



HEDGE FUNDS

UK £50, EUROPE €85, US \$75

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY **REVIEW**

Managing money

Liquidity and good returns are key for Preservation Trust

JC Clark offers an insider's perspective on the success of his Preservation Trust

BY DAVID WALKER

Toronto's JC Clark aims to offer investors a slightly different perspective on the North American continent, by keeping at least 55% of assets in its long/short Preservation Trust invested in stocks listed on Canada's markets.

The firm's founder and lead manager on the trust, John Clark, chairman of the board of governors of the Toronto Stock Exchange between 1995 to 1997, says he started the fund in 1999 mainly to preserve family assets – hence its name – but opened it to external investors as demand grew.

According to the group, between May 1999 and the end of June 2002, the Can\$100m fund has

ruary 2001. During this period it has achieved a Sharpe ratio of 1.32 compared to the Dow Jones All Industrials Index's -0.59.

The fund's overall goal, Clark explains, is to return investors 10% to 15% annually, which it has exceeded, on annual standard deviation of 10% to 12%, without taking directional bets on the markets and while preserving capital. The portfolio's actual volatility is 10.5% and it displays a -0.25 correlation with America's Dow Jones All Industrials Index.

The fund need not maintain a bias toward long or short positions. At the end of June, its US long posi-

overall between 90% and 120%, and net exposure of -20% to 20%.

CANADA

By buying into the Canadian market, investors are entering a market roughly the size of Italy or Germany, at Can\$530bn, with pricing discrepancies to match.

John Clark, founder of JC Clark, says the market is "operationally efficient but informationally inefficient," and adds the Preservation Fund achieves a degree of non-correlation with the US market simply by investing in Canada as well. Since April 1997, Clark notes the S&P Toronto Stock Exchange index has differed in returns from the Dow Jones Industrials Index on average by 3% per month and has a correlation with its southern neighbour of 0.7.

A tight-knit community of investors, who can often have easier access to corporate chief executives than analysts in the US, helps information circulate in an environment where the smaller size of the analyst fraternity guiding investment decisions can also lead to stark over and undervaluations.

STOCK PICKING APPROACH

Clark, who has 20 years' experience in long/short investing and remains invested in the fund himself, adds liquidity is a key issue when investing the hedge fund's portfolio. The Preservation Trust can sell 90% of its positions in two to three days if need be, he notes, and the remainder between five and 15 days. "About 80% of our positions are significantly less than one day's trading volume in that stock, and the average trading volume per security is about 3.9 million shares," Clark explains. Overall, the fund trades around core positions to produce an aggregate turnover of portfolio each year.

The average size of companies in which the fund takes long positions is US\$4bn, while the importance of being able to exit short positions rapidly means the average firm for shorting is worth US\$19bn.

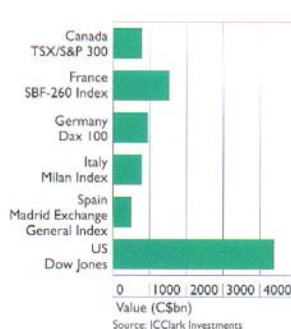
While the holding period for short positions may range between two weeks to two years, long positions may persist for longer, from six months to three years.

The bottom-up stockpicking fund's largest positive sector stances include a long exposure

Distribution of monthly returns



Stock market capitalisations



produced a compound return for investors of 70.81%, an average annual return of 18.4%, by holding between 60 and 80 positions. No more than 7.5% of the fund's equity is invested in any one position.

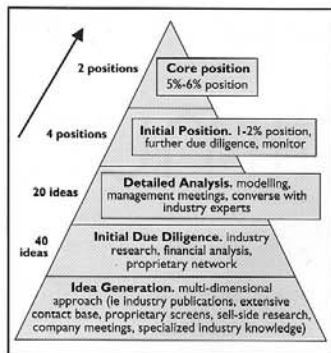
This compound return compares favourably with the Tremont Long/Short index return of 33.83% and the Dow Jones's fall of 14.33% over the same time period. Across these 39 months, the fund has suffered 13 negative periods, the two largest posting around -4%. This was offset slightly by a 10% rise in May 2000 and a gain of 6.5% in Feb-

ruary 2001. During this period it has achieved a Sharpe ratio of 1.32 compared to the Dow Jones All Industrials Index's -0.59. The fund's overall goal, Clark explains, is to return investors 10% to 15% annually, which it has exceeded, on annual standard deviation of 10% to 12%, without taking directional bets on the markets and while preserving capital. The portfolio's actual volatility is 10.5% and it displays a -0.25 correlation with America's Dow Jones All Industrials Index.

Overall, the fund had a net exposure of 11.8%, "however, due to the higher volatility of short positions the beta-weighted exposure is slightly negative," Clark says.

He says the fund does not take large bets in any specific sector – and generally runs gross exposure

Investment process



9.2% in four positions in death care, 5.1% in four oil and gas firms and 4.9% long (3% net exposure) in business services.

Clark says Canada's listed cemetery and undertaking industry has been undergoing a similar liquidity squeeze to that of global telecoms firms, and has been "selling assets and cleaning up balance sheets, paying down debt."

