

WEEK AHEAD

All eyes on key data as investors worry about U.S. economy

COMMENT

Subprime fallout: worst yet to come

US\$300B in mortgages are resetting to higher rates

main depressed for some time.

The worst is yet to come for mortgage lenders and, perhaps, the housing sector. Roughly US\$300-billion of securitized subprime mortgages with adjustable rates (ARMs) are resetting to higher rates in 2007 alone, and the maximum impact of subprime resets happens at the end of the year. It is difficult to see how house prices can move higher from here, especially since lending practices will be tightened significantly.

Billions — make that hundreds of billions — of mortgages have been securitized and sold as collateralized debt obligations (CDOs) to investors. That has allowed the issuers of these mortgages in varying states of credit-quality to take some risk off their books. CDOs had been a major source of demand with emphasis on the word *had*. The “CDO machine is wheezing,” according to Grant’s Interest Rate Observer, and if this market dries up, it will undoubtedly just add to the tightness in U.S. housing.

Fed policy was a major contributing factor that led to the creation and subsequent fallout in U.S. housing. Mortgage lenders got a considerable boost when the Fed Funds rate was cut to 1% in 2003 and have since been undermined by a credit squeeze, also courtesy of the Fed, as rates were normalized to current levels of 5.25% (Of course, mortgage lenders lacked any sort of controls on lending).

The yield curve, the difference between the Fed Funds rate and the 10-year treasury yield, has been a reliable predictor of stock market weakness over the past two decades, and currently it is inverted, meaning short-term rates exceed bond yields, suggesting access to credit has tightened.

Monetary policy works with a lag, but it proves potent with patience. The yield curve inverted on four separate occasions (using a moving average) since 1988 and each time it coincided with or led a subsequent weakness in the stock market by several months. The last yield curve inversion, prior to the current one, was in 2000-01.

Perhaps the effects of tighter credit will not spread from housing to the broader economy. Thirteen per cent of ARMs, worth US\$326-billion, are likely to end in foreclosure, according to Dr. Christopher Cagan, director of research at First American CoreLogic, and total losses would amount to about one-third that amount — admittedly small by U.S. economic standards.

A financial market crisis may not exactly be around the corner, but it is unclear what will take over from the housing market as the driver of U.S. economic growth. Corporations have been increasing borrowing to buy back their own shares rather than for capital spending. Dividends and share buybacks combined exceeded 100% of non-financial companies’ profits in 2006, according to London-based Smithers & Co. Ltd. Buybacks will boost earnings per share but will do so through fewer shares, not higher earnings.

So, as the U.S. housing market continues to grind down over the next year, the U.S. economy remains at risk. This could be the year that the U.S. consumer finally capitulates. That possibility looms large over U.S. equity returns.

Financial Post

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Business far from dead

CURRIER

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While too much of it can cause a raft of troubles, that doesn’t mean none of it should be done. The pertinent questions are how best to go about it, and wherein lies the optimum price (interest rate).

Lots of smart people are wrestling with those subjects right now. While some bail out of the subprime market, others are buying in — for example, the hedge fund

Farallon Capital Management LLC in San Francisco, which has just advanced the subprime mortgage company Accredited Home Lenders Holding Co. a US\$200-million loan, and another hedge fund, Citadel Investment Group LLC, which bought 4.5% of Accredited.

Mangled though it may look at the moment, the subprime mortgage business is far from dead. It is following the same path others have taken that ultimately led to success and respectability.

Bloomberg News

U.S. stock investors will look to a slew of economic data this week to sustain Wall Street’s recovery, but lingering worries about the economy and the subprime mortgage market could create more jitters. Critical among this week’s data will be two reports on consumer sentiment, which could shed light on how the recent turmoil in the subprime lending market is

affecting the view of the economy. There will also be reports on new-home sales, U.S. durable goods orders and gross domestic product. Investors also will keep an eye on further developments in the Middle East after news on Friday that Iranian forces seized 15 British sailors and marines. The news sent U.S. crude oil prices above US\$62 a barrel. Reuters



