

NEWS FROM THE GLOBE AND MAIL

## When good things come in pairs

**Defensive investing is a tough sell in a bull market, but it begins to look appealing when volatility takes hold**

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The problem with defensive stocks is that they, too, are susceptible to losses in a deteriorating market, just less so than average.

Whereas non-cyclical stocks might limit the damage from economic threats, a good pair trade can make money no matter the direction of the market.

"Whether markets go up or down, we still think we're going to make money on the trade," said Jerome Hass, a partner at Toronto-based hedge fund Lightwater Partners. "What is key in a pair trade is not the direction of how the two stocks move but how they move in relation to each other."

This is a technique designed to neutralize much of the prevailing force of the broader market, which will appeal to those Canadian investors rattled by the past six months and fearful of worse days ahead.

Pair trading involves playing one stock against another - one long position and one short. Typically, the stocks are in the same or similar industries and tend to be highly correlated. So when an event at the market or industry level pushes both stocks up about the same amount, for example, the net portfolio effect will be something like zero - the gains on the long position will more or less offset the losses on the short.

Where a pair trade can pay off is by choosing stocks that have a variance in valuation, essentially representing a bet that that gap will narrow.

Take **PrairieSky Royalty Ltd. and Freehold Royalties Ltd.**, two companies that Lightwater has pair traded. Both have land holdings on which energy producers pay royalties to drill.

PrairieSky was spun off from Encana Corp. and spiked sharply after its May initial public offering. In July, when PrairieSky peaked, it was trading at a forward enterprise value (EV) to discounted annual cash flow (DACF) of more than 21 times. Freehold, by comparison, traded at around 13 times.

"Whether Freehold is undervalued or PrairieSky is overvalued doesn't matter to us, we just know there's going to be a convergence between the two," Mr. Hass said.

He continues to pair a long position in Freehold against a short position in PrairieSky. Both have been hammered in the oil rout.

Since crude prices peaked in late November, just prior to OPEC's decision to maintain production levels, prompting a commodity slide of more than 35 per cent to date, Freehold shares have fallen by 24.8 per cent. But PrairieSky has fared worse, dropping by 29.2 per cent over the same period. So that pair trade is a winner, at least since late

November, since Freehold gained ground on PrairieSky, if only by losing less. Mr. Hass is betting that the valuation spread between the two stocks will shrink further.

Another way to pair trade is to look for a long and a short trading in opposite directions off the same theme.

The trend of cord cutting - cancelling cable subscriptions, often in favour of online options - is likely to benefit **Espial Group Inc.**, a developer of software services that enable the delivery of Internet protocol television, more so than **Shaw Communications Inc.**, said Fabrice Taylor, publisher of The President's Club newsletter.

So he has paired a long position in Espial while shorting Shaw. "I don't even care about winning on both ends of the trade," Mr. Taylor said. If both decline for whatever reason, "as long as Shaw falls more than Espial, I'm still a winner."

As with traditional forms of defensive investing, pair trading is a tough sell in a bull market, acting as a drag on performance. Its appeal rises when volatility takes hold.

"If you're a stock picker, it's a great time to be doing pair trading," Mr. Hass said. "You can take out the market risk and focus on stock-specific risk."

Pair trading can be a useful tool but it is not for every investor. There is the risk that both sides of the bets turn out to be wrong, and there is no limit to the possible loss on a short position. Also, to "initiate and unwind one pair trade you have to buy twice and sell twice, plus you have interest to pay on your short position so you have a large drag due to costs," said Preet Banerjee, a consultant to the financial services industry and personal finance commentator.

"I think the average retail investor would be better served focusing on asset allocation, rebalancing, and diversification."

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Associated Graphic

Pair trading involves playing one stock against another - one long position and one short. The stocks tend to be in the same or similar industries.

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