"Their debt will be reduced by 50% from their positions 18 months ago by the end of the next six months," Clark explains, adding that the aggregate capitalisation of the listed industry players fell from around Can\$32bn at the end of 1998 to around Can\$800m in January 2001.

Overall, Clark says, the fund aims to buy high quality businesses trading at a 50% discount to their intrinsic value, while selling businesses with poor management and weak fundamentals.

The portfolio's biggest negative bet recently has been a 13.1% short exposure (7.6% net exposure) in financials. Its next two largest negative positions are a -14.1% in manufacturing and consumer, and a -12% position in technology and telecoms.

Clark says the fund is often the only one shorting a specific stock, thus avoiding the herd mentality more prevalent in US markets. With as few as 30 hedge fund managers running about Can\$2bn to Can\$3bn it is not difficult to avoid the crowd.

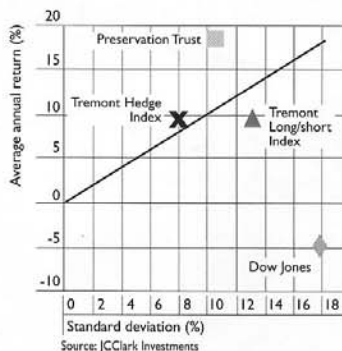
Clark adds that Canada's lower volume of stock research compared to the US, very few independent research sources outside the market's largest five investment banks, combined with many cases of the firm being the "main cheerleader" for its own stock, make pricing anomalies more prevalent in Canada.

SELECTION PROCESS

A typical selection process at JC Clark may begin with the generation of stock ideas from industry publications, contact and company meetings, sell-side research and proprietary screens, which may pare down the many offerings to 40.

These firms then undergo financial analysis, research of the dynamics of their wider industry group to halve the ranks. The 20 survivors are then visited by one of the 10-person JC Clark team and are run through further financial modelling, and experts in the industry under examination are consulted on the firm's prospects. The firm's P/E, price to cash flow and price to book value characteristics may be examined, as well as its leverage and

Risk and return



goodwill provisions.

Four firms emerge, with a possible initial position of 1% to 2% of fund assets taken in them while further due diligence is undertaken and performance monitored. A full position of 5% or 6% of fund assets may be taken.

Overall, attractive companies may display significant free cash flow with clean balance sheets and strong management teams, while earning a high return on invested capital and be a low-cost industry leader. Unattractive firms could be extremely overvalued with little cash flow, have a "promotional management team" growing the firm through acquisition, adopt aggressive accounting practices and have slowing inventories and receivables turnover.

Clark says the intrinsic value of each company examined is made using proprietary discounted cash flow models, and accounting methodologies are analysed for potential discrepancies.

While all the fund's individual positions are not generally released, Clark says investors are welcome to attend JC Clark's Toronto offices and discuss the fund's positioning at any given time.

He adds that the Canadian markets offer some key advantages for hedge fund managers over the more efficient American markets and the fund can hold up to 70% of assets in Canada.

While the fund is currently taking extra inflows and, as reported exclusively in *Hedge Funds Review* last month, JC Clark is to launch an offshore version of the Barbados-domiciled fund listed in Dublin for European investors, John Clark sees an upper limit on size.

Underlying securities, trading volumes and market capitalisations of firms in which the fund specialises hints at optimal capacity at around Can\$500m (US\$322m), but the firm aims to soft close the portfolio to reassess the impact of its growth on performance at Can\$250m (US\$161m).

The company's Dublin-listed version of the fund, to be called the Preservation Capital, will offer euro, dollar and Canadian dollar share classes, but a minimum investment is yet to be decided. The fund administration will be provided by the Bank of Bermuda.

Clark says Barbados was chosen as domicile for the fund mainly because of tax advantages to US investors of investing in a fund based there.

However, the offshore fund cannot use any of the up to 150% leverage the US-targeted fund can, partly due to extra concern non-US investors have voiced about volatility generally.

Fundamentals

Investment manager: JC Clark
Fund: The Preservation Trust
Manager: John Clark
Size: Can\$100m
Address: JC Clark, BCE Place, 161 Bay Street, Suite 2240, PO Box 218, Toronto, Ontario, M5J 2S1, Canada

Website: www.jcclark.com
Contact: 001 416 361 6144
Launch: April 1999
Objective: The fund seeks to preserve capital, attain outstanding risk-adjusted absolute returns and remain uncorrelated to the broader market indices.

Geographic focus: North America
Administrator: Bank of Bermuda
Prime broker: National Bank Financial
Auditor: Deloitte & Touche
Fees: 2% management, 20% performance

High water mark: NAV at inception of investment
Subscriptions: Daily
Min investment: Can\$2m
Domicile: Barbados
Listing: Dublin (for offshore mirror fund)
Share classes: Canadian dollar
Share classes for offshore mirror fund: US\$, Euro, Sterling

MONTHLY AND COMPOUNDED RETURNS



Fund manager biography

John Clark



Present: Founder and chairman JC Clark & Co.
1995 - 1997: Chairman of the board of governors, Toronto Stock Exchange.
1989 - 1999:

Director, The Empire Company.
1989 - 1995: Director, Arbor Capital.
1982 - 1987: Founder and chairman, Connor Clark & Lunn.

1977 - 2000: Founder, chairman and chief executive, Connor Clark & Co wealth managers.
1963: BA, Duke University.