

FUND LIBRARY ANALYSIS: FRONT STREET CANADIAN HEDGE FUND

Front Street follows capital investment



LEVI FOLK

Wherever the greatest amount of capital spending occurs, is where you want to position a good chunk of your portfolio." This has always been the core thesis of Frank Mersch, manager of the Front Street Canadian Hedge Fund, the larger of their long/short funds. Once it was tech; in this cycle, it just happens to be energy and materials. "That's the cycle we're in. That doesn't mean that we'll be there forever. You play what works."

What "works" has been "evolving" over the years, Mersch explains. Initially what worked handsomely was merger arbitrage (with a pending merger, buying the target while shorting the acquirer). Beginning in 2000, there was a first wave of consolidation in the energy sector that offered 20+ percent returns for such arbitrage. When market efficiency eliminated this play, they moved more into pairs trading (long one company, short another in the same sector), with some interest in pre-IPO and mezzanine financing.

Currently, the focus has clearly shifted to commodity-driven net-long strategies. But throughout this "evolution," insists Mersch, they have remained essentially "an

alpha-generating firm" with the goal of a 12 percent annualized return.

Mersch points to the announcement by Phelps Dodge Corp. (July 10) that metal prices are strong enough to pay for its \$39-billion takeover of both Inco Ltd. and Falconbridge Ltd. within two years—and that's assuming prices discounted 30-40 percent from where they are today. "That's astounding," repeats Mersch in awed tones.

To back up: historically, he says, companies have not been able to sell production forward at a premium. About two years ago, however, the gap between spot and futures prices began narrowing along the futures curve. Where a company can now sell 75 percent of its production forward for a premium, banks are happy to finance 60-70 percent of the project. The result, predicts Mersch, will be that "quality" companies are "going to make a ton of money on a cash flow basis."

The difficulty in Canada, continues Mersch, is the list of M&A targets is too small: there are too few "quality" names in actual production. Accordingly, he's moving out along the risk curve, or as he puts it, "you layer it all the way down." His focus is on companies with production coming online in about six months or so. The key is that a given company must be able to participate in production at today's prices.

Decades of underinvestment combined with the greatest global expansion since WWII is driving the infrastructure build. "It's an evolution of economies that we haven't seen before." China has adopted Japan's basic blueprint, except they're growing bigger and faster than the Japan of the 60s. As

long as China's growing 10-11 percent per year, nickel (the key input of steel production) will be hard to come by.

It's easy to get distracted by copper and nickel, though; and forget gold. Uranium, claims Mersch, is where the real action will be. Why? As we already see in Ontario, governments around the world are attempting to expand nuclear-power generation in the face of chronic power shortages.

Uranium's at 45 dollars, he notes, but the demand cycle hasn't even started yet; rather, he says, speculation is simply anticipating the coming "mad scramble." About three years ago, Front Street started getting into uranium in a big way. They began with Cameco Corp. converts and bought into uranium-related stocks; depending on which fund, they'll have between 4 and 14 percent exposure to uranium.

Natural gas is presenting a buying opportunity too. "There's a real serious disconnect going on between oil and natural gas in North America." Historically, he points out, the oil-to-gas range has been from 6:1 to 11:1, and we're approaching the latter extreme now. We cannot stay at the extreme of the range forever: something has to give.

Mersch readily admits, however, that it might be the oil price that gives. Not surprisingly, this is where he's doing most of his pairs trading, going long Imperial Oil, for example, while shorting Petro-Canada. In terms of valuation and future opportunity, he especially likes Husky on the long side.

Mersch's long strategies include experimenting with "special situations," playing to Front Street's core competency in security selection. "Some of the technology stocks in

Canada are so overlooked—and nobody cares!" He sees a five-year cycle under way in HDTV, for example, and likes Everett in this space. But above all he's looking for companies that are becoming the standard in their industry. Certicom in the burgeoning field of encryption is accordingly a key holding.

Like so many other hedge-fund managers, he says "It hasn't paid to be extraordinarily short." On the assumption that we're experiencing a "mid-cycle correction" in commodities rather than a turnover, he's been building a huge cash position instead, with a little "tactical" trading at the margins. He won't put on full positions while the spectre of rising interest rates is making him nervous. "I don't think it's time to be a big hero these days."

"There will be a time to short this market. I think it's coming." It's unreasonable, he warns, to suppose that China can continue to grow at 11-12 percent a year without a financial crisis. "We still focus our attention to 2008, with a potential top in 2008." Nevertheless, he sees no need to short proactively: he can afford to miss the first 10 percent down of a 20-30 percent bear.

Financial Post
librarian@fundlibrary.com

This is a summary of a Fund Library OnTheSpot™ Advisor Report, which can be downloaded at www.fundlibrary.com.

All data provided by Funddata. Levi Folk is the President and Managing Editor of The Fund Library. Fund Library occasionally licenses these reports to certain fund companies.

