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The hard-landing hedge fund: A new way to bet against housing

By TARA PERKINS

The central bank has said they expect a soft landing in the real estate market, but Spartan Fund Management expects a downturn of at least 30 per cent

A Toronto financial firm is creating a hedge fund that will allow Canadian investors to bet on a housing slump, a move that underscores the skepticism that exists about policy makers' ability to engineer a soft landing for the real estate market.

The proposed fund by Spartan Fund Management Inc. is catering to investors with an outlook that is at odds with the Bank of Canada, which has said it is growing more comfortable with the state of the property market. Governor Stephen Poloz said in a speech last week that "the Bank expects a soft landing in housing," though he acknowledged the risk that household borrowing will continue to climb, setting the stage for a correction.

Many economists at the big chartered banks agree with the central bank's forecast. But the bears are becoming more bearish. Economists at Deutsche Bank said last week that they think Canadian home prices are 60 per cent too high, making them the most overvalued in the world. Nouriel Roubini, the New York University economics professor known for his predictions on the U.S. financial crisis, pointed to frothiness in the Canadian market this month. And a number of global organizations and media outlets have done likewise.

The bears point to measures like the house-prices-to-incomes ratio, which Deutsche Bank says is currently 32-per-cent higher than its historical average in this country after a long period in which home prices have risen faster than wages. Canada is not alone in this respect – low interest rates have raised housing-bubble fears in countries from Australia to Sweden. But by Deutsche Bank's analysis, Vancouver is now more expensive than New York when measured by median house price to median household income, and Toronto is not far behind.

"I think it's a tough slog going forward," said Michael Brown, the portfolio manager of the new fund at Spartan, which he hopes will launch in the first quarter of 2014. "I don't know what rabbits [the government is] going to be able to pull out of their hat."

He's expecting a smaller downturn than the burst of the U.S. subprime bubble, but a downturn nonetheless. "It may not be a fall of 50 per cent, but it's got to be a fall of 30 per cent," he says.

Mr. Brown says it's more difficult to bet on a housing downturn in Canada than it was in the U.S., where hedge fund investors like John Paulson made a bundle by way of credit default swaps. "There really is no vehicle that we know of for somebody to make this bet in Canada," he says.

Seth Daniels, a managing partner at JKD Capital LLC in Boston, which is providing analysis and research on the market for Spartan, subscribes to the Austrian business cycle theory, which says that it's credit that drives the business cycle. He believes that at some point a decline in the availability of credit is likely to lead to a housing correction and recession in Canada.

"The Canadian debt bubble that began in the late 1990s and accelerated from 2007 to present is a classic example of Austrian business cycle theory," he said. "The Bank of Canada's easy credit policy, coupled with taxpayer-subsidized lending practices via the CMHC, has led to an unprecedented boom in debt and real estate.

"The artificial debt creation has misled consumers into extracting equity from their homes, increasing their mortgages, and taking on risky loans to buy houses at inflated prices."

The new fund, called the Libertas Real Asset Opportunities Fund, is geared toward wealthy investors who want to use it as a hedge against real estate assets they own, not average investors who want to speculate on which way the housing market will go. Mr. Brown declined to discuss specific trades, but the fund will short stocks or other securities in a bet that their values will fall. He said he's looking at financial companies, insurers, real estate and consumer firms.

The new fund also illustrates the increasing diversification of Canada's hedge fund industry, said Gary Ostoich, the president of Spartan and the chair of AIMA Canada, a body for the alternative investment management industry. Spartan is a company that provides "emerging" Canadian hedge fund managers with legal, back-office, marketing and regulatory functions.

"The Canadian hedge fund space has really changed dramatically since 2007," Mr. Ostoich says. Assets under management in the industry have more than doubled from about $15- or $16-billion to north of $34-billion during that time, he said, and there's now a broad range of investment strategies. "Prior to 2008, really levered long-biased resource managers dominated the assets under management. What you'll find today is there isn't one in the top 10 in Canada in that strategy."