CANADIAN HEDGE FUND PERFORMERS

Top 10 by 1-year return with minimum investment greater than 25K

| Rank | Fund name | YTD return | 1yr. comp. | 3yr. comp. | 5yr. comp. |
|------|----------------------------------|------------|------------|------------|------------|
| 1 | Dynamic Power Hedge Fund Class A | 4.002 | 42.946 | | |
| 2 | Sprott Hedge Fund L.P. | 3.801 | 22.701 | 19.635 | 18.679 |
| 3 | Sprott Bull/Bear RSP Fund | 3.634 | 20.765 | 18.149 | |
| 4 | Sprott Hedge Fund L.P. II | 3.64 | 19.667 | 17.173 | |
| 5 | Epic Limited Partnership | 5.163 | 18.238 | 19.211 | 30.126 |
| 6 | Arrow Epic Capital Fund | 6.178 | 18.232 | 20.796 | |
| 7 | Front Street Canadian Hedge Fund | 4.961 | 17.579 | 16.77 | 19.892 |
| 8 | Arrow WF Asia Fund | 1.32 | 16.194 | 14.225 | 14.651 |
| 9 | Vertex Fund | 4.774 | 14.087 | 19.989 | 21.017 |
| 10 | Goodwood Fund Class A | 4.057 | 13.006 | 18.612 | 12.791 |

Bottom 10 by 1-year return with minimum investment greater than 25K

| Rank | Fund name | YTD return | 1yr. comp. | 3yr. comp. | 5yr. comp. |
|------|---|------------|------------|------------|------------|
| 1 | DeltaOne Energy Fund LP | -19.468 | -74.868 | -29.938 | |
| 2 | Hillsdale Canadian Long/Short Equity Fund Class A | -2.659 | -13.285 | 7.694 | 9.06 |
| 3 | Hillsdale Canadian Long/Short Equity Fund Class I | -2.486 | -12.286 | 9.438 | 10.556 |
| 4 | Hillsdale Canadian Market Neutral Equity | -1.371 | -2.875 | 1.461 | -0.123 |
| 5 | CI Global Opportunities Fund | 6.577 | 1.174 | -1.101 | -0.213 |
| 6 | Trident Global Opportunities Fund CS | 3.345 | 1.335 | 2.518 | 2.713 |
| 7 | CI Global Opportunities II Fund | 4.423 | 1.432 | -1.112 | -0.167 |
| 8 | SciVest Conservative Market Neutral Equity A2 CS | -0.68 | 1.602 | | |
| 9 | SciVest Conservative Market Neutral Equity Fund | -1.634 | 1.958 | -0.064 | |
| 10 | SciVest Market Neutral Equity Fund | -1.88 | 4.475 | -2.81 | 1.769 |

Top 10 by 1-year return with minimum investment less than 25K

| Rank | Fund name | YTD return | 1yr. comp. | 3yr. comp. | 5yr. comp. |
|------|-------------------------------------|------------|------------|------------|------------|
| 1 | Salida Multi Strategy Hedge Fund | 9.729 | 56.719 | | |
| 2 | The Friedberg Currency Fund | 1.993 | 9.724 | 13.497 | 14.909 |
| 3 | BNP - Mesirov Notes Series 1 | 2.913 | 7.6 | 3.468 | |
| 4 | BNP - Mesirov Notes Series 2 | 2.907 | 7.598 | 4.131 | |
| 5 | Arrow Multi-Strategy Notes Series 1 | 1.653 | 7.323 | 6.235 | |
| 6 | Arrow Multi-Strategy Notes Series 2 | 1.334 | 7.283 | 5.38 | |
| 7 | Arrow Multi-Strategy Notes Series 3 | 1.551 | 7.267 | 5.033 | |
| 8 | Horizons Mondiale Fund | 0.595 | 6.485 | 2.098 | 3.57 |
| 9 | IA Multi-Strategy | 2.063 | 3.637 | 2.032 | |
| 10 | National Life Multi-Strategy Fund | 2.044 | 3.618 | 2.026 | |

Bottom 10 by 1-year return with minimum investment less than 25K

| Rank | Fund name | YTD return | 1yr. comp. | 3yr. comp. | 5yr. comp. |
|------|--|------------|------------|------------|------------|
| 1 | AGF Managed Futures Fund | -5.952 | -37.795 | -16.149 | 0 |
| 2 | Asset Logics Managed Futures Hedge Fund | -5.044 | -20.427 | -27.059 | -11.528 |
| 3 | TA3 - Campbell A' CS | -2.501 | -3.101 | -0.17 | |
| 4 | BDC Managed Futures Notes Series N-5 | -1.553 | -2.294 | -3.315 | |
| 5 | BDC Managed Futures Notes Series N-4 | -0.926 | -1.336 | -3.415 | 1.615 |
| 6 | ONE Financial Guaranteed Absolute Return Notes | -0.164 | -1.263 | 0.159 | |
| 7 | BDC Managed Futures Notes Series N-7A | -0.361 | -0.193 | -2.349 | |
| 8 | BDC Managed Futures Notes Series N-7 | -0.098 | 0.201 | -2.153 | |
| 9 | BDC Managed Futures Notes Series N-6 | 0.144 | 0.691 | -2.123 | |
| 10 | ONE Financial MSCI Hedge Invest Index Nts Series 1 | -0.635 | 1.24 | -1.532 | |

SOURCE: FUNDATA

NATIONAL POST

COMMENT

Do your due diligence in hedge fund land

BOB THOMPSON

The general perception of hedge funds is they are free-wheeling, gunslinging, swashbuckling, ultra-capitalistic investment vehicles for fat-cat wealthy investors.

