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PRAIRIESKY NEEDS US$55 OIL FOR FLAT PRODUCTION: TD

It's important to track the oil price required for companies to keep production steady. Aaron Bilkoski did just that for **PrairieSky Royalty Ltd.** The TD Securities analyst calculated the that the Calgary-based oil and gas royalty company needs US$55 per barrel in order to maintain flat production.

Since oil prices could climb above US$55, Bilkoski looked at what the company's free cash flow would be in various scenarios.

Based on a crude price of US$60 for the next decade, the analyst estimates that PrairieSky could generate $3.6 billion in free cash flow, or $15.53 per share.

In such a scenario, he thinks that would generated an annualized return of roughly five per cent for shareholders. In a US$70 per barrel environment, that return climbs to a very attractive eight per cent.

Jonathan Ratner

AIRLINE TURF WAR A 'PARADOX,' ANALYST SAYS

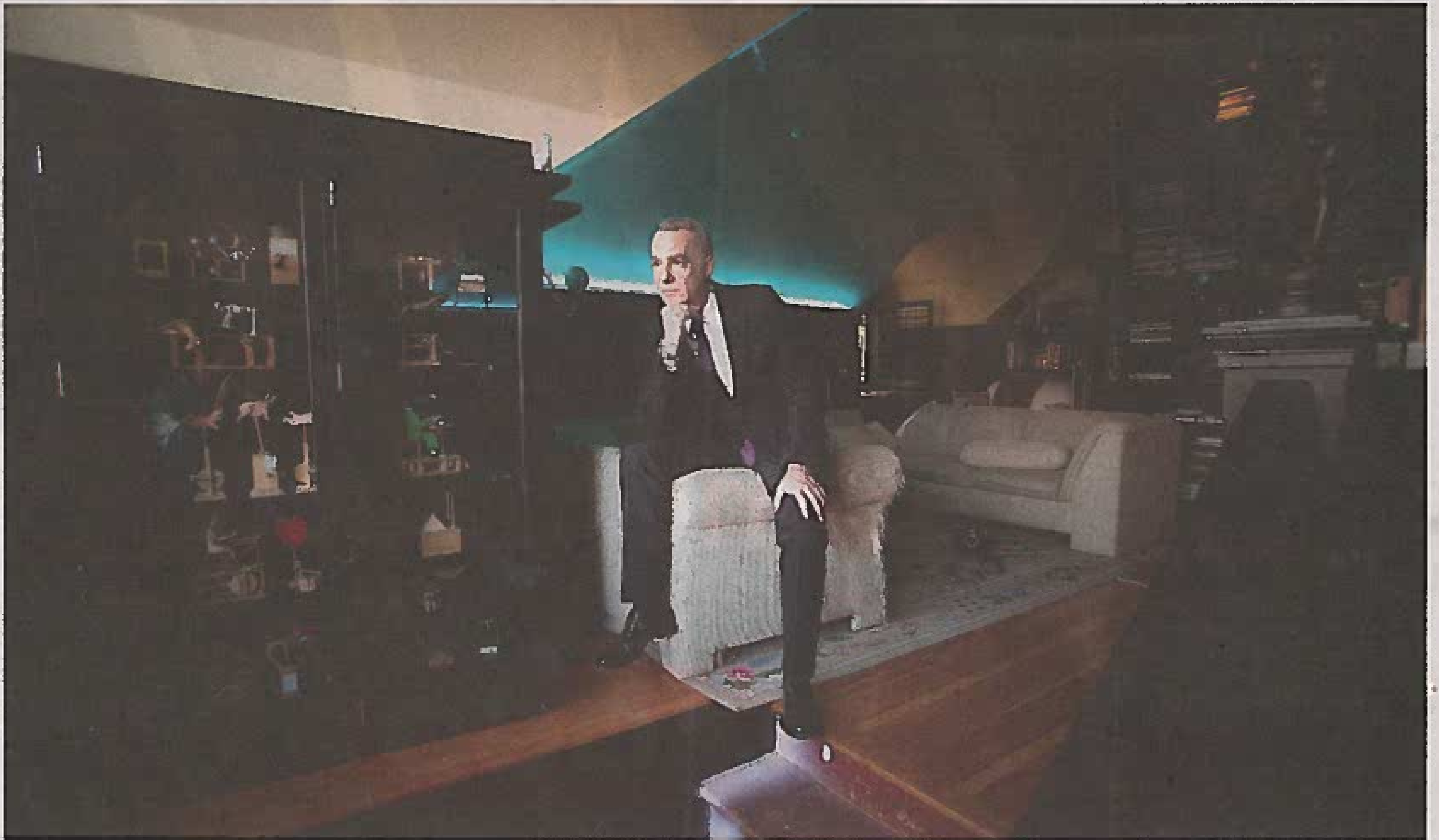
WestJet Airlines Ltd. is creating a "paradox" for investors by escalating its turf war with **Air Canada**, according to a new report from Raymond James Ltd.

