

Hedge funds profit in stormy markets

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In the second half of the roundtable on hedge funds, the portfolio managers tell Sonita Horvitch how they choose stocks in keeping with their specific strategies. There are as many investment styles as there are hedge fund managers -- and there are 5,000 to 6,000 managers around the world. While all sell stocks short, some use leverage (borrowing), some concentrate their portfolios or use derivatives such as put and call options, or mix and match an assortment of techniques. Our portfolio managers highlight the differences in approach across strategies -- and even within one strategy, the well-known long/short hedge fund.

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Peter Puccetti, chief investment officer of Goodwood Inc. which is a long/short manager with \$170-million in assets, holds 28 positions. At present, some 17 are long and 11 short positions.

"We have a net long bias." Some 70% of the fund is in long positions and about 9% is short. Over the six and a half year history of the fund, it has been less than 100% invested, says Puccetti.

"You take the market value of the longs and add the market value of the shorts together and if that adds up to 100%, it means you are fully invested."

Goodwood tends not to use leverage or derivatives. "We consider that our results will have plenty of zing, if we pick stocks well," says Puccetti.

Goodwood's portfolios are concentrated. Its top six or seven stocks, both long and short, would add up to 30% to 40% of the total fund's equity.

"What we are really trying to do in any 12-month period, is find three or four ideas that we know like the back of our hands that we think can double or more."

The other long/short manager in the panel is David Fawcett, founder and partner in Epic Capital Management Inc., which has roughly \$50-million under management. Although Epic has a larger number of positions in its portfolio than Goodwood, it generates performance off 20 to 25 core names, says Fawcett.

When it comes to leverage, this manager has the flexibility to go up to 150% of capital invested, but like Goodwood, it has had about 100% of capital invested since inception. Roughly 75% of the portfolio is in long positions and 25% is short. Epic does use "minimal" derivatives to mitigate risk.



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David Fawcett, partner at Epic Capital management, says Epic generates its performance off of about 20 to 25 core stocks, with about 75% in long positions and 25% sold short.



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Warren Irwin, Managing Partner at Rosseau Asset Management, is focused on just 15 core names.

"We find that in certain situations, where we are negative on a stock and cannot borrow it to short it, derivatives are useful," says Fawcett.

Perhaps the most concentrated portfolio is run by special situations manager Warren Irwin, president of Rosseau Asset Management Ltd. in Toronto.

Irwin, who has \$50-million under management, is focused on some 15 core names, be that long or short. The ratio of long to short? "We have a high degree of flexibility in this regard."

Sometimes, Rosseau does match its longs and its shorts. Right now, given the paucity of bankruptcies, Irwin says he is having a tough time finding short sale candidates. This manager does not use a lot of leverage.

"Our positions often have sufficient inherent risk, without cranking up that risk with leverage." Irwin's mandate does allow him use derivatives.

At the other end of the spectrum in terms of number of positions in a portfolio is John Schmitz, president of SciVest Capital Management Inc. in Toronto, which has \$150-million under management.

The firm's core fund, the SciVest Market Neutral Equity Fund, typically holds 360 to 380 positions, with no position being more than 2% of capital or equity. Half the positions are long and half are short. SciVest do use leverage. But, says Schmitz, "If you can remove market risk and diversify the portfolio widely, leverage is not nearly as dangerous as some think."

In a market neutral setting, leverage is a more efficient means of getting risk adjusted returns than say taking bigger stock bets, he says. The portfolio has exposure to almost every U.S. industry. Of the 55 industries in the United States, SciVest typically has positions in 45. The bulk of its positions are in U.S. equities, but it does have some exposure to Canadian equities. Schmitz does not use derivatives.

Q: Starting with long/short managers, it is time to discuss the positions in your portfolios.

Puccetti: We are value driven in selecting our positions. We have a list of short ideas, where the individual weightings are modest. Our biggest short position is a 2% weighting in (XIU/TSX), a basket that represents the S&P/TSX index. If we are good at purchasing long ideas, then this helps in taking out some of the overall index risk, by shorting the index. I am waiting for this index to go a little higher and we take that position a lot larger than it is today. We are also short International Business Machines Corp. (IBM/NYSE) and, by the looks of things, we will be short this for a number of years to come. This company perennially overstates its earnings and the stock is overvalued. Again, it is a small short at 1%, if the timing is right it could be a 5% short. But, I do not think that the timing is right today. We are also short, with very small weightings, a basket of Internet stocks, like Yahoo! Inc. (YHOO/NASDAQ) and Amazon.com Inc. (AMZN/NASDAQ) that we made a lot of money shorting two years ago. These stocks have had tremendous runs, they have either doubled or tripled in the last six months.



