

# FP INVESTING

## LEVI FOLK'S FUND WATCH

### FRONT STREET CANADIAN HEDGE FUND

If inflation takes hold in North America, investors in Front Street Canadian Hedge Fund are well insulated from its effects. In fact they will continue benefit from a secular rise in food and energy prices feeding through to the general economy. Fund manager Frank Mersch is currently focusing on these "macro themes" in the portfolio. It's not a foregone conclusion but it's a distinct risk that Mersch is positioned for.

The fund is best classified as a long/short Canadian equity fund managed with a macro investment style. Mersch identifies sector themes that he pursues and manages risk by shorting stock (profiting when it falls). He is always looking for that "key driver where demand goes through that pinch point [of supply]." His track record suggests that he has found that point on more than one occasion.

The manager will also take short positions on a short-term basis to reduce portfolio volatility. After a "substantive move in a sector", in oil for example, Mersch will "layer in shorts to reduce the volatility, tactically." This amounts to hedging some of the long positions in the portfolio by shorting the weakest names in the group rather than taking profits outright.

Mersch is currently on inflation watch especially in the context of weak economic growth and a repeat of 70s style stagflation. He points to leadership in hard assets in this type of economic environment and the fact that the Canadian market outperformed over that period. Any possible rebound in the U.S. economy will exacerbate the current food price inflation and Mersch expects hog prices to rise strongly later this year.

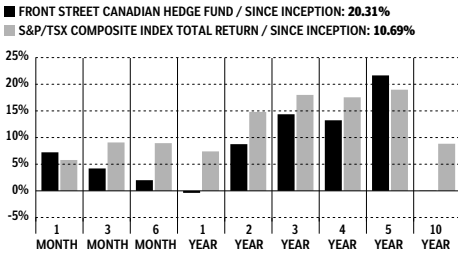
Front Street capital has beefed up (pun intended) its expertise in the agricultural space over the last year to augment its expertise in commodities. Mersch points to high grain prices as being uneconomic to "mature your hog."

The temporary inventory build will give way to a shortage and higher pork prices later this year. Here Mersch drills down from the macro risk in inflation to the micro opportunity in pork prices.

Mersch also looks for technology that can be applied to any business that can enhance returns. He points to the natural gas market in Canada, for example, where the gas is "unconventional, and locked in rock that needs to be fractured." Recent technologies and high gas prices are making this market attractive.

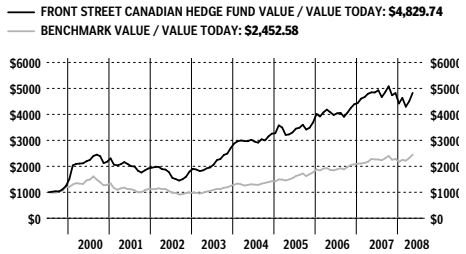
### FUND PERFORMANCE

PERFORMANCE AS A PERCENTAGE



DATA SOURCE: FUNDATA CANADA INC./THE FUND LIBRARY

PERFORMANCE IN DOLLARS



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"If inflation turns secular, the quality of earnings will decline and you don't want to pay for inflationary earnings. I came into business in the late 70s and I saw what inflation did... in 1969 the S&P 500 traded at a 25 to 30 P/E multiple and went to a multiple of 8 times by the 1981 recession."

Frank Mersch, senior portfolio manager, Front Street Capital.

### FUND HOLDINGS

The portfolio is heavily invested in three distinct sectors that Mersch believes will drive returns. The agricultural sector (25% of assets), much like the mining and energy sectors (45% of assets) in the 1980s and 1990s, was in a bear market for the last decade.

It will take years before spending enhances productivity in the agricultural sector to meet rising demand from emerging markets. Companies like Agrium Inc. and Potash Corp. in Canada are in the portfolio because fertilizers are needed to "enhance yield," and prices have been in a bull market as a result.

TOP TEN INVESTMENT HOLDINGS

	Ticker	Sector	Market Cap	%
AG GROWTH INCOME FUND	AFN.UN/TSX	Industrials	\$373 M	N/A
BORALEX INC	BLX/TSX	Energy	\$597 M	N/A
DESCARTES SYSTEMS GROUP	DSG/TSX	Info. Tech.	US \$190 M	N/A
DRAGONWAVE INC	DWI/TSX	Info. Tech.	\$150 M	N/A
FRONTEER DEV. GROUP INC	FRG/TSX	Materials	\$413 M	N/A
HANFENG EVERGREEN	HF/TSX	Consumer Disc.	\$693 M	N/A
HEMISPHERE GPS	HEM/TSX	Info. Tech.	\$253 M	N/A
INTERMAP TECHNOLOGIES	IMP/TSX	Info. Tech.	\$282 M	N/A
POTASH CORP. OF SASK.	POT/TSX	Industrials	\$70.2 B	N/A
VITERRA INC.	VT/TSX	Industrials	\$3.3 B	N/A

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Mersch tackles the sector across the board looking to own small to large capitalization names opting for sector risk vis-à-vis individual security risk. He is also a great believer in technology (15% of the portfolio). It's a driver even in the oil sands and the agricultural business.

He also focuses on wireless technology pointing to the "phenomenal" growth potential in the emerging markets. Moreover, "when this whole commodity cycle ends," says Mersch "you will really have to go aggressively global, and I had better know the other areas of the market."

SECTORS OF INVESTMENT

	Fund	Index
Agriculture	27.0	--
Energy	23.0	31.57
Materials	23.0	18.16
Information Technology	15.0	5.08
Other	12.0	--

FOREIGN ASSETS:	0%	MER:	2.00% +20% performance fee
NUMBER OF HOLDINGS:	Varies		on net profits if annual ROR is 6%+
TOTAL ASSETS:	\$234.9 Million	CURRENCY HEDGE:	None

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