

# ACTIVE VERSUS PASSIVE?

By Mark Purdy and Keith Tomlinson



The active/passive debate asks whether investors would be better to buy low-cost “passive” funds that simply replicate a stock market index or invest in higher-fee “active” funds where a fund manager uses his smarts and trading savvy to try and beat the market. There are countless studies on the subject, and for the most part, the data proves that active managers just aren’t smart and savvy enough — passive funds outperform active funds by roughly the difference in the fees.

But there is a simple fact that doesn’t ever seem to get mentioned in all the reports we’ve seen: many mutual fund managers are not exactly what we would call active managers. So why would anybody ever expect them to outperform? We’ll elaborate shortly, but first a quick word on the debate itself.

There is a lot of research on the active/passive debate, which we are not going to regurgitate here. Whether you agree with our conclusion that active funds underperform or not, you cannot argue with industry trends: investors are increasingly turning away from active funds and the advisors who sell them. Hastened by the growth in exchange traded funds (ETFs), passive market share is soaring. According to Morningstar, passive strategies fund assets reached \$1.7 trillion in 2009, representing a market share of 22% compared to just 11% in 2000.

## THE ACTIVE/PASSIVE DEBATE IS A RED HERRING

We believe the active/passive debate is asking the wrong question. The question should not be: do active funds outperform passive? The question should be: why aren’t actively-managed mutual funds more active, when it comes to protecting investors from bear markets?

CHART 1: MUTUAL FUNDS VS INDEX



Source: Globefund.com

This chart shows the performance of the two largest active mutual funds in Canada relative to the S&P/TSX 60 Total Return Index. There is clearly a large directional correlation.

No disrespect to mutual funds — or those in the transportation industry — but in our view too many mutual fund managers are little more than glorified bus drivers. That is because mutual funds are typically required to stay fully invested. The manager cannot go to cash even if he wants to. From an investor’s perspective that’s great in a bull market. But when market conditions turn downwards do you really want to have your money with somebody who must always keep their foot on the gas pedal?

The typical mutual fund, which ostensibly provides active management, will have over 90% of the variance in its returns explained by the movements in the benchmark index. This partly reflects fund managers’ tendency to never stray too far from their benchmarks. Moreover, even when they do stray,



it makes little difference. Stock picking is rarely as important as overall market direction. That's because most mutual funds are over-diversified and in a bear market, most stocks — good and bad — go down. In a bull market, the opposite is true. In a commodity-driven economy like Canada, stock selection plays an even smaller role, as share prices react to commodity movements.

The average mutual fund manager knows that there is little they can do to protect you in a falling market. That's why they harp on about their performance relative to the market. So when the market falls 40% and their portfolio falls 38%, they'll brag to investors about how they did a good job. To that end, perhaps the active/passive debate should be renamed the passive/slightly-less-passive debate.

## THE CASE FOR HEDGE FUNDS

Let's back up for a second and ask why investors — whether they're in mutual funds or ETFs — even buy equities in the first place. The logic is simple. Studies have shown that over the long-term, stocks deliver expected returns higher than bonds and cash. Intellectually, this seems likely to continue: over the long-term, population growth and improved productivity leads to higher economic growth which leads to higher earnings which leads to higher share prices. However as any seasoned investor knows, the long-term can turn out to be a lot longer than you ever expected.

CHART 2: JAPAN'S LONG RUN



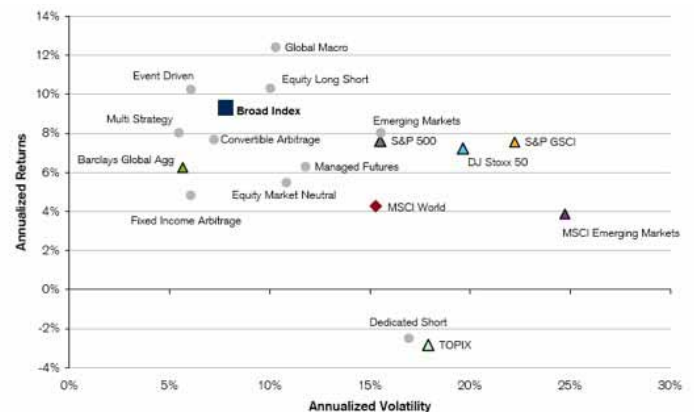
Source: Pertrac. Arrow Hedge Partners Inc.

