly or largely outside the United States.

These requirements were relaxed nearly a decade ago, but industry members in Toronto say there remain various practical reasons why US-based managers may still find it preferable to use administrators in Canada. That's certainly the thinking behind the decision of UBS, which administers a global total of more than $100bn in hedge fund assets, to set up a Toronto office this year to take on part of its western hemisphere business currently handled in Grand Cayman.

The dynamism of the sector is also seen in the recent merger between the fund services business of Royal Bank of Canada and the Belgo-French Dexia group, creating a new industry powerhouse with hedge fund administration operations in Dublin, Luxembourg, Cayman, Jersey and Guernsey as well as Toronto.

UBS and RBC Dexia Investor Services are among a mix of domestic and global players in a keenly contested marketplace, with international names including Citigroup and Citco competing alongside specialist local firms such as Felcom Data Services, which focuses on start-up and smaller funds that are often overlooked by the bigger service providers, according to Ron Landry, Felcom's executive vice-president and chief operating officer.

He says: "It's a fairly competitive market, consisting of a handful of very large American-based service providers like Citigroup and IFDS, and a number of smaller companies like ourselves. As well as size, service providers also differ in their approach to the market and who their target client is. Generally you can tell from a client's focus which provider would fit best. If their concern is purely the bottom line of what they're going to spend, they may be more appropriate for one particular provider, whereas if they're more concerned about the service quality they're receiving it might be a different one."

Says Mark Purdy, chief investment officer with Toronto-based fund of funds manager Arrow Hedge Partners: "There is a legacy of good administrative back office business in Toronto dating back to the 10 commandment days with firms like State Street and Citco, and in addition several of the global players are strengthening their hedge fund administration business. From a prime brokerage standpoint, there's been a big push recently from the local banks in response to the growth in hedge fund managers setting up shop in Canada."

In contrast to the administration sector, few of the leading global prime brokers have made a serious push into the Canadian market, leaving the field open to the country's leading domestic banks such as RBC, Toronto Dominion and Scotia. According to Lionel deMercado, managing director and global head of equity finance with TD Securities, for the time being the domestic hedge fund market is not large or lucrative enough to justify the kind of investment required for the global players to match the market experience and insider knowledge of the local institutions.

At present the Canadian market targeted by the prime brokers consists of more than 200 single-manager funds. Although the country's sizeable community of fund of funds managers have traditionally made significant allocations outside Canada, deMercado says they are starting to show p10 p7 greater interest in the homegrown market as a result of the success of domestic managers over the past few years.

Up to date figures on Canada's hedge fund industry are hard to come by, but in June 2004 Toronto-based research firm Investor Economics estimated conservatively that assets totalled some C$26.6bn (US$22.7bn), consisting of C$10.9bn in pension plan assets, C$14.1bn in domestic hedge fund products (of which as much as half consisted of principal-protected structured products aimed principally at the retail market) and C$1.6bn in offshore funds run by Canadian managers, largely targeted at European investors. Although modest measured against a global hedge fund industry whose assets have been estimated as high at US$1.5 trillion, these figures represent rapid growth for the Canadian market, with domestic hedge fund assets growing six-fold between 1999 and the end of 2004.

Arrow Hedge chief executive Jim McGovern cautions, however, that because much of the current growth in hedge fund assets is flowing to the offshore vehicles of Canadian managers, domestic service providers may not gain the full benefit. He says: "A lot of the new capital flows that they're getting are actually coming from international investors investing in their offshore funds, domiciled in Cayman, BVI or Bermuda."

According to deMercado, the strategy adopted by many managers is to establish a track record in the domestic market and then to set up an offshore fund to market to international investors. He says: "We find that many managers who have offshore accounts have a domestic administrator for their onshore business and an offshore administrator in somewhere like the Cayman Islands."

Managers and service providers are unanimous that Toronto can hold its own with the best in terms of the skills it can provide in hedge fund servicing and their cost. Adds deMercado: "Growth in the services sector has benefited not only administrators but firms offering audit and legal services, and providing structuring for hedge funds."

The city's broad-based financial services industry is a ready source of qualified staff with many of the skills required by the hedge fund sector. Says Sean Flynn, managing

director and head of UBS Hedge Fund Services: "Toronto has a good supply of qualified and experienced labour for the fund administration business.

