

Hedge manager isn't ready to short yet: Too early to have large short position in U.S. stocks

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Illustration: Color Photo: Yvonne Berg, National Post / "High valuations on their own do not precipitate a short signal for us," says hedge fund manager Peter Puccetti, as markets can trade at excess valuations for quite a while.

Chart/Graph: Bloomberg News / LAIDLAW INTERNATIONAL INC.: LI/NYSE: Mar. 25 close: US\$13.84, -US1 cents, Vol. 526,700: (See print copy for complete chart/graph.) Chart/Graph: Bloomberg News / KINGSWAY FINANCIAL SERVICES INC.: KFS/TSX: Mar. 25 close: \$14.89, +1 cents, Vol. 119,480: (See print copy for complete chart/graph.)

The time is still not quite right to have a large short position in North American stocks, says Peter Puccetti, chief investment officer at Goodwood Inc., a long-short hedge fund manager.

"There is still too much fiscal and monetary policy stimulus, which is keeping the economies growing and the bulk of companies continue to deliver ever-stronger earnings, he says. "There is no sign yet that these earnings are topping out."

His cautious approach to shorting stocks could change rapidly, he says, if these circumstance were altered. "We have a long list of names, including some technology stocks, that are ripe for shorting, based on valuations," says Toronto-based Puccetti, who founded Goodwood in October, 1996. Since then the funds he manages are up around 22% a year (net of fees), which is more than double the performance of the S&P/TSX composite index over that period. Last year, his fund was up 30.5% (net of fees), which was also better than the total return of the composite.

Goodwood's discipline is bottom up, value driven. "High valuations on their own do not precipitate a short signal for us," says Puccetti, as markets can trade at excess valuations for quite a while. Witness the technology boom. But clearly they do point to short opportunities.

On the long side, Puccetti is highlighting as a pick:

- Laidlaw International Inc. (LI/NYSE). It recently closed at US\$13.85 and has a 52-week range of US\$15.30 to US\$13.35. "This is an under-followed, out-of-favour stock suffering from the taint of the company's past bankruptcy and we have a big holding in it." This stock constitutes 8.3% of the total equity of the fund. This Naperville, Ill.-based company provides passenger services, including school busing and intercity and municipal transit services in Canada and the United States, ambulance services, and hospital emergency management services. Its operations include Greyhound bus

services. The bulk of its business is in the United States.

The company emerged from two years of bankruptcy protection early last summer and the stock was recently listed on the New York Stock Exchange. It had previously traded over the counter in the United States. It also trades on the TSX under the ticker BUS. It recently closed in Toronto at \$18.38 (\$20.48 - \$10).

Puccetti notes that the company had filed for bankruptcy protection in June of 2001. It had been an aggressive acquirer of companies and had built up a lot of debt on its balance sheet and was having trouble servicing this.

"It has restructured and emerged from bankruptcy with a stronger balance sheet," he says. Under new management, Laidlaw has been trimming costs and improving its efficiency in all its businesses.

Its ability to generate good free cash flow, thanks, in part, to an improving climate for some of its services, will, he says, allow the company to pay down its high-cost debt, which will greatly improve its profitability.

Also, he says, the new management team's compensation is structured so that it has a strong incentive to improve Laidlaw International's share price and will move to "unlock value in the various businesses." His call is that Laidlaw could be a US\$20 stock. Goodwood bought the stock over the counter around US\$12.70. On the first day of trading on the NYSE, it opened at US\$15.

A big-cap U.S stock that has recently fallen from grace, but which the Goodwood team of Puccetti and Rob Kittel, partner and senior analyst, see as a trading opportunity is:

- Microsoft Corp. (MSFT/NASDAQ) US\$24.41 (US\$30 - US\$23.60). This stock currently represents 4% of the portfolio. The stock of this software giant

has come under pressure because the European Commission imposed a huge fine on Microsoft for alleged abuse of its Windows monopoly. The European Union also required Microsoft to remedy this by offering computer manufacturers a version of Windows without its built-in audiovisual software and to share proprietary information with rival server makers. The company is appealing the ruling. "The stock market is focusing on this event and giving Microsoft little credit for its strong balance sheet with huge cash and investments, representing some US\$6.17 a share, and its ability to generate strong cash flow," says Puccetti.

The company currently has a modest dividend yield of 0.66% and could greatly enhance the attractiveness of its shares by boosting its dividend.

Goodwood, he says, has a main competitive advantage in analyzing smaller, under-followed companies, but "in the case of Microsoft and other very large cap companies, it sometimes pays to buy on the bad news and wait." Puccetti believes Microsoft could bounce 20% or more with an improved dividend policy and the EU concerns minimized.

A Canadian company that the Goodwood team believes does have a competitive advantage is:

- Kingsway Financial Services Inc. (KFS/TSX) \$14.88 (\$19.60 - \$11.75). This stock is Goodwood's biggest single holding at 10% of the total equity in the fund. Kingsway, a North American property and casualty insurer, was one of Puccetti's picks in this column on Oct. 23, when it traded at \$13.05. This manager started buying stock in Kingsway in the spring of 2003 and continued to boost his holding, with an average cost of around \$15 a share.

The firm had disappointed the Street by taking additional charges against earnings for business it had written in previous years. The Street "remains skeptical," but Puccetti thinks the worst is over.

In perspective, he says, since Kingsway went public in 1995, the company has increased its book value per share at an annual rate of approximately 27% -- a much faster pace than most Canadian companies. And this has been achieved despite recent difficulties, including the negative impact of a stronger Canadian dollar.

Also, he adds, "few predicted that the Ontario auto insurance business would have the problems that it did, which indicates that this was an industry problem, not a Kingsway-specific problem."

Consensus estimates call for Kingsway to generate earnings per share of \$2 for 2004, whereas Goodwood is looking for it to do better than that. "It could earn \$3 a share."

- Another stock Goodwood bought when it was out of

favour -- and which has since risen sharply, to the point where this hedge fund manager has been taking some profits -- is Dundee Bancorp Inc. (DBC/TSX) \$26.66 (\$28 - \$12.40). Based in Toronto, this company provides wealth management and financial services, mainly through its listed subsidiary, Dundee Wealth Management Inc. (DW/TSX) \$8.90 (\$9.35 - \$4.70), which both manages assets and has a national group of professional investment advisors. "This stock was a classic situation we look for -- it was under appreciated and very cheap."

Goodwood bought the stock some two years ago at an average cost of about \$14 a share. At that average price, he says, the Street was putting a negative \$2 per share value on Dundee Bancorp.'s stake in Dundee Wealth Management.

"CI Fund Management Inc.'s purchase of Assante Corp. with its large group of financial planners alerted investors to the value attached to Dundee Wealth Management's franchise, says Puccetti. "Also, the wealth management arm is doing better with more assets under management and improved stock markets and the stock took off." It currently represents 4.3% of the portfolio.