Japan's financial advisors probably had some very pretty PowerPoint presentations back in 1989 arguing for the superior expected returns of Japanese equities. Those presentations have long since been revised. A Japanese investor who ploughed into the markets back then would still be down some 70%. The thing about risk and return is that there

are never any guarantees that actual returns will actually achieve the targets. There are countless examples of multi-decade bear markets across history. If you are comfortable with the possibility that equities could fall in value and deliver sub-par returns for decades, then by all means, limit your investments to passive ETFs and less-passive mutual funds. Otherwise, you might want to consider an alternative.

Unlike the mutual fund manager who would expect a bonus for falling less in a falling market, hedge funds managers only get a bonus if they achieve a positive return. So they're very active in their search for profit — using a myriad of strategies to deliver absolute returns — even in bear markets. Mutual fund managers don't have these options in their toolkit. The dramatic v-shape of the market rebound has helped investors forget that most mutual funds gladly rode the markets down and will gladly ride them down in future. A mutual fund will have risen with the recent rebound, simply because it was required to stay fully invested the entire time. But in the hedge fund community, the cream has clearly risen to the top.

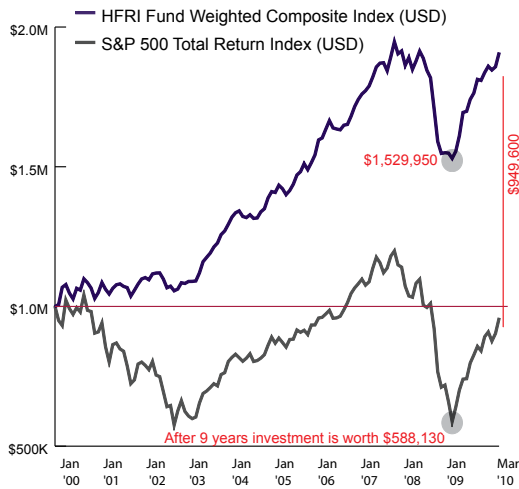
CHART 3: LONG-RUN HEDGE FUND RETURNS



Source: Pertrac. Arrow Hedge Partners Inc.

Over the years, studies have shown the hedge fund advantage with higher performance, lower volatility and reduced correlation to the markets. Clearly this has paid off in the last decade, with two bear markets hitting equity markets. Despite sustained outperformance, we don't believe hedge funds should be strictly compared against equity markets. An investor who invests in short-duration bonds does not do so because he believes the expected return will be higher than the equity market. Rather, he does it, because he wants to reduce volatility of returns and achieve an actual return that is more likely to approximate the "expected" long-term return. To that end, hedge funds shouldn't be evaluated against mutual funds. They should be evaluated relative to cash in the bank and associated with risks taken to earn a better return than cash.

CHART 4: HFRI VS S&P 500



Source: Pertrac. Arrow Hedge Partners Inc.

We've generalized a lot in our discussion of hedge funds. There are so many different kinds of strategies, that lumping them all under one category is as misleading as calling both potatoes and apples fruit. The popular perception is that hedge funds are riskier than mutual funds, but in fact, they can be much safer. We stress the word "can," because it all depends on the fund, recognizing you are taking on different risks. Unless the stock market goes to zero, a long-only mutual fund is never going to blow up. Where the hedge fund industry gets a bad rap is from managers who take on too much leverage or too much concentration or simply don't hedge at all. When they collapse, the whole industry gets painted with the same brush.

One has to take the time to understand the risks of a particular hedge fund. Modesty aside, we'd place our fund of funds in the ultra-safe category given our distaste for leverage and stringent requirement for transparency and liquidity. Please refer to our 4Q09 Quarterly, What's Next, where we described in great length our investment methodology.

The growth in the segregated fund market clearly demonstrates that there is a real demand for safety among investors. In Canada, segregated fund assets totaled \$173 billion in 2009, more than twice the levels of 1999. Mutual fund assets were \$600 billion, a 53% increase on the same period. Most investors we talk to, invest with us, because they want steady returns and to preserve their capital. If the markets are up strong, they're not particularly bothered if we're up less. They just want us to try not to lose money in the years that the markets are down. These are investors who are not satisfied with traditional benchmarks — for them the only relevant benchmark is cash.

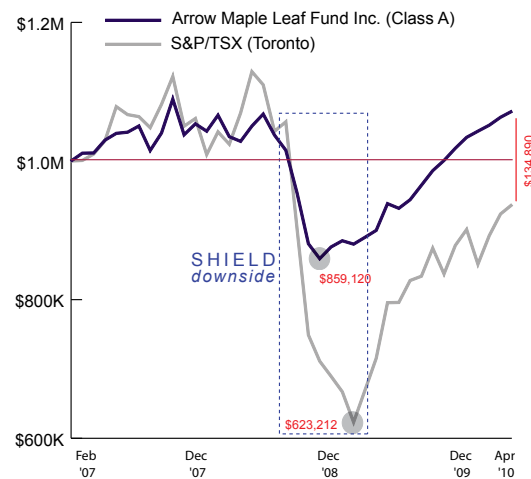
The irony is that for all the safety of hedge funds, they are still not perceived as safe, and are not easily accessible to small investors. In contrast to long-only mutual funds, which can be sold to anybody, hedge funds must be sold to "accredited investors" who have met the necessary requirements of capital or investment experience. Oddly enough, regulators do allow less experienced non-accredited investors to purchase hedge funds if they invest a minimum of \$150,000.