FUND LIBRARY ONTHESPOT™ ANALYSIS: FRONT STREET CANADIAN HEDGE FUND



Frank Mersch
Vice President &
Co-Chief Investment Officer

Loads:
No Load

Inception date:
July 31, 1999

Total assets (\$mil.):
\$197.11

MER (includes GST):
2.00 %
20% performance fee on net profits if annual ROR is 6% +

ALL DATA SUPPLIED BY FUNDATA

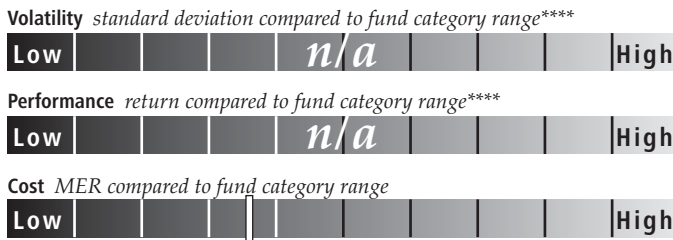
FUND LIBRARY VALUE RATING*: —
PERFORMANCE RATING:** —
INCOME STABILITY RATING*:** —

PORTFOLIO COMPOSITION — TOP HOLDINGS
Data as of Q2, 2006

| Exchange | Sector | Industry | Market Cap. | % of portfolio |
|---|------------|--------------------|-------------|----------------|
| Major Drilling Group International | | | | |
| TSX | Materials | Drilling | \$478 M | 1.8 |
| Shawcor Ltd. | | | | |
| TSX | Energy | Oil and Gas | \$1,099 M | 1.5 |
| Sun Life Financial Inc. | | | | |
| TSX | Financials | Financial Services | \$25.5 B | 1.4 |
| Cameco Corp. | | | | |
| TSX | Materials | Mining | \$15.9 B | 1.2 |
| Storm Exploration Inc. | | | | |
| TSX | Energy | Oil and Gas | \$223 M | 1.1 |

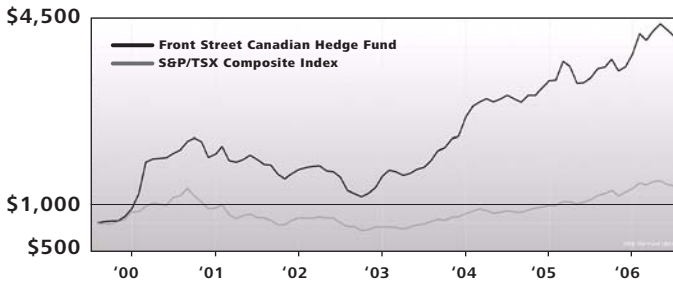
Note: Long positions only, short positions are not disclosed.

ONTHESPOT™ QUICK VIEW



HISTORICAL COMPOUND PERFORMANCE

Data as of June 30, 2006



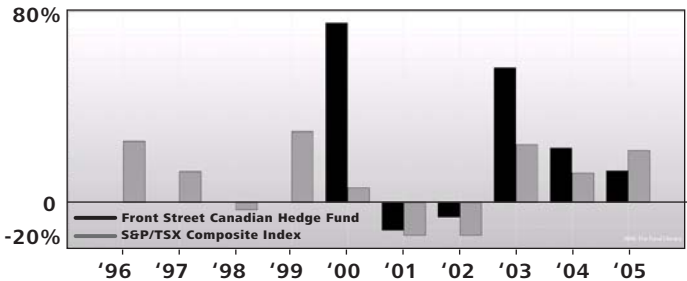
COMPOUND PERFORMANCE****

| | 1mo | 3mo | 6mo | 1yr | 2yr | 3yr | 4yr | 5yr | 10yr | Incep |
|---|--------|-------|------|-------|-------|-------|-------|-------|------|-------|
| Front Street Canadian Hedge Fund | -11.33 | -5.20 | 9.09 | 24.53 | 21.13 | 26.41 | 12.28 | 10.69 | -- | 9.19 |
| S&P/TSX Composite Index | -12.21 | -6.77 | 6.09 | 20.47 | 19.36 | 24.22 | 12.13 | 9.95 | 4.18 | 4.94 |

* Measure of cost and portfolio turnover relative to the category ** Measure of risk-adjusted returns relative to the category
*** The risk of distributions being cut

YEAR-BY-YEAR PERFORMANCE (PAST 10 YEARS)

Data as of June 30, 2006



CALENDAR YEAR PERFORMANCE****

| | '05 | '04 | '03 | '02 | '01 | '00 | '99 | '98 | '97 | '96 |
|---|-------|-------|-------|--------|-------|--------|-------|--------|-------|-------|
| Front Street Canadian Hedge Fund | 29.65 | 14.34 | 25.06 | -12.05 | 1.27 | -20.91 | 48.27 | -12.28 | 16.37 | -- |
| S&P/TSX Composite Index | 26.66 | 13.22 | 25.65 | -8.91 | -2.70 | -29.19 | 55.15 | -16.93 | 0.25 | 15.56 |