"There are already a number of players who have been active for many years in the traditional fund administration business, as well as a small but growing number of hedge fund administrators, but there is also a skills pool coming from traditional business who can easily be retrained into the hedge fund business. There is a good supply of accountants coming out of the Big Four professional services firms."

According to a local adage, "Americans love to make money and Canadians love to audit it", and McGovern says: "There is a very strong infrastructure here for managing and administering funds." Mark Fieldhouse, director of technical sales and relationship for global products with RBC Dexia Investor Services, notes that Toronto has one of the highest levels of new Chartered Financial Analyst qualifications of any city in North America.

Members of the industry note that while Toronto may look pricey to Canadian eyes, it is certainly competitive on cost with its rivals for hedge fund servicing business. Says Felcom Data's president and chief executive Kevin Beatson: "Toronto is expensive by comparison with other Canadian cities except maybe Vancouver, but from a global perspective it can offer considerable savings. Any administrator in one of the offshore island domiciles would find it profitable to outsource back office work to Toronto."

Adds McGovern: "Not only is this is a very competitive place for recruitment, things like wages and other staff costs, rental costs and operating expenses are substantially lower here than in other jurisdictions. There's also a level of comfort from the fact that there's a bigger infrastructure here in terms of the legal and accounting professions."

Toronto offers a very viable alternative to other leading financial centres, Fieldhouse says. "If anything it would be toward the low end of the cost scale compared with alternatives in the US, although it has probably been affected by the strength of the Canadian dollar over the past 18 months to two years," he says. "RBC Dexia has a global presence and I would say Toronto is in the middle of the pack when it comes to cost structure."

These factors are likely to encourage other service providers to follow the lead of UBS and look beyond the domestic Canadian market to broader opportunities throughout the Americas. Says Fieldhouse: "With the trend on the part of institutional investors to adopt hedge fund or hedge-like strategies and the overall institutionalisation of the hedge fund market, we can see Toronto growing as a key hub for all of North America. We expect these trends to produce double-digit growth over the next one to two years."

Depending on their specialisation and strategy, providers differ on the importance of the domestic market in boosting business growth. For instance, it is not currently a high priority for UBS, which has always conceived its Toronto operation as internationally focused. Says Flynn: "At this point in time Canada is not a significant market. There is a growing hedge fund business, but at the moment the major market is clearly the US, and that's the market we are looking to service."

By contrast, the outlook for prime brokers like TD Securities is rosy, according to deMercado: "We continue to see new business and we're always in dialogue with new managers for new mandates," he says. "We pick up a substantial amount of new business based on our reputation in the marketplace and referrals from other clients, and I see no sign of it stopping any time soon."

The new business, he says, is coming from a combination of existing managers setting up offshore funds, the growth in assets of managers that have been performing well, and the departure of traders and analysts from established institutions to set up their own funds. "There's no question that over the next 12 to 18 months we will continue to grow and to increase the range of services we offer to funds," de Mercado says, "and perhaps to a broader geographical range of funds."

Beatson believes that increasing numbers of managers outside Canada will add to the flow of business, even for administrators that are currently focused mainly on the domestic market. Arguing that UBS's decision to set up an administration business "speaks well for Toronto and where they see it going", he adds: "One of the great advantages that we bring to the table is Toronto's experienced and educated workforce.

"We've seen that one of the ways we can move forward in some of these offshore markets is providing back office services for some of the administration companies there. They are dealing with the client directly as the face of the relationship, but they have a shortage of skilled employees, so they can outsource the actual work out to us. But we also expect to see growth from the established domestic market too."

The increasing international spotlight on Toronto might bring more competition into the market from the leading global hedge fund administrators, but Beatson argues that they may not have things all their own way. He says: "We've seen in the past that US service providers have come to Canada with the approach that they can set up a small shop doing the same thing they do at home.

"Some of them have been through very difficult times coming to terms with the differences between the two markets. You find that Canadian companies and the professionals working in them have, generally speaking, a higher level of exposure to what's happening worldwide, and Canadians are generally very well versed in offshore product and what's happening in that market. There's a certain global awareness among Canadians that you might not find in other places." ■