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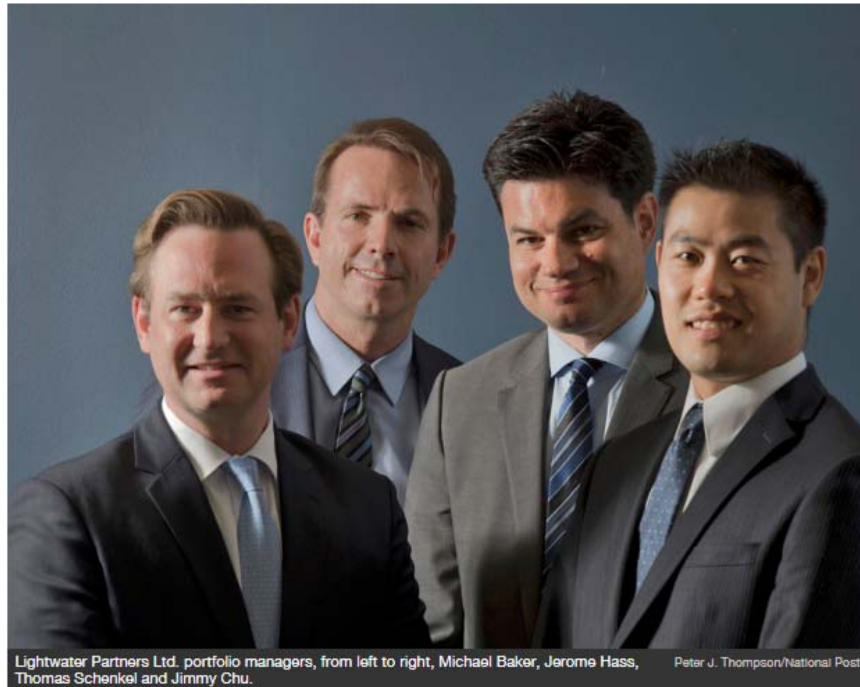
# How to make your portfolio 'as inefficient as possible': Pay down the mortgage

By Jonathan Ratner



Lightwater Partners Ltd. portfolio managers, from left to right, Michael Baker, Jerome Hass, Thomas Schenkel and Jimmy Chu. Peter J. Thompson/National Post

There's been no shortage of fear-mongering about the Canadian housing market – whether that's Deutsche Bank stating it is overvalued by 65 per cent, or U.S. hedge funds shorting the country's banks and mortgage providers.

Jerome Hass, a portfolio manager at Lightwater Partners Ltd., had similar views about the London, England, property market just under a decade ago, as well as Australian housing prices 15 to 20 years ago.

"I thought Sydney was so overheated that it had to implode sooner or later, he said. “The same goes for London. I lived and worked there, but never wanted to buy property because it seemed so expensive."

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Then Hass moved back to Canada and bought a house in Toronto. He couldn't believe how cheap it was.

"Go visit friends in London and see how they live," Hass said. "Then go visit people in Toronto, Vancouver and Montreal. I don't think too many people would think Canadian housing is overvalued after that."

For Canadians that put the minimum 20 per cent down on their home purchases, there seems to be no more attractive asset class from a portfolio perspective. Where else can you get a bank to lend you at a ratio of five-to-one, phenomenally low volatility, steady appreciation and tax free capital gains?

This prompted Hass to conduct an economic thought experiment of sorts. He wondered how one could make their portfolio as inefficient as possible. The answer? Pay down your mortgage.

"At an individual level, I think the worst thing people can do is pay down their mortgages," he said. "From a capital-efficiency point of view, the money can be put to better use elsewhere."

He is part of a team at Toronto-based Lightwater that includes Jimmy Chu, Michael Baker and Thomas Schenkel. They run the flagship Lightwater Long/Short Fund, which has been around for about seven and a half years, and is up 12.7 per cent in the past year. Its focus is on mid- and large-cap stocks, with half of the 40-name portfolio in pair trades.

Roughly 10 of those positions overlap with the company's The Nimble Fund, which is up 62.3 per cent in the past 12 months as of May 31. Its 20 positions are limited to high conviction longs and shorts - with the pair trades broken up.

Their view on the Canadian housing market has contributed to a bias toward non-bank financials, as mid- caps are the firm's sweet spot.

One of the biggest beneficiaries of the tightening in the mortgage market a few years ago due to concerns about overheating was Home Capital Group Inc. With the banks becoming more restrictive in their lending, some marginal borrowers with pushed to non-bank lenders.

Home Capital had a huge growth spurt as a result, as have smaller players like Equitable Group Inc. and Street Capital Group Inc. (SCB/TSX) – Lightwater's preferred name among the three.

"Home Capital has mortgages on their books, but Street Capital simply acts as matchmaker between financial institutions looking to deploy capital and brokers," Hass said.

It's surprising that a lot of investors haven't heard of Street Capital (formerly Counsel Corp.) because it has about $20 billion in mortgages – not far behind Home Capital – but less than a tenth of the market cap.

Another non-bank financial holding is Guardian Capital Group Ltd. (GCG/TSX) – a long position paired up with a short on Bank of Montreal (BMO/TSX) – and a trade that's been in place since April 2009. Guardian exchanged its mutual fund business for five million BMO shares in 2001, and for a long time was trading at a big discount to these holdings alone.

"The Street was valuing the entire stub of the business at negative," Hass said, noting that Guardian has since returned to its historical premium versus its BMO shares.

Guardian's most recent quarterly results valued its position in BMO at about $16.84, while the stock currently trades near $20. So the Street is still only valuing Guardian's core business at a few dollars per share.

Hass noted that applying the market's valuation for AGF Management Ltd. to Guardian produces a value of about $31 per share.

"So I have no interest in taking a trade like this off," he said. "Guardian is still very undervalued and one day we may wake up and read BMO is taking the company out. We happen to know Guardian, and it's a pretty good asset manager in its own right."

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Currency Exchange International Corp. (CXI/TSX) does a lot of business with North American banks, but also capitalizes on a niche many financial institutions would rather stay away from – delivering cash.

More anti-money laundering compliance has made this business somewhat unattractive for the banks, so they outsource the movement of currencies to companies like Currency Exchange.

"If you're in Thunder Bay and you need some Korean won, they do the physical transportation from vaults in Toronto, Miami and Los Angeles," Hass said.

It doesn't hurt that the company's chief executive, Randolph Pinna, has done this before. He built up the business in the 1980s, sold it to Bank of Ireland, which got in trouble and moved a lot of it to Wells Fargo & Co. Then Pinna bought back some of the retail side of that business and started it all over again.