

Alternative Facts for Alternative Investors | July 2017

“All generalizations are dangerous, even this one.”

Alexandre Dumas

Across the taxonomy of investment products, the hedge fund category invokes some rather extreme reactions. On the one hand, there are images of ruthless and greedy managers, whose performance doesn't always justify their fees or egos. On the flip side, you have some of the world's best performing endowments and pension plans advocating significant allocations to alternatives as part of a well balanced and diversified portfolio.

The difficulty in forming any concrete conclusions or opinions is that they make one guilty of generalizing a very diverse and broad industry. After all, hedge funds are defined based on the legal structure of the offerings and not the underlying investments. While the original conception was long/short equity funds, the category has grown with strategies ranging across asset classes and the risk spectrum. There are even folks that view the Canadian hedge fund industry as a unique animal unto itself, with its' very own appeal.

At this point, the typical Canadian reaction is: Really? Why would global portfolio managers care about our little alternative market?

The argument is that Canadian capital markets are smaller and less liquid, creating more inefficiencies for active managers to exploit. Also, there is less competition chasing these opportunities relative to larger markets. Furthermore, investors are drawn to the smaller size of Canadian offerings, with the advantage of being more nimble and able to execute niche strategies.

From what we have been able to gather, the best estimate of the size of the industry in Canada is \$35bn across approximately 150 funds, with the majority of them managing less than \$50mm each. To put that into perspective, our entire industry would have difficulty cracking the list of top 5 hedge funds by assets. Bridgewater, AQR, and Renaissance Technologies alone combine for over \$233bn under management.

While this data is supportive of the hypotheses, as we all learnt in science class, it's the results that count. Since its inception in 2005 to the end of June 2017, the annualized return of the Scotia Bank Canadian Hedge Fund Index was 6.76%. Over the same period, the annualized gains of the HRFX Global Hedge Fund Index and the TSX were 0.73% and 6.98% respectively. It is worth noting that the hedge fund figures are net of fees whereas the TSX returns are gross. Furthermore, the Scotia Index exhibited about 30% less volatility than the Canadian stock market.

We offer this data to provide a broad perspective of the industry but would caution against overemphasizing a fund's performance in isolation. Too often allocations to alternatives are driven by a chase for high returns when we would argue the purpose of adding 'alts' to your portfolio is diversification.

While traditional public markets offer many baskets to put your eggs in, you also have to make sure these baskets are not all on the same shelf. Today's alternative funds provide a broad range of return streams, from merger arbitrage and private debt to wine and cryptocurrencies. The key is to find investments that zig when the rest of your portfolio zags, to help you smooth returns, reduce volatility, and sleep better at night.

The Fund

Domestic credit markets followed the summer script last month. Supply was light (\$7.8bn) and spreads ground modestly tighter. We saw robust demand for financials, buoyed by FTSE Russell deciding to include bank NVCC debt in the Canada Universe Bond Index. Although widely expected, the announcement was a catalyst for bank spread tightening. The star performer in July was the energy sector with spreads performing on the back of rising commodity prices.

The portfolio was well positioned for the month in both rates and credit. While the increase in yields saw the domestic bond index down 1.90%, our hedges and trading generated a positive return through the rate move. On the credit side, the carry was bolstered by exposure to outperforming securities and active trading. In particular, we benefitted from exposure to bank debt and from a position we exited in long CNQ bonds which rallied 20bps. The result was a strong monthly gain of 0.94%.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	-	-	-	-	-	5.89%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

Barring any surprises, we anticipate August to follow the summer theme, with another month of light issuance and dull markets. Things become more interesting as September approaches, with portfolio managers repositioning ahead of the expected Fall supply. As history has shown us, the market impact of the new issuance isn't clear cut.

If the new deals are well received and perform strongly, they can take secondary spreads along for the ride tighter. Alternatively, if the amount of supply is overwhelming, spreads could react poorly. Accordingly, we have positioned our portfolio to retain flexibility and to take advantage of the opportunities created by the flows around new deals.

Rates

With the Bank of Canada and Federal Reserve hikes behind us, attention turns towards September when the Federal Reserve is expected to commence the tapering operation. It also seems that the ECB is ready to join the party and will provide some insight into how they intend to manage their exit from quantitative easing.

The central banks have done an admirable job convincing everyone that the 'exit' should be a rather smooth process. For this to play out according to their script, private capital would have to step in and buy the debt that central banks no longer need. We wonder what the source of this cash will be. If it requires the sale of other assets, we imagine that yields would need to be quite a bit higher to entice folks to move from other investments into government debt.



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