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Sovereign debt bears prowl hedge fund summit

Sovereign debt fears were daily front page news a few months ago, but have faded into the general background noise of worry.

Not so at the World Alternative Investment Summit Canada, the annual Niagara Falls gathering of the hedge fund industry.

Here, some high profile people with a lot of experience in the debt world are warning investors in the audience to keep their focus on sovereign debt because the problems of countries not being able to pay their debts are not going away.

Alex Jurshevski, a debt restructuring expert at Toronto's Recovery Partners, had this simple and dire take on the situation: When it comes to restructuring and reducing debt on a global scale in numerous economies at once, it's never been done. And there are a lot of reasons to believe it won't work this time, starting with governments' chronic inability to cut spending. Add to that the fact that the globe's traditional banker and source of bailout money, the United States, is in tough shape.

As taxes rise in developed economies to try to service mounting debts, and more of that tax burden shifts onto the remaining companies and working-age people with jobs in an economy that's graying and struggling with unemployment, the pressure will rise. To survive, companies will move jobs offshore to lower-cost regions, exacerbating the problem.

"The result is depressed tax revenue from corporations and increased unemployment in Western economies that transform into pure service and consumer economies while emerging economies pick up the manufacturing jobs. Cutting the vicious cycle will be painful if not politically impossible."

In fact, rescues almost never work, Mr. Jurshevski argued in his presentation at the summit.

"The reality is that there are only a handful of success stories among the more than 140 attempts at fiscal consolidation in the last few decades. Defining 'success' as a consolidation that reduces debt/GDP by at least 10 per cent, something that is required for all of the sovereign zombies, yields a list of only two countries, New Zealand and Canada, that have done so in the past."

In that environment, investors should be very wary. Mr. Jurshevski has a good seat to this show -- he helped restructure New Zealand's debts after too much foreign-currency borrowing crippled the country in the 1990s. He's also working on a plan to help the government of Iceland get that country out of its mess, as an alternative to the International Monetary Fund's proposal to lend the country money.

"Running for shelter will be difficult in a scenario where the public debt crisis spins further out of control, sovereign defaults and even bankruptcies of whole nations potentially become a widespread occurrence rather than a possibility and civil unrest ensues as populations lose whatever confidence they had left in their governments."

The investment implications, Mr. Jurshevski said, are that bond investors should stay to short durations to mitigate interest rate risk; that equity investors should use downside protection such as stop-loss orders; and that bullion starts to look attractive. On top of that, structured products where the issuer provides insurance for a price as part of the security start to look attractive.

Buy and hold, he concludes, is dead.

That's not far from the prognostications of bond manager Barry Allan. Mr. Allan, who runs about \$4-billion of mostly debt assets at Marret Asset Management, says he has a "pretty high degree of conviction that sovereign debt issues will overwhelm the market" in coming years and argues that investment returns will be depressed, if not downright depressing, for years to come.

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