Nevertheless, we remain optimistic that hedge funds will have their day. In addition to the active/passive debate there is growing interest by the media on the topic of "fiduciary duty" — an area that advisors who plug underperforming mutual funds fall short. We expect that over time, the use of properly constructed hedge funds must by necessity become a more important part of the advisor arsenal.

## ARROW MAPLE LEAF CANADIAN FUND

In Canada, despite the sharp rebound, equities are only now back at 2000 levels. We believe the case for investing in Canadian hedge funds have never been stronger. The Canadian hedge fund space is underdeveloped and profit potential from hedge fund strategies is exceptionally attractive. There are also meaningful risks to equity markets that are not appreciated by investors in long-only funds. To that end, in January 2010, we commenced sales of the Arrow Maple Leaf Fund in Canada. This multi-strategy fund of funds invests in ten to twenty hedge fund managers, who are typically based in Canada. The fund was launched in 2007, but until now was only sold to international investors. It weathered the financial crisis quite well, outperforming both the TSX and the Global Hedge Fund Index.

CHART 5: ARROW MAPLE LEAF FUND<sup>1</sup> VS S&P/TSX



Source: Pertrac. Arrow Hedge Partners Inc.

## THE CANADIAN HEDGE FUND SPACE

In a global context, Canadian markets offer exceptional opportunities for a hedge fund of funds. There is a greater selection of funds employing strategies that are not focused on predicting the direction of the market. Equity market neutral, merger arbitrage, convertible/fixed income arbitrage and event driven strategies provide attractive risk/reward in the Canadian hedge fund space. Profit spreads are wide and there is a lot of low-hanging fruit.

This reflects a number of factors: Canadian markets are relatively small and traditionally haven't captured the interest of large global players while domestic banks have been less active in proprietary trading. In addition, the hedge fund industry is relatively new, only coming into prominence a decade ago. Most of the hedge funds we invest in have a wealth of talent but a dearth of money. Their small size does not reflect their skill set, with many bringing extensive overseas experience back home to Canada. This comes in handy with respect to mid-market Canada where there's less competition from the big banks for financing and restructuring transactions. For those with the know-how, there are abundant opportunities with limited downside and option-like upside.

Local knowledge matters in Canada, with many "Made in Canada" opportunities for profit. This is particularly true for cross-border transactions. When Thompson bought Reuters, a lot of US firms didn't even bother with the trade. They just didn't have the Canadian knowledge. But Canadian managers can never be so parochial. Given Canada's reliance on global commodity markets, Canadian managers must by necessity understand the global market place. This gives them a distinct advantage over their foreign counterparts.

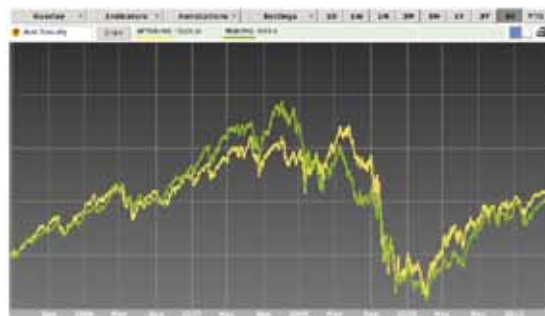
## RISKS TO MARKETS

In a global context, there are many arguments for being long Canadian markets: its banking sector, balance sheet, exposure to emerging markets and healthy property market — the latter of which benefits from Canada's mimicking of United States interest rate policy. But there are some underappreciated risks to the Canadian story, risks that threaten investors in ETFs and mutual funds. Most of our managers have a healthy respect to these risks. They'll ride momentum upwards but could turn bearish very quickly if conditions warrant. Our positions in the Maple Leaf Fund reflect this, with our gearing low but still modestly net long.

