

HEDGE FUNDS

COMMENT

Shorting strategies cut risk in income products

Everyone seems to want income these days, with no risk of course.

Well, we can't always have what we want, but we can try, right?

Let's take a look at how two hedge fund managers aim to achieve the income that investors want, but also reduce the risk of investing in overheated and pumped up prices.

Enter Marret Asset Management and Front Street Capital. Last week I sat down with Barry Allan, founder, president and chief investment officer of Marret. It runs several mandates for various institutions, but we specifically discussed the High Yield Hedge Product distributed by Arrow Hedge Partners of Toronto. The fund can go long or short any part of the capital structure, and a favourite trade is to go long the bond of a company and short the common stock.

High-yield bonds are cyclical. This can create some short-term headaches if you happen to invest in high-yield bonds at the wrong time. However, the idea of being able to long or short the high-yield bond sector means that with some astute foresight, the otherwise poor times for high-yield investing can be moderated or even become profitable.

The Arrow High Yield Hedge Fund pays out a set 6 cents per share, monthly, on a unit value of about \$8.90, resulting in an 8.1% yield to the investor -- not too shabby for today's rate environment.

Allan says the high-yield hedge portfolio should be able to achieve about 30% better return than a long-only high-yield strategy, with about 30% less volatility. Having said this, even a long-only high-yield fund has shown equity-like returns over long periods, with much lower risk than a strict equity portfolio. In the case of the Arrow product, it closes to new investors in a couple of weeks, as the idea is to keep the fund small and nimble.

Front Street has taken a different tact when it comes to hedging income portfolios, but it is equally opportunistic. Enter the Front Street Long/Short Income Fund, a new issue being marketed at this time, and closing in mid-May. (Refer to the preliminary prospectus for more information.) Front Street is home to two of the best and most

opportunistic money managers in Canada, Frank Mersch and Normand Lamarche. According to Front Street, there are many overvalued trusts in the income trust area. They are generally all about risk controls. Why? The purpose of having more flexibility with an investment portfolio is to develop a strategy that produces a more efficient portfolio. In Front Street's case, shorting income trusts that they find less desirable than their picks on the long side can give them the ability to reduce risk in the portfolio. You see, shorting can be used exclusively for profit generation, or for risk reduction of the underlying portfolio.

In Front Street's case, risk reduction is the key, and this translates into a target beta of 0.5 to the income trust sector. (Beta is a measure of the volatility of a portfolio in relation to the market, in this case the income trust market. A beta of 0.5 means the target volatility of the long/short trust portfolio is half that of the income trust market in general.)

If you are concerned about the managers putting their money where their mouth is, the partners will be putting in \$5-million to \$10-million of their own money, of the total \$100-million issue. The Front Street team, including lead managers Eric Dzuba and Prakash Hariharan, is bullish on the future for hedging the income trust sector and is definitely turning heads with their novel approach to managing risk in the trust sector.

Simply put, investors want income these days. The Front Street product will target a 6% annual income, paid monthly and will have an initial target of 85% long and 15% short the income trust sector. Of course, this can change over time, but should never be net short on the trust market.

Traditional high-yield options like income trusts and high-yield bonds can be managed by alternative methods that aim to control the cyclical risks normally associated with these income alternatives. Hedge fund investing is not necessarily all that different from traditional investing, it is just that managers have more tools available to achieve their goals.