



strategy profile

(July 2003) Special-situation investing is a common, but hard to define hedge fund strategy. It is often taken as a synonym for event-driven strategies; however, Warren Irwin of Rosseau Asset Management says that it is a subset of event-driven strategies. Event-driven strategies may involve corporate restructurings, stock buybacks, turnaround situations, credit improvements, merger arbitrage and earnings surprises.

Oftentimes, a long-only strategy is used in event-driven investing, waiting for the market to come around to a more realistic view of a company's prospects. Leverage is infrequently deployed — the discounts on the securities are attractive enough — but shorting can be used to protect positions.

For Irwin, special situations are "unusual and often non-recurring corporate events." It could be a restructuring, a bankruptcy, a spin-off, a merger, a consolidation or simply a corporate turnaround.

Above all, he says, "research is the driver behind special-situation investing." As an example, he cites Nortel. "Nortel's not an easy one to figure out. You had to go in, roll up your sleeves and understand a lot about the company. You needed to understand whether they were going to turn enough cash flow to make it through the downturn in the cycle."

To exploit a special situation, Irwin uses distressed debt, preferred shares, common equity and special warrants that come with stock options. With Nortel, he says, "there's a number of different ways of playing it, depending on your risk profile. You can play it aggressively through buying the equity or you can play it more conservatively through buying the bonds." Irwin started with the short-term bonds, the "03 paper," due in 2003. "We were buying them cheaply at a 65% yield. Even if the company did go bankrupt, we were well-protected and wouldn't lose a significant amount of money," he says, because bondholders have prior claim over shareholders during a bankruptcy. As for the Nortel 2003 bonds, he notes "those are now trading around par."

Deep research can uncover other opportunities, Irwin suggests. "We also bought some of their longer term paper, the '06 paper' and we got that as cheap as 38 cents on the dollar. We sold that at 85, and now it's in the high 90s. You can move right along the credit tiers." Credit instruments also provide a modest hedge against default, "so just in case the company does go under and your analysis was incorrect or you're hit with some

unforeseen circumstances, your downside is somewhat protected," Irwin explains. Should the company manage a turnaround, "you're able to make a significant amount of money and now you can start rolling into the equity of the company."

Lots of analysts' eyes are focused on Nortel. But there are some special situations analysts just aren't interested in. Laidlaw, the Canadian concern that runs school buses, ambulances and the Greyhound line, was one of them. During the high-tech era when NASDAQ was the centre of attention, Irwin says, "a company that had just recently gone bankrupt like Laidlaw was definitely off people's radar screens. They really didn't care about it. Everybody was redeeming out of those types of funds that would hold Laidlaw as an investment." As a result, he explains, "we were able to pick up Laidlaw bonds in bankruptcy at 28 cents on the dollar." Laidlaw emerged from bankruptcy in June 2003, and "debtholders received approximately 55 cents' worth of consideration."

Special-situation investing doesn't limit itself to downtrodden companies. It can involve anticipating corporate woes. "We started shorting Bombardier at \$13," Irwin says. "We felt that they were going to be running into quite a few troubles and fortunately for us, they did. It's worked out very well for us. We knew that the airline business was in trouble and that Bombardier was going to feel the impact of this. We also weren't comfortable with the level of financial disclosure. We weren't getting the answers we wanted from the investor-relations people."

Still, anticipation needn't involve guesswork — and that's why research plays such a crucial role. "In a lot of cases, the fundamentals of a company anticipate change in advance of it happening," argues Irwin. "If things start to happen and the situation gets overdone, either on the upside or the downside, it's important to have the courage and conviction to take advantage of that situation. For instance, earlier this year we felt Nortel got ahead of itself on the common stock, so we shorted the common stock for a period of time. Same with Bombardier — there were actually times when we were covering because we felt Bombardier had oversold."

In the end, Irwin says, "the only constant in the corporate world is change. Special-situation investing takes advantage of that."

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