

Tera Balanced Small Cap Fund

Hedge Fund Research Summary

Morningstar Analysis | Josh Charlson 06-03-2008

Tera Balanced Small Cap Fund takes a slightly broader perspective on Tera Capital's expertise in small-cap technology.

Managers Lyle Stein and Howard Sutton both have extensive experience, as industry analysts and portfolio managers, investing with small companies. Tera Capital's flagship Global Innovation fund focuses narrowly on very small high-tech companies with cutting-edge scientific innovations. This fund also focuses on smaller companies (Canadian \$100 million and less), but positions itself as the more diversified offering from the firm. For example, whereas Global Innovation holds only about 20 positions in total, this fund holds around 30 long equity positions. Stein, the lead manager, also invests in a wider range of asset classes and sectors here: the fund has a decent chunk of fixed-income holdings on the long side, and about 25% of holdings are in natural resources and energy.

Still, the fund is diversified only in a very limited sense. With the ability to run winners up to 20% of assets, the potential for individual position risk is considerable. The fund's fixed-income holdings are primarily in corporate bonds and preferred stocks, and while these holdings do provide a reliable income stream and lessen the fund's volatility profile, they are certainly not without risk and overlap many of the same sectors covered in the fund's equity lineup. At year-end 2007 at least one significant holding, VIQ Solutions—a maker of digital audio recording systems with a \$32 million (CAD) market capitalization—was held as both straight equity and debentures. Stein can also invest in private placements, and recently about 10% of the portfolio was spread among four such holdings.

The fund has indeed shown a fair degree of volatility, which we'd expect given the micro-caps in which it frequently invests. Its two-year standard deviation of 17% annualized is less than the micro-cap-oriented S&P/TSX Venture Composite Index, but about twice that of its Morningstar category. At the same time, the fund's since-inception returns handily beat both benchmarks. With a generally long bias (as of April 2008 about 76% net long, which the managers consider cautious) and appreciable correlations to Canadian small-cap indexes, investors should expect not a true equity hedge but a long-oriented fund that hedges sporadically. Stein uses both broad market hedges like ETFs as well as specific short plays when he engages in shorting.

This fund requires a full market cycle to really prove itself. However, for investors who seek access to small Canadian companies but want a somewhat broader representation of the Canadian marketplace than Tera's Global Innovation Fund can offer, this fund has potential.