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Why one of Canada's top investors is playing it safe

By SHIRLEY WON
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Frank Mersch of Front Street Capital is sitting on cash as he bets the market pullback is not over yet

Veteran money manager Frank Mersch warns that the recent pullback in the Canadian stock market is not over yet, and is keeping more than 25 per cent of his funds' assets in cash to take advantage of the buying opportunities that he believes will emerge.

"There's a buyer's strike still on, and it takes nothing to knock a stock down," said the portfolio manager and co-chief investment officer at Toronto-based Front Street Capital.

"I expect to see a bottom some time in late June or early July," and will look closely at battered energy and metals stocks at that point, said Mr. Mersch, an active trader who has beaten the index during most of the past 23 years, first at Altamira Investment Services Inc. and now at Front Street.

The S&P/TSX composite index, which has fallen nine times in the last 11 trading sessions, is off 2.6 per cent this year, and 8 per cent from its high of 14,270.53 points in April. It closed up on Tuesday at 13,097.82 points.

Mr. Mersch, who oversees about $400-million in Canadian hedge funds and equity mutual funds, said that a 12,000 to 12,500 level for the TSX composite would constitute "a good buying point" for him.

He cautioned that the TSX will probably gain only 5 to 6 per cent this year because the outlook for bank stocks has dimmed after they recently missed analysts' expectations. Still, he sees Canadian stocks outperforming their U.S. counterparts over the second half of the year.

Rising commodity prices, which have fuelled much of the run-up in Canadian stocks over the past couple of years, "needed a breather," he said. "But the stocks [of commodity producers] have come off a lot more than the commodities ... Either the commodities come down, or stocks come up. I am betting the stocks come up."

No Faith in Banks

Mr. Mersch, a growth manager who prefers to concentrate on small- to mid-cap stocks, recently sold all his bank stocks. He doesn't see himself plowing his cash back into the sector in the foreseeable future, because he believes better returns are to be had elsewhere. To beat the market, "you want to have some horses in your portfolio that can give you doubles or at least 50 per cent."

His Front Street Canadian Hedge Fund took a beating in the 2008 financial crisis, but has posted a robust 14.8-per-cent annualized return from its inception in 1999 to the end of May, handily beating the 9.1-per-cent return of the S&P/TSX total return index over the same period.

Mr. Mersch has made a successful comeback as a hedge fund manager after his career briefly came to a halt in 1998. He was banned from working in the industry for six months after telling securities regulators that he misled them about his involvement in a penny stock investment while at mutual fund company Altamira.

"There have been bumps along the way, but overall the fund performance has been quite strong," said Dan Hallett of HighView Financial Group. "If you look back to the Altamira days, he was the rock star putting up unbelievable returns ... His success is due [to] his skill, and not just luck."

He has a "little blemish on his regulatory record, but I think it's no more than that," Mr. Hallett said. "One of the things I like about him is ... the fact that he doesn't restrict himself to any particular part of the [Canadian] market."

Commodities and China

Mr. Mersch is "fairly bullish" on commodities stocks, which have been hit hard as investors worry about the imminent end of the U.S. Federal Reserve's quantitative easing program and the prospect of slower growth in China.

Despite the worries, China remains "the second-largest economy in the world," Mr. Mersch said. "Even at 5- or 6-per-cent growth, there is still a lot of consumption."

The energy sector is particularly attractive as oil prices CL-FT hover close to $100 (U.S.) a barrel. With rising demand, companies are going to continue drilling, said Mr. Mersch, who owns "lots of drillers" including Canyon Services Group Inc., Trinidad Drilling Ltd. and Xtreme Coil Drilling Corp.

He's also a fan of oil and gas companies with operations in Colombia. Companies such as Parex Resources Inc. and C&C Energia Ltd. are compelling because they "have cash on the balance sheets, invariably no debt and lots of prospects for growth."

He is growing increasingly enthusiastic about copper HG-FT stocks. While he is mostly mum on specific stocks, because he is "accumulating them," he does like copper and coal producer Teck Resources Ltd.

Mr. Mersch expects the market to rebound in the months ahead despite economic data suggesting that U.S. economic growth is anemic. "We know all about that," he said. "It's the things that we don't know about that come back and bite us."

Mersch's stock picks

Cline Mining Corp. CMK-T

Shares of the coal miner, which recently raised $86-million to develop its New Elk coal mine in Colorado, have been "unduly punished" in the market downturn, Mr. Mersch said. Cline, which could start up its mine in the fourth quarter, was trading at about $5 a share "when the resource was less than it is today" he said. "We think it [Cline] could be a double."

WiLan Inc. WIN-T

The technology patent holder expects to earn 65 cents a share this year, he said. The stock, which trades at 11 times forward earnings versus a multiple of 14 or 15 for its U.S. competitors, could reach $10 a share, he said.

Descartes Systems Group Inc. DSG-T

Descartes, which provides logistics-management software and services, has seen annual revenue rise by 20 per cent, and earnings between 15 to 17 per cent over the past five years, he said. The stock trades at 12 to 13 times forward earnings, and at a 25-per-cent discount to U.S. peers, he said.

Upcoming Event

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Title: Chat live with Nancy Woods

Date: Wednesday June 15, 2011
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