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**HEDGE FUND
PANELISTS: Jim
McGovern, CEO of Arrow
Hedge Partners;**



CREDIT: Photo: Yvonne Berg, National Post

**...Peter Puccetti,
chairman and chief
investment officer of
Goodwood; ...**

Perhaps, we are getting a second chance to build short positions in these stocks. Their weightings are very small, 0.5% to 0.7%, depending on the names.

Turning to the long positions, we have a substantial holding in CanWest Global Communications Corp. (CGSa/TSX) and our average cost is \$5.40. The stock closed recently at \$9.34. The company [which owns the National Post] is 45% owned by the Asper family. These guys have a tremendous record of capital deployment and that is something that most companies that are large and publicly traded do not. Nine times out of ten, the CEO is someone who came up through the ranks, perhaps from marketing, and does not know how to allocate capital. In 1992, the Aspers bought Network Ten in bankruptcy in Australia for \$45-million. Since then, they have received \$549-million in interest and dividends and this property is now worth \$1-billion. They have done this in other situations, not quite with the same size of the return. They know this field very well. I suspect there is a possibility that they will sell off non-core assets which include New Zealand, Australia, Ireland and a few other properties. If so, you will see the company significantly reduce debt from roughly \$3.4-billion today to probably in the low twos in terms of billions of dollars. As that happens, the Canadian institutional investor, that is today under-represented in this stock, will come back. The market is not fully valuing CanWest's non-core assets. As they get sold off, the stock goes higher. We think that the stock is worth \$12 to \$15 .

We also have a position, that is only now starting to be profitable for us, but where we think that there is very substantial upside and that is Great Atlantic & Pacific Tea Co. Inc. (GAP/NYSE), which has a network of supermarket chains in the United States and Canada. This stock recently closed at US\$9.54. Our cost was around US\$6.50. About a year ago, this stock was US\$28 to US\$29. A wealthy German family, Haub, which owns 55% of GAP, bought into the company in 1979 for US\$5 a share. There have been no stock splits. For most of the last two decades, the stock has traded between US\$30 and US\$60 a share. More recently, as grocery stocks in the United States have come under a lot of pressure, this stock sold off to US\$4, about two or three months ago. The company is close to selling off its targeted US\$300-million in non-core assets. What got us interested is the value of the company's Ontario business, which represents some 23% of its total US\$11-billion business. The Ontario business is doing well. It is not understood by the U.S. analysts, those that follow it at all, because this is now a small cap stock. We think the Canadian business is worth, at least, US\$21 a share ...

Another stock I will talk about is Extencicare Inc. (EXE/TSX), a Canadian company that runs long-term care centres and retirement homes in North America. This stock is for the longer-term. The company has debt. We have been in it before in a big position. We have had another opportunity to get bigger in the name. Nursing homes in the United States and Canada are vastly different. In the United States, nursing homes are subject to lot of litigation in certain states and Extencicare has been proactive in getting out of those states. In Canada, it is much more of a utility-like rate of return. We do not have the litigation risk.

What is interesting about Extencicare, the first time we bought the stock starting at \$1.60 a share and it owned \$2.10 per share worth of a redundant



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...Robert Parnell, president of Tremont Investment Management; and ...



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...John Schmitz, managing director of SciVest Capital Management.

asset, Crown Life, which was being wound up and being turned into cash. We got the substantial nursing home operations for a negative value, which did not make any sense. The U.S. business, when you ex out the money being spent on settling patient care liabilities, is substantially free cash flow positive. We have been told, and we tend to agree with this guidance, that two years out from now, all those liability claims in the United States will have been dealt with. If so, you will be left with a company generating substantial amounts of free cash flow and the stock can trade for a lot higher than it does today. Four years ago, this was a \$24 stock, trading at 10 times [earnings before interest, taxes, depreciation and amortization]. Today, it is trading at five and a bit times EBITDA. The demographics favour this business. We think that there is substantial long-term upside in the stock.