This month, I figured why fight the perception, so I decided to run with it. First, the perception is fun, and second, I get tired of fighting it. Third, the funds I mention in this column all have stellar records, and I have the utmost respect for them.

Yes, hedge funds are limited to wealthier individuals, and yes, I happen to think that many hedge fund managers have the best investment minds in the world. That’s why I have much of my net worth with many of them.

I’ll tell you one thing, however, and that is they don’t put up fancy numbers by doing the same as everyone else, or tracking the market, or refusing to deviate from the index. They do think outside the box in all respects, from how they approach investing to how they name their firms.

For instance, you gotta love a hedge firm out of Connecticut named Pirate Capital. The swashbucklers at this firm specialize in taking big positions in companies that they think are undervalued, then demanding that the firms put themselves on the block.

When the firm’s Jolly Roger Fund takes a big position in your stock, somebody in management may be walking the plank in the near future.

Pirate Capital took a large position in Intrawest, a Vancouver-based operator of ski resorts, and politely asked them to extract shareholder value. This resulted in Intrawest being sold to another high-profile hedge fund firm of braniacs, Fortress Investment Group.

Brash and confident they are at Pirate Capital, with a life-sized Pirate statue at the entrance to their firm, complete with a wooden leg and the customary hook for a hand. The confidence is not without merit, as they have generally backed it up with a great rate of return since the firm was started a few years ago. Who knows, if you see them around you may get one of the coveted “Surrender the Booty” hats. As for me, I’ve seen one but have yet to add that bit of loot to my treasure chest.

George Soros, a free-wheeling hedge fund manager, took on a central bank in the early 1990s and made his fund £1-billion in one day. Soros was called a bully, a capitalist pig and a plethora of other nice names, but the fact is he took a bet, had conviction, and acted upon it.

In fact, Soros and his former partner Jim Rogers say one of their first rules of investing is to bet against central banks, for when central banks try to manage the market, the market will usually win out.

I am always amazed at how we are quick to persecute someone who thinks differently. It’s no wonder many money managers fail to put up good performance, if they figure it is better to be mediocre than to take a

chance on being wrong.

Most of the time, Soros says, it is best to do nothing when investing. Wait, he says, until there is a big pile of money in the corner and then just go and pick it up. When you are very sure you are right, bet, and bet big. In his opinion, that is the only way to make outsized returns. Of course, the losses can also be spectacular using this approach.

The high-wire act at Trapeze Asset Management here in Can-

When you’re sure you are right, bet and bet big

ada continues to put up stellar numbers, which I believe is due to their “safety net” approach to investing.

In their minds, high returns do not mean high risks, as their value-based approach is structured to give them a safety net. Beyond the stunning show of performance, read the quarterly commentaries by principals Herb and Randall Abramson (<http://www.trapezeasset.com/news.html>), especially the one about the U.S.-Canada bra wars involving Canadian based La Senza and U.S. based Victoria’s Secret that they so eloquently describe.

Hedge fund managers are oh so much more fun than the average traditional manager, but there

is always someone to blame hedge funds for something.

As a matter of fact, they get blamed for most things, from the Asian Contagion of the late ’90s, to the rise and fall of daily oil prices — likely due to the fact that many of them are unregistered and unregulated, therefore making many official types nervous.

It’s kind of hip to blame hedge funds, those “capitalist pigs.” Shame on them, trying to make their investors money, or taking advantage of market opportunities. They should be like other managers and simply track the index and charge a fee for it.

Whether it is Pirates, Trapeze artists, or people who like to take on central banks, hedge fund managers are a colourful bunch who are full of confidence and don’t mind being non-linear thinkers.

With confidence and free-wheeling flexibility comes certain things you should watch for. Excess leverage and subsequent illiquidity, along with a sprinkling of too much concentration and no trade oversight can be a recipe for negative surprises. As always, due diligence is the key to identifying a winner in hedge fund land.

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