WHAT READERS THINK

Sept. 19: Nothing to fight over? – letters to the ROB editor

Special to The Globe and Mail
Published Monday, Sep. 19, 2016 5:00AM EDT
Last updated Monday, Sep. 19, 2016 7:43AM EDT

Long on hedging

Re Why are the hedgies still shorting the banks (Aug. 27):

Scott Barlow writes "The short positions on Canadian banks have almost uniformly resulted in losses … [and] considerable financial pain for the doomsayers." It is incorrect to assume all who short Canadian banks are doomsayers. Hedging is about managing risk, not spreading doom.

How would Mr. Barlow know that shorting banks led to losses? He ignores the long side. The key to hedging is how two stocks move relative to each other. If the short position goes up but the long position rises by more, the hedge makes money. Suppose a U.S. hedge fund was long Bank of America stock at 0.6 times book value. Canadian banks trade on average at 1.7 times book value. That's almost twice as expensive from an American perspective. Over the past five years, Bank of America, JPMorgan and Citigroup are up an average of 93 per cent while the Canadian Big Five are up an average of 16 per cent in U.S. dollar terms. Hence, this hedge has been a big winner.

Suppose a foreign fund was bullish on resource stocks in early 2016 and invested in Barrick Gold (up more than 130 per cent year-to-date) or Teck Resources (up more than 300 per cent YTD). Shorting Canadian banks would neutralize market and currency risks, as the banks are perceived as liquid proxies for the Canadian market. The Big Five banks are up about 12 per cent YTD. Once again, shorting Canadian banks makes a lot of sense on a risk-adjusted basis.

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