absolute return partners

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The Dollar – Debacle or Opportunity?

Two highly distinguished financial newspapers. Same weekend. Same subject. Two very different conclusions. No wonder some investors find it difficult to decide what to do next.

The Economist (A–a–and down! Expect the dollar to slide further after this week's sharp decline – 27th September 2003) concluded that the U.S. dollar has further to fall and bases its conclusion on the large, and increasing, trade deficit. As of the latest count, the deficit is well in excess of 5% of U.S. gross domestic product (GDP) and, so the argument goes, a deficit of this magnitude will force the dollar lower.

The Barron's (Don't Give Up on the Buck – 29th September 2003) amazingly enough uses the same starting point (large trade deficit) to argue that the greenback is set for a nice recovery. Their argument is based on the anticipated rise in U.S. based assets such as shares, bonds, real estate, the dollar itself, etc.

Which camp do we belong to? Well, let's take a closer look at the facts. For a start, the trade deficit is now running at about $50 billion *per month*. Although sizeable, compare that to the recently published U.S. flow of funds figures. July saw a net inflow of $75bn, bringing the 12-month rolling number to about $700bn of inflows (net). So, contrary to popular belief, it does not appear to be too difficult for the U.S. to fund its current account deficit.

It is also worth mentioning that, whilst Asian investors predominantly buy Treasury ($117bn of $273bn) and Agency ($114bn of $273bn) bonds, Europeans have apparently fallen in love with corporate bonds ($140bn of $288bn).

On the equity side, net buying was down to $22bn - only 3% of total inflows and actually less than the $41bn U.S. investors spent on buying shares outside the U.S.

Secondly, the Japanese economy is turning out to be a fair bit stronger than expected only a few months ago. Now, GDP growth estimates for Japan are fast approaching 3%, whereas, just a few months ago, most analysts expected growth of only 1% or thereabout in Japan. However, the picture is a very different one in Europe with several European countries continuing to deliver disappointing news as far as economic growth is concerned. So, all in all, relative growth dynamics are delivering a rather mixed picture with only Japan looking like a clear-cut winner at the moment.

Thirdly, on a trade-weighted basis, the dollar is down a lot less than what first meets the eye. It is estimated that, on this basis, the dollar is only down about 10% from its peak. This is (in our opinion) well within the "gradual depreciation" range that the U.S. government itself has been advocating for the benefit of U.S. exporters.

A gradual drop in the value of the dollar is in fact in the interest of many nations around the world, as the U.S. economy needs to pull the rest of the world out of the current lull. Therefore, we do not foresee a concerted effort to reverse the current trend unless the fall accelerates out of control.

Finally, in addition to its external deficit challenges, the U.S. Treasury is also battling with a large, and escalating, budget deficit. Higher bond yields may be required to finance the rising deficit, which again may lead to increased foreign demand (as the spread to Europe widens). At present (as of 30/09/03), the 30-year T-bond yields 4.99%, whereas, in Euroland and the UK, the equivalent bond yields 4.84% and 4.70% respectively. If this spread widens significantly, it has the potential to cause a reversal of current dollar trends, as bond investors all over the globe chase higher yields. The only problem with this argument, though, is that budget deficits are on the rise in many European countries as well.

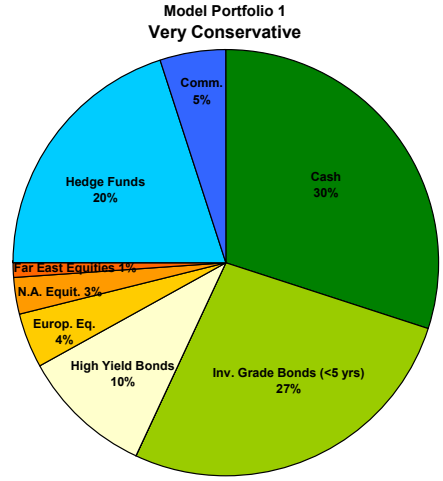
Before we draw any conclusions, remember we are contrarians by nature. Over the years, big fortunes have been made by going against the prevailing view, not by following it.

