Create Medium-Term Wealth With This Interesting Long/Short Trade

Description

A long-short play is an investing strategy whereby an investor takes a long position in one stock that's expected to appreciate to complement a short position in a stock that's expected to fall.

It's a pretty great combo if you spot an opportunity to bet on a widening gap between two players in an industry, if you're looking for a way to hedge either your larger position or if you want to amplify your gains from a trend you've spotted (i.e., shorting a utility and going long on the banks as a play on rising interest rates).

The long-short (or pair trade) that I'm about to present to you in this article involves two players within the same sector. I believe one is far better positioned to capitalize on opportunities within the space, and the other is a perennial underperformer that's apparently ill-equipped to capitalize on a future industry-wide opportunity.

As you may have guessed, I'm talking about the Canadian airline industry, with **Air Canada** (TSX:AC)(TSX:AC.B) being the long position and **WestJet Airlines** (TSX:WJA) as the short position.

In a previous piece dated May 31, 2018, I'd encouraged investors to go long Air Canada while going short WestJet. Since the long/short recommendation, Air Canada stock has increased 2%, whereas WestJet has fallen by 11%. Not a bad result for a two-month pair trade, but over the course of the next year, I believe the long/short trade will be profoundly more profitable given the difference in trajectories and the potential for the industry to pick up in conjunction with the strengthening economy.

While WestJet certainly has the potential to bounce back with its ULCC arm, I suspect any gains by WestJet will be dwarfed by Air Canada's. On the flip side, any decline in the broader industry, I believe, will hit WestJet harder than Air Canada due to Air Canada's cheaper valuation. And it looks better prepped to capitalize from Canadian economic growth.

WestJet recently clocked in a net loss of $21 million, as management reduced its full-year guidance, causing shares to retreat. Revenue per available seat mile declined 2%, and management expects it will continue to drop by 4-6% moving forward.

It was a pretty underwhelming quarter, and as with underwhelming guidance from management, it certainly looks like Air Canada has the opportunity to steal WestJet's slice of the lower-cost pie.

WestJet, which has primarily been known as a lower-cost carrier, looks to be shedding its cost advantage thanks to Air Canada's impeccable cost-saving initiatives, which will allow it to better compete for budget-conscious travelers. Moreover, Air Canada's low-cost airline, Rouge, could put a dent in the top line of WestJet as its ULCC Swoop attempts to take off.

Foolish takeaway

WestJet's ROIC and its cost advantage over Air Canada will likely continue to trend downward over the medium term. As such, Air Canada is making all the right moves and investments to get the most of what I believe will be the next leg-up for the airline industry.

I think Air Canada could soar past $30 in value, whereas WestJet will struggle to break $20.

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