Fawcett: The two shorts I have are more pair trades [where the portfolio manager matches a long position with a short position in the same industry or sector]. We like, on the long side, Bonavista Petroleum Ltd. (BNP/TSX) which was recently announced it was converting into an income trust, which will own 90% of the company's existing producing assets. In addition, shareholders receive shares in a separate publicly listed company, NuVista Energy Inc., which contains the remaining exploration properties. Typically, when you see a conversion to a trust, there is a lot of selling as U.S. holders will not hold trusts. So the current stock price has been kept down. But if you do a sum of the part analysis, the stock recently traded at around \$36, the assets in the trust are worth \$40 to \$45 per share. Also, this is one of the top management groups in the oilpatch. CEO Keith MacPhail has a large stake in BonaVista and a great incentive to make it all work. Coupled with the trust unit, you will get an exploration company stock, NuVista Energy, which could be worth \$5. If you add the two entities together, we get a \$45 to \$50 price target.

Because you are taking on a commodity risk in an oil and gas trust/stock, we hedge that. We have two short positions. One is in Enerplus Resources Fund (ERFun/TSX), which has just had a huge move up and trades at an all time high valuation and the other short is the Canadian Energy Index Fund (XEG/TSX), the oil and gas index.

A similar type of pairs is in the telecom services sector. We are long Manitoba Telecom Services Inc. (MBT/TSX). It is a stock we have been in for a while. It is a good valuation. A big driver for the stock is the company's stake in Bell West Inc. in partnership with Bell Canada. Manitoba Tel can put back its stake to BCE for \$650-million. This is a little more than \$10 per Manitoba Tel share. The stock recently closed at \$38.93. We think that BCE will take out Manitoba Tel to avoid paying this put. BCE already owns 20% of Manitoba Tel. If BCE acquired Manitoba Tel, it would reduce the leverage on BCE's balance sheet. It fits well with BCE's strategic view to return to its core. It is a great fit; Manitoba Tel has a lower valuation than BCE. If we are wrong on this, ManitobaTel has other options, like turning itself into a trust to recognize value. You are taking very little business risk and little financial risk when you buy Manitoba Tel.

Against this long, as we think that it will be BCE that buys Manitoba Tel, we have shorted about one quarter of our position in Manitoba Tel against BCE Inc. (BCE/TSX). This is not saying we do not like BCE. If the acquisition did occur, BCE's stock could come under a little bit of selling pressure.

Similar to what Peter [Puccetti] was saying, we are not seeing a lot of great investment shorts [rather than hedge shorts undertaken to mitigate risk] right now. But a stock that we have not been too keen on is Intrawest Corp. (ITW/TSX) which builds and operates ski and other resorts. It has a philosophy of spend and build and the customers will come. We have seen a lot of negative free cash flow, we have seen a good amount of debt. This is a company that continues to miss targets and to revise its EBITDA down.

Schmitz: Market neutral is a different mentality to long/short. We looking for spreads between our longs and shorts. We can be long positions that we actually expect to lose money on, because we expect to make more off the short side, so that the net spread or differential between the two will be positive. We hold 370 positions in the portfolio and tend to hold stocks on average for two to four months. We pick stocks based on the characteristics of the stock and of the company. I will give you some examples from some of the more exciting U.S. sectors.

We are bullish on the U.S. software industry and are marginally net long this industry. We have a number of stocks both on the long and the short side. One long in our portfolio is Titan Corp. (TTN/NYSE) which provides a broad range of information technology services and one short is Manhattan Associates Inc. (MANH/NASDAQ).

We are bearish on the electronic equipment sector and to the extent we can be net short, we are net short this sector. Our biggest long is Inter-Tel Inc. (INTL/NASDAQ) a provider of business communications and voice-mail systems. A significant short is Photon Dynamics Inc. (PHTN/NASDAQ) which produces systems for the flat panel display manufacturing industry. In the U.S. consumer services-media industry, one of our biggest long positions is Fox Entertainment Group (FOX/NYSE) a giant media-entertainment company. One of the shorts in this industry is Cablevision Systems Corp. (CVC/NYSE) an entertainment and telecommunications company. We are slightly net long the media sector.

We have also been slightly net long the wireless area for the last three months, for the first time since the inception of this fund. On the long side, we like Nextel Communications Inc. (NXTL/NASDAQ) on the long side which has the right to provide digital wireless communications services in 31 states, and Telephone & Data Systems Inc. (TDS/AMEX) on the short side, a diversified telecommunications services company which includes cellular services.

All four of these pairs I have cited, have similar characteristics. Our long positions tend to have insiders of the companies buying the stocks and our shorts tend to have heavy insider selling. In addition, we look for positive earnings revisions for the long, versus negative earnings revisions for the hedge shorts. For our longs, we tend to be forecasting that they will beat next quarter's earnings estimates versus the converse for our shorts. We try to get at what managements are thinking by looking at what they are doing, rather than talking to them. Over the last years, it has become evident that what they say and what they do can be different. We look at earnings quality. We look at valuation and stock momentum type characteristics. Right now we are looking for growth as well.