It is very tempting to stick with the Economist view, as there are many reasons why the dollar should probably continue to weaken for a while yet, only some of which have been listed above.

However, when it is difficult to find a bull, we start to look for reasons to become one, and although it is probably a little bit premature to reverse our position on the dollar (which has been negative for a couple of years now), we are definitely warming to the idea. Keep an eye on the yield spread!

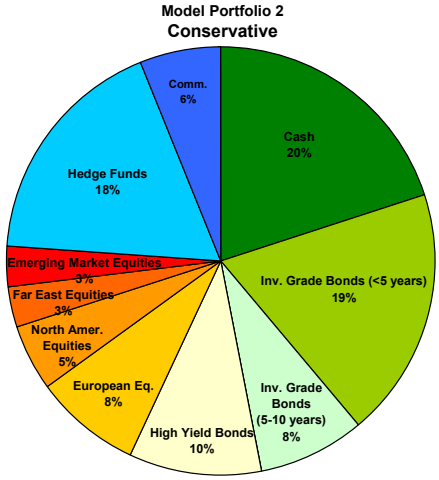
30 September 2003

Model Portfolios



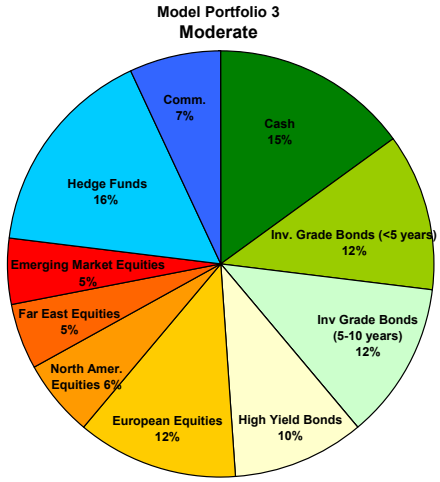
Comments:

Our recommended allocation to cash and short-dated bonds remains fairly high, although, due to the shape of the yield curve, we increasingly favour short-dated fixed income securities over cash. In the high yield area, returns on emerging market bonds have been nothing short of spectacular year-to-date. This is a source of concern to us (30-40% returns over a relatively short period of time usually tempt investors to take profits); however, corporate high yield bonds still appear attractively priced with yields on 5-year BB-rated paper averaging 450 basis points over similar maturity AAA-rated government bonds. Needless to say, our weighting in high yield bonds is therefore tilted towards corporate rather than sovereign paper.



Comments:

Longer dated investment grade bonds (5-10 years maturity) offer attractive investment opportunities mainly in the corporate area. Our equity allocations strongly favour value stocks over growth stocks, mainly because value stocks under most market conditions offer better risk-adjusted returns. We remain cautious on small cap stocks until the evidence of economic recovery becomes clearer. Our allocation to hedge funds (18%) is overwhelmingly biased towards relative-value based funds-of-funds where directional risk is limited. Only small allocations to directional hedge funds are considered appropriate for conservative investors.



Comments:

For somewhat less conservative investors, we recommend some exposure to more aggressive hedge funds, although our asset allocation model still favours relative value based strategies. Commodities, which are present in all our model portfolios, play an important role for two reasons. Firstly, they contribute to reducing the overall volatility due to the fact that their returns are virtually uncorrelated with traditional asset classes. Secondly, we like commodities. They usually offer attractive returns in the early stages of an economic upturn. The only thing we don't like about them is that they seem to be favoured by a lot of people at the moment. Hence we continue to allocate slightly less than the 10% that our strategic asset allocation model suggests.

The Academic Corner

The Case for Diversification – An Introduction

Asset allocation is the key driver of investment returns. In the text below, we attempt to introduce our readers to the basic concepts of asset allocation. The key factor is *diversification*. Imagine that your $100 portfolio consists of a coin and that the coin is tossed once a year to determine your portfolio return. Furthermore assume that tail results in a profit of 30% and that head results in a loss of 10%. The matrix looