

# Noncorrelated Canadians

*Front Street Capital sells itself as the way to play northern resources boom*

By M. Corey Goldman



GARY SELKE

Lots of hedge fund shops go to great pains to explain what they are—what their strategy and style is, how it works, why it works and what their expertise in it is.

Not so for Front Street Capital. The Toronto-based firm takes the exact opposite tack, telling existing and potential investors what exactly its strategy and style isn't.

What it's not is an arbitrage shop, a global macro concern, a distressed or event-driven player or a special situations firm. Rather, Front Street is a 100% Canada-focused long/short fund that makes no bones about focusing on energy, commodities and other natural resources that account for the vast majority of the country's financial markets.

Indeed, Front Street's self-professed niche is its experience and focus on global macroeconomic cycles in energy and resources as well as the Canadian energy and resources landscape, which has been on a tear over the past 18 months as prices for oil, natural gas, precious metals and even lumber have surged, boosting the S&P/TSX Composite Index to record highs and fueling Canada's economy and dollar in the

process.

"Canada is a happening place that is clearly benefiting from the resource boom around the world, and groups like us are positioned to take advantage of it," Gary Selke, Front Street's president and chief executive, explained in a recent interview at the firm's downtown Toronto offices.

"We possess local knowledge. We drink the local water. We know what's happening on the ground, and we are here to make money off of it."

### Merged firms

Front Street was founded in October 2001 from the combination of two Toronto-based investment management firms: Casurina LP, founded by Frank Mersch in 1998, and Tuscarora Capital Inc, founded in 1996 by Selke and Normand Lamarche. The firm's initial assets were approximately C\$400 million (US\$300 million).

Mersch is currently lead portfolio manager for Front Street's diversified and long/short opportunistic Canadian equity hedge funds; Lamarche, along with Craig Porter, manages the firm's various energy and resource-focused

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### Vital Statistics

|  |                          |
|--|--------------------------|
| <b>Assets under mgt</b>                              | US\$2.3 billion          |
| Front Street Canadian Opportunities Fund             | US\$49 million           |
| Front Street Energy & Power Performance Offshore Ltd | US\$333 million          |
| Other funds, managed accounts                        | US\$2 billion            |
| <b>Minimum investment</b>                            | C\$100,000               |
| <b>Registration</b>                                  | OSC; BCSC; SEC           |
| <b>Domicile</b>                                      | Cayman Islands           |
| <b>Redemptions</b>                                   | Monthly, 30 days' notice |
| <b>Fee structure</b>                                 |                          |
| Management fee                                       | 2%                       |
| Incentive fee  | 20%                      |
| <b>Auditor</b>                                       | Ernst & Young            |

long/short funds, including the Front Street Energy & Power Performance Fund. And Eric Dzuba and Prakash Hariharan oversee Front Street's income trust portfolio.

Front Street initially managed investment products for Canadian retail investors and a few select Canadian institutions. However, in September 2003, the firm began marketing to non-Canadian institutional investors with the launch of Front Street Energy & Power. The fund, which currently has US\$333 million in assets under management, was closed to investment in April 2005.

The firm offers four other resource-focused products: FS Mining Opportunities Fund and FS Energy Growth Fund for Canadian investors, and FS Energy Venture Fund and FS Resource Hedge Fund for non-Canadian investors.

All told, Front Street has 16 funds focused on diversified and opportunistic strategies and more specifically on the Canadian income trust market.

### Investment mantra

Front Street's overall investment mantra centers on what it describes as intensive global macro-

economic analysis, with a particular focus on the energy, resources and related markets, to understand supply/ demand conditions in the context of overall global economic conditions as well as how Canadian players—from exploration firms and suppliers down to drillers and shippers—can benefit.

The firm also uses its extensive contacts with management teams of companies that focus on various aspects of Canadian energy and resources exploration to continuously explore and invest in various types of investments, including venture capital funds, initial public offerings and equity stakes in emerging and junior micro-cap companies.

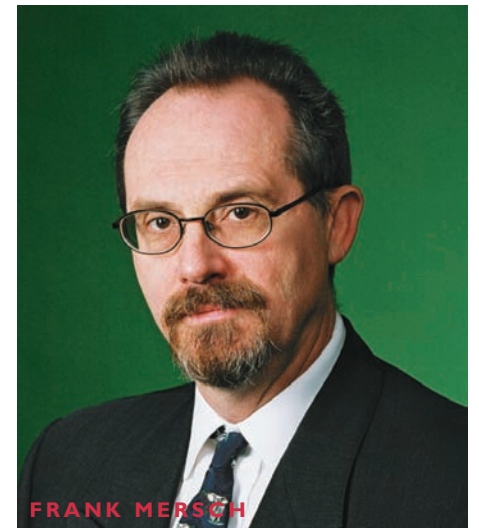
"The price of oil going up or down is just background noise to us," says Selke. "We're more interested in other areas of growth—companies that are looking at discovering more oil or increasing reserves or developing technology for better exploration, transportation, pipelines, storage. Those are the kinds of investments we make, and we make them with management teams we know have experience and expertise."