The first major risk is also the major strength — China. There was much backslapping about Canada's fiscal management and conservatism during the financial crisis. However, we think the secret of its success is a little less flattering; we sell rocks and we sell oil. China is the world's largest incremental buyer of commodities and its renewed appetite for raw materials mid-2009 gave Canada the

boost it needed to bounce back. Canada remains disproportionately dependent on its continued growth. Any doubt that Canada's success is driven by much more than the China story should be put to bed by the next chart, which compares Canadian equities to another major commodity exporter — Australia.

CHART 6: CANADA VS AUSTRALIA



Source: Arrow Hedge Partners Inc.

The second risk is a homegrown one: the housing market. While there is much debate over whether a record high price/rent ratio in fact constitutes a housing bubble, there is one issue which is incontrovertible yet rarely receives much press. That is, half of all outstanding mortgages and the bulk of mortgages where the loan-to-value ratio is greater than 80 percent are guaranteed indirectly or directly by the Canadian Mortgage Housing Corporation, whose chief mission is to promote home ownership.

Ask yourself how overvalued property prices might become when banks can originate mortgages and pass on the riskiest bits to a government entity whose chief mission is to promote home ownership? It didn't work too well in the United States via Fannie Mae and Freddie Mac, did it? If things weren't a little bit overcooked then why would all five major banks in March have petitioned the government to impose stricter lending standards? Maybe they've learned something from the global experience even if it hasn't stopped them from benefiting from politicians' inertia. Or maybe they just realize that when this bubble bursts, they too will feel the pain, even if the worst part hits the taxpayer.

The thing about bubbles is you never know when they will burst. Asset values can go from cheap to expensive to very expensive to just plain stupid. But it always ends in tears. The naïve Buy & Hold Mentality is a risky strategy that leaves investors vulnerable to the almighty Beta. An active manager is a necessary tool, but not the sort of active manager who simply drives the bus, going wherever the road takes him. Rather the active manager who has the power to take his foot off the gas, or even reverse, on the turn of a dime. Or even better, one who's willing to take another form of transportation.

## ARROW MAPLE LEAF CANADIAN FUND (CLASS A)<sup>2</sup>

Security Exposure (%) as at March 31, 2010			
	Long	Short	Net
Equities	73.6	-52.1	21.5
Corporate	27.0	-4.9	22.1
Warrants/Other	4.7	0.0	4.7
TOTAL	105.3	-57.0	48.3

Strategy Exposure (%) as at March 31, 2010	
Global Long / Short	27.3
Relative Value	11.8
Event Driven	32.0
Macro	20.8
Cash & Working Capital	8.1
TOTAL	100.0

## ARROW MULTI-STRATEGY FUND (CLASS A)<sup>2</sup>

Security Exposure (%) as at March 31, 2010			
	Long	Short	Net
Equities	50.5	-40.3	10.2
Corporate	39.6	-6.5	33.2
Warrants/Other	5.6	0.0	4.6
TOTAL	95.8	-46.8	49.0

Strategy Exposure (%) as at March 31, 2010	
Global Long / Short	27.2
Relative Value	24.2
Event Driven	24.5
Macro	13.9
Cash & Working Capital	10.2
TOTAL	100.0

## ARROW FOCUS FUND (CLASS A)<sup>2</sup>

Security Exposure (%) as at March 31, 2010			
	Long	Short	Net
Equities	67.6	-43.5	24.1
Corporate	23.9	-4.5	19.5
Warrants/Other	6.2	0.0	6.2
TOTAL	97.7	-47.9	49.8

Strategy Exposure (%) as at March 31, 2010	
Global Long / Short	33.8
Relative Value	13.8
Event Driven	27.1
Macro	23.2
Cash & Working Capital	2.0
TOTAL	100.0

## ARROW ENHANCED INCOME FUND (CLASS A)<sup>2</sup>

Security Exposure (%) as at March 31, 2010			
	Long	Short	Net
Equities	37.3	-31.3	6.0
Corporate	71.4	-9.8	61.8
Warrants/Other	5.0	0.0	5.0
TOTAL	113.6	-41.1	72.5

Strategy Exposure (%) as at March 31, 2010	
Global Long / Short	6.9
Relative Value	30.0
Event Driven	36.9
Macro	22.4
Cash & Working Capital	3.9
TOTAL	100.0

1 From February 2007, returns are for the Arrow Maple Leaf Fund (Class A), net of all fees in U.S. Dollars. The Fund has a 1.5% management fee and a 10% performance fee.

2 From January 1, 2010 the returns are for Arrow Maple Leaf Canadian Fund (Class A), from July 2001, returns are for Arrow Focus Fund (Class A), from January 2002, the returns are for Arrow Multi-Strategy Fund (Class A) and from January 2005, returns are for Arrow Enhanced Income Fund (Class A). All returns are net of all fees in Canadian dollars.

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