Q: Warren, over to you to discuss your war stories in playing special situations.

Irwin: An example of a turnaround candidate, where we made some money a while ago is Moore Corp. Ltd. (MCL/TSX) which provides business communications products and services. We got wind that there was a new management team in place led by Bob Burton, who was highly experienced. Also, when we looked at Moore's financials, we thought they were in better shape than what was being portrayed in the media. We bought common shares and these rebounded.

An example of a capital structure arbitrage is the case of 360 Networks. We noted at the time, that their bonds were trading at 40¢ on the dollar, yet the company still had a multi-billion-dollar equity market capitalization. There was clearly a gap between how bond investors and stock investors viewed the company. We bought the bonds and shorted the stock; we felt the company was going to hit the wall. As our conviction strengthened, we increased our equity short position to the point where we could not borrow any more stocks. We were more heavily short the stock than we were long the bonds. This worked, as the company went bankrupt and we covered the stock at zero.

An example of a corporate reorganization is Bombardier Inc. (BBDb/TSX). We do not have a position in this company right now. But we did short the stock. We have always found that financial reporting in the aerospace industry is highly subjective given the latitude the companies have in the way expenses are capitalized and how they are run through the income statements. In addition, we were concerned about the general downturn in the industry. When we combined Bombardier's level of disclosure and Bombardier Capital's accounting complexity, along with the downturn in the aerospace business, we established a short position in the low teens. From time to time, until we recently covered our short position in the low single digits, we also had offsetting trades in the company's fixed interest securities, specifically the

preferred shares. This was to partially hedge our short position...

Finally, Nortel Networks Corp. (NT/TSX). When the stock slipped in the low single digits, we thought that there would be a turnaround. We did an extensive financial review of the company and it was our view was that it was not going bankrupt, but it was difficult to pick a bottom in the stock. Its 2006 bonds were yielding around 40%, we bought some of those. We also bought their 2003 paper and it had a 50% yield. These bonds went back to par, so we did well. We moved out of the high yield paper as it approached par. We believed this whole market for high yield debt market was getting overheated. We then moved into the preferred shares around the \$9 level, as we felt that this was the cheapest part of the capital structure. Right now they are trading in the mid-teen area and have a good yield. Throughout this process, we did not make as much money as we may have if we had picked the bottom in the common, but it was a much lower risk approach to playing the turnaround in Nortel. Our view on Nortel is that it is going to be a survivor, but the common stock remains highly volatile.

Q: Time to sum up this discussion on hedge funds.

Jim McGovern (managing director and CEO of Arrow Hedge Partners in Toronto):

We think the fund of funds is a nice entry point for individuals and institutions. It is a nice way to get your feet wet. Your fund of funds manager should be able to tie in an expected return, the expected volatility and the expected correlation to other asset classes. So you can judge how this fits into your portfolio.

Rob Parnell (president of Tremont Investment Management Inc. in Toronto, who chooses strategies and managers for its funds of funds approach):

Some of the tools and discretion that hedge fund managers have over and above active managers, like the ability to short, the ability to think in return of caps and absolute returns are value added. It speaks to this whole issue that sound active management is best domiciled within the hedge fund industry because it is conducive to good active management. The other big theme from this roundtable is that a lot of discussion was about risk management. It is a common misconception that hedge funds are more risky. There should be more democratic access to the hedge fund business.

Puccetti: It is important for the investor to understand the style of an individual hedge fund manager, if they are not going the fund of funds approach. Investors have to do their homework thoroughly, if they are going to be comfortable with a manager.

Fawcett: We do make an effort to mitigate risk. Hedge funds do have a place in a portfolio and this is not yet the case in Canada.

Schmitz: Risk adjusted returns show that the average hedge fund does better than most asset classes, even through the great bull run of the '80s and the '90s. This is important in the low return environment we are entering. There are not a lot of places to get 7% to 9% returns and hedge funds are one of the few that is offering this. It also offers diversification as an asset class. There should also be a diversification within this hedge asset class across a number of managers. Investors should have allocations to hedge funds over the next decade, anywhere from 5% to 35% of their total portfolio.

Irwin: All portfolio managers here, and most hedge fund managers I know, own a large percentage of their funds. This ensures that our interests are fully aligned with investors. We also, as hedge fund managers, have the flexibility to make a lot of money in a variety of different markets.

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