The firm's portfolio managers will not only

## Front Street Capital PERFORMANCE HISTORY

February 2000 – April 2006

|                                    | FS Canadian Opportunities Fund | FS Energy & Power Fund | Barclay/Equity Long/Short Index | S&P/TSX |
|------------------------------------|--------------------------------|------------------------|---------------------------------|---------|
| <b>Return (%)</b>                  |                                |                        |                                 |         |
| Annual comp rate                   | 25.50                          | 43.69                  | 7.99                            | 4.82    |
| 2000 (10 mths)                     | 23.50                          | N/A                    | 5.31                            | (2.14)  |
| 2001                               | (5.42)                         | N/A                    | 4.92                            | (13.94) |
| 2002                               | 2.87                           | N/A                    | (1.78)                          | (13.97) |
| 2003                               | 87.85                          | 19.41(4 mths)          | 15.81                           | 24.29   |
| 2004                               | 22.94                          | 36.70                  | 6.56                            | 12.48   |
| 2005                               | 23.11                          | 47.52                  | 11.47                           | 21.91   |
| 2006 (4 mths)                      | 18.80                          | 9.18                   | 7.59                            | 8.26    |
| <b>Risk (%)</b>                    |                                |                        |                                 |         |
| Annual std dev                     | 18.72                          | 17.15                  | 5.51                            | 15.11   |
| Semideviation                      | 18.31                          | 17.89                  | 5.75                            | 18.06   |
| Maximum decline                    | (27.81)                        | (8.99)                 | (5.96)                          | (45.05) |
| <b>Return/Risk</b>                 |                                |                        |                                 |         |
| Sharpe Ratio                       | 1.16                           | 2.09                   | 0.89                            | 0.19    |
| <b>Correlation with Benchmarks</b> |                                |                        |                                 |         |
| S&P 500 Total Return               | 0.55                           |                        |                                 |         |
| ML 3-month T-Bills                 | 0.01                           |                        |                                 |         |
| ML Master Treasury                 | 0.10                           |                        |                                 |         |



FRANK MERSICH

rich sands projects.

“Our resources funds are not just oil and gas funds,” says Selke. “There are numerous opportunities that we seek to take advantage of as part of our broader knowledge and understanding of the industry. That is our specialty.”

To be sure, the firm does have a soft spot for up-and-coming producers with experienced management. Calgary-based Profico Energy Management Ltd, the biggest private natural gas producer in Canada, recently sold most of the company for roughly C\$1.2 billion to Focus Energy Trust. As of March 31, Front Street held a 6.4% stake.

Duverney Oil Corp was another winner for Front Street. Run by the former chief executive of Berkley Resources Inc, a Vancouver-based oil and gas exploration firm, Front Street made a venture capital investment in Duverney in August 2001. The company went public at C\$11 a share in 2004; it rose as high as C\$48 and currently trades around C\$42.

make long-term investments in securities with strong fundamentals and a positive outlook, but will also seek out and invest in companies undervalued relative to their peer group as well as larger-cap names, which allow them to take advantage of commodity movements, reduce volatility and stabilize their portfolios.

“We are often ‘first call’ by management teams when they’re looking to raise capital,” says Selke. “The benefit of our network is that we know many of these management teams and their track record, which helps us in our investment decisions.”

### Varied positions

On the short side, Front Street managers will exploit opportunities to short companies with



CRAIG PORTER

weak financials or that are expected to underperform, and they will employ pairs-trading strategies to take advantage of pricing spreads in securities within the same industry.

They will also buy warrants or convertible securities while selling short the underlying securities, and utilize more traditional merger arbitrage strategies by buying stock in a firm targeted for takeover and selling short the acquiring company.

A mature portfolio will typically look to be 120% long and 25% short, with no derivatives and with leverage of approximately 20–25%. The firm’s most extreme bear market stance would compel it to adjust its portfolio to be market neutral—equal long and short—which the firm has done twice since inception.

Strategies vary somewhat among its three portfolio groupings. For the diversified and opportunistic portfolio, management tends to be more heavily trading oriented, with a relatively large number of holdings—between 80 and 100 different companies, mostly large-cap equities, though positions are taken in mid- and small-cap names.

The sector-specific energy and resources portfolios tend to have an average allocation of between 50 and 60 names tilted to larger positions in small- and mid-cap names. While technical and fundamental analyses are employed in both portfolios, the sector portfolios tend to rely more heavily on technical and momentum signals for trading.

Front Street’s income-trust portfolio, its newest strategy, focuses on analyzing and ben-



NORM LAMARCHE

efiting from the substantial dividend payouts of companies organized as Canadian income trusts. The short side of the portfolio tends to be done in pair trades; the fundamentals of cash flow and yield are viewed as more critical.

### Seized opportunities

Selke rattles off examples of Front Street’s team seizing opportunities to make money:

- Accumulating a stake in a power consumption reduction firm that helps office buildings reduce their power intake and save money;
- Shorting natural gas after last fall’s hurricanes sent prices soaring amid supply woes;
- Shorting a large oil refiner that lost out on a particular stake in western Canada’s oil

### Home grown

For the future, Front Street plans to continue focusing on Canada’s rich energy and resources sector, which it believes is still in its infancy in terms of growth potential. The firm also plans to streamline its various offerings and boost its investor base to include more international investors—funds of funds looking to make an allocation to Canada with a hedge fund that knows the landscape and, in Selke’s words, drinks the local water.

“Global macro is a strategy that managers in New York or London follow, not Canada,” he says. “If you want that strategy, go there. If you want a sector-based or a lower- or noncorrelated strategy, then come to Canada. Canada is where the alpha is.”

Of course, Front Street recognizes that competition for investors’ capital is getting fiercer, particularly as international investors increasingly look at Canada as a potential investment opportunity and as more players enter the hedge fund space looking to capitalize on the country’s unprecedented resources-led boom.

However, Selke insists that local knowledge and local experience trump all else. “One of the things you have to learn is that you can’t do everything from a central spot,” he says.

“You have to establish relationships with people in different parts of the world based on their local knowledge and abilities. Someone coming to Canada without that would meet with the same success as if we went to Russia.” ♦

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