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Frank Mersch 'weeks away' from calling market bottom

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TORONTO — Hedge fund manager Frank Mersch believes the decimated North American stock markets are getting close to a bottom although the waters are murky. "It's very scary times," said the veteran manager at Toronto-based Front Street Capital.

"But if you believe that the world will function and go ahead, we are approaching something toward a bottom," the manager of his firm's flagship Front Street Canadian Hedge Fund said yesterday before his speech in Toronto to a hedge fund forum for investors.

"I am probably weeks away from saying it's time to buy," but there are some things that have to happen first, said Mr. Mersch, who has had 25 to 40 per cent of his portfolios in cash for two months. "I have a lot of money in my own funds, and I don't like losing money."

U.S. Congress needs to give its blessing to a $700-billion (U.S.) bailout package to buy the toxic mortgage-related assets and rescue the financial sector, but that alone is not sufficient to revive the ailing markets, he said.

With countries such as Spain and Italy slumping, governments there have to step in to do their share, added Mr. Mersch, who is chairman and co-chief investment officer of Front Street Capital. "I do believe Europe will backstop their banks, as well as start to lower interest rates."

The problem facing the markets is that there are numerous events conspiring at the same time "which is typical of a market bottom," he said.

"You have a credit crisis. You have de-leveraging. You have bank failures that cause liquidation, and you have tax-loss selling especially in the September-October period for U.S. mutual funds."

If you look at the major crashes or declines, they are often in September and October, he said, in reference to the big stock market crash in October, 1987.

"Here we are go again," quipped Mr. Mersch, a former high-profile mutual fund manager in the 1990s with Altamira Investment Services Inc. "Obviously, out of all of this, there will be new market leadership."

That leadership could come in "certain commodities," and natural gas may be interesting as big producers have cut down on production and the recent hurricane has had an impact on supply, he suggested.

On Monday, Chesapeake Energy Corp. said it would slash its capital budget by $3.2-billion or 17 per cent through to 2010, mostly by drilling fewer wells. Canadian firms like EnCana Corp. and Canadian Natural Resources Ltd. (CNQ) did that a couple of years ago, he noted.

Mr. Mersch said he likes EnCana, which will be splitting its refining and oil sands assets from its natural gas assets. "If you look three or four years out, they have such a huge inventory of drilling opportunities so growth should be there," he said.

"CNQ is another wonderful company in the sense that Horizon - its oil sands project that they have been building - is coming into production so it is now going to flow pretty good cash flow," he said.

"In this environment, if you can get a company that can grow despite weaker commodity prices, it will hold you in better stead."

In Canada, there are good resource plays, such as Horn River-Montney in British Columbia, he said.

Storm Exploration Inc., which is in that play, is "forecasting 25- to 30-per-cent production growth so that's pretty good," he added.

"Even if there is further weakness in natural gas prices, a company that can grow through that ... is something you want to own in your portfolio."

There are lot of Canadian mining companies that have a lot of cash, but the question is how they are going to deploy it, he said.

"Considering where stock prices are now compared to where they were a year or two ago, assets are a lot cheaper now."

This is a "very, very serious financial crisis, but hopefully coming out of this there is some of the best opportunities we have seen," he said.

The fact that the troubles in the financial sector have been serious enough for both the Democrats and the Republicans to co-operate to draft a final bailout plan is "unprecedented," he said.

"They are doing that, and I think somewhere Europe will do the same thing," he reiterated. "That will set the stage for the next cycle."

While investors have been taught to buy stocks in really bad times, "our emotions override that," Mr. Mersch said.

"We have to fight back those emotions of fear, and deal with simple principles - good companies, good balance sheets and an environment that may not be good today, but in a year, two or three years, will be better than what it is today."