

Hedging bets by being net short

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Feeling a bit bearish? The beauty of well-run hedge funds is that it doesn't matter whether the market is going up or down; there is always some way to make money. Hedge funds that specialize in short selling are few and far between, but they are everyone's heroes in a bear market, and if used correctly, they can reduce overall portfolio risk in any market environment. Keep in mind that these funds don't always seek to outperform the broader index. This week, I interviewed John Schmitz, CEO of SciVest Fund Management, who runs a whole slate of hedge products. We discussed in particular the firm's net short fund.



CREDIT: Brent Foster, National Post

John Schmitz, CEO of SciVest Fund Management, runs a whole slate of hedge products. His net short fund is one of only about 25 in the world.

Q. First of all, what is shorting?

A. Shorting is the process of borrowing a stock, usually from a prime broker. We would say: "Can we borrow 1,000 shares of XYZ?" After borrowing, we will sell the shares in the market. Since we don't own the shares we are selling, it is called selling short. We then get the cash from the sale in the account, and we can do what we want with it. In our case, we use much of the money and invest it in T-bills. We could also buy stocks long with the cash. Some day in the future, we will go and buy back those shares and return them to the lender. We hope to buy them back at a lower price than what we sold them for initially.

Q. How is the fund structured?

A. We are always net short the North American equity markets. It is 175% of net asset value short, 125% of net asset value long, and 150% sitting in T-bills. It actually leverages up T-bill yields, which is a nice feature, so we also achieve 150% of T-bill yields; the extra 50% being financed by larger short positions than long positions. Our net short strategy is unique here in Canada. It is probably one of the lowest-risk net short funds in the world. As far as I know, it is the only active net short fund in Canada available to high-net-worth retail investors. There are only about 25 net short funds in the world, and what makes this unique is that we don't try to time whether the markets are going up or down.

Q. What are all the possible ways you generate return from the fund?

A. The beta is the best measure of market exposure with a benchmark set at one. A fund is riskier than the benchmark index if it is above one. If it is below one, it carries less risk. Therefore, our beta is set on a forward-looking basis at -0.5, so we expect to make half of what markets fall, or lose half of what they go up. As an example, if the S&P 500 goes down 10%, we would be expected to make 5%. In addition to making our net short exposure

return, we would expect to pick up a T-bill return of 150% of the going T-bill rate. The third return generator is our alpha, which is our stock-picking ability to buy long positions that go up on average more than the market, and to short companies that on average don't go up as much as the market. We expect the fund to generate a positive return despite the fact we are always short, and despite the fact that the market generally rises. This is due to the yield-enhancing ability of our T-bill positions, and the stock-picking ability we have.

Q. What factors do you use in picking the stocks on the long and short sides?

A. Generally, we have 250 stocks long and 250 stocks short across North America. Everything we do is highly risk-controlled and highly diversified. To pick the stocks, we use a systematic, quantitative (computer-based model) process, as opposed to using our 'gut' or judgment to get involved in the portfolio-building process. In fact, the models look at well over 100 factors when picking stocks. The models that pick the stocks are very fundamental in orientation, so we tend to be long companies with good valuations, good earnings momentum and decent growth characteristics. We tend to be short the exact opposite type of companies, in other words those that are fundamentally weak. Using these models we hope to make money on both sides of the portfolio.

Q. John Templeton said a few years ago that he had a substantial amount of his net worth in market-neutral equity hedge funds. Can you discuss how adding your net short fund could enhance an existing portfolio?

A. Obviously, we should make lots of money if the market starts to fall, but the fund should also have a headwind if the markets go up strongly. As a result, the best way to view a fund like this is as a part of a portfolio that would include a bunch of long-only equity funds. This fund should diversify the risk of being long the market. In general, when your long-only funds are going down we will be going up fast, thereby insulating losses when markets go down in value.

Q. Does the model change as the markets change? In other words, is it adaptive?

A. Our core model is a dynamic model that adapts to the current equity-market environment and economic conditions. It will phase in and out of different styles, as they start and stop working. As an example, momentum as a style has not been working well at all over the last three to six months and as a result our core model is neutral on momentum characteristics, be it earnings or price momentum. Until this spring, we were very bull-market oriented in the stock-picking models, favouring momentum, as well as Growth at a Reasonable Price factors. That all changed over the last six months. Interestingly, for the first time in three years, the model likes dividend yield, meaning we are net long high dividend yields at this time. In a bear market, the models focus primarily on quality and conservative characteristics. In a bear market, you would want very high earnings quality, high earnings sustainability, low leverage on the balance sheet and low volatility of cash flows.

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