The fierce competition between the two airlines is certainly nothing new, but analyst Ben Cherniavsky argues WestJet's launch of Encore flights from Toronto to Boston earlier this week provides a "glaring example" of the impact this turf war has on fares. Raymond James' analysis found Toronto-Boston fares at Air Canada and Porter Airlines fell as much as 65 per cent the day Encore entered the mix.

Although lower fares should help stimulate demand, "the net impact to incumbent profits will still be materially negative," Cherniavsky wrote in a note to clients.

Cherniavsky rates WestJet "market perform" and Air Canada "underperform."

Kristine Owram



BEN NELMS FOR NATIONAL POST

Ari Shiff of Vancouver-based Inflection Management Inc. has allocated capital toward portfolios run by volatility specialists.

When markets are scary, bet on volatility

JONATHAN RATNER

It may be hard for some of us to remember, but share prices, commodities and other assets used to move on the basis of their intrinsic value.

That hasn't been the case for the past eight years, as governments have got involved in financial markets like never before. As a result, markets continue to move based on where people think policy-makers will or will not intervene.

When the U.S. government was throwing tons of money at mortgage-backed bonds, for example, that market was the place to be. But as Ari Shiff at Vancouver-based Inflection Mangement Inc. points out, central banks in many countries have generally run out of ammunition.

As the population grows more restless amid ongoing levels of high unemployment, austerity, slow growth and limited opportunities, investors are also becoming more aware that the "fundamental plumbing" that led to the financial crisis of 2008 has not been fixed.

Things may have improved dramatically in the U.S. and elsewhere since, but Europe is an example of a region where structural challenges are perhaps only beginning to be addressed.

Shiff, whose firm runs the Inflection Strategic Opportunities Fund — a fund of hedge funds that typically focuses on three or four themes and managers that use related strategies — sees this as a primary source of the elevated volatility currently impacting many markets.

"When you get a population that is unstable and unhappy, it doesn't take much for them to rush toward one extreme or the other," he said. "When you have a flat sea, a little ripple can become a big wave very quickly."

The Chinese equity markets serve as Exhibit A for volatility, but real economic data across the globe makes it clear that we're in a low-growth period, which tends to make people unsure of where things are going.

That's why Shiff and Inflection's Jamison McAuley, are steering the portfolio toward strategies that have a low dependency on equity and bond market performance, while at the same time offering Canadians an option for diversifying their investments.

With equity-market valuation metrics looking to them a lot like 1929, 1965, 2000 and 2007 — all of which tended to be followed by a decade of poor returns, and the risk-return trade-off looking very poor on a historical basis in the bond market, Inflection is staying away from those areas.

Instead, they've allocated capital toward volatility specialists — managers that perform best when volatility is the highest.

One way to capture this volatility is through mean reversion on a short-term time scale, such as three days or less.

Whether it's redemptions and forced selling at a high-yield bond fund, or short covering as investors get squeezed out of a rising stock, asset-price moves often tend to overshoot.

"That creates an opportunity to bet that the price is going to swing back the way it came in the very short term," McAuley said. "Those types of moves can be very profitable for active traders, and one of our managers says this is the best time to do so since 2007."

Inflection is also focusing on niche markets encountering elevated volatility, including municipal bonds, structured credit and energy.

While the firm tends to avoid the energy sector, extreme volatility there has made the opportunity too attractive to pass up.

The fund has allocated capital to an energy-products trader who has built a proprietary supply and demand model that tracks both the upstream and downstream networks for oil.

"He counts barrels of supply and demand, then looks at market prices to determine where the inefficiencies are," McAuley said.

That can result in a directional trade — prices moving up or down, a relative value or arbitrage-type trade such as European oil looking cheaper than U.S. crude, or a time spread such as if oil in 2018 looks undervalued relative to 2016.

Structured credit strategies that try to capitalize on the unintended consequences of the shift toward less accommodative lending, are one of Inflection's highest conviction ideas these days.

The firm found a manager within a very large credit firm, that runs a small strategy able to short the credits of weakening companies.

"They looked for companies with flawed balance sheets that likely wouldn't get refinanced, or when they did, it would be a much higher rates," McAuley said.

"As soon as it becomes more expensive for them to be on life support, they are having the legs taken out from under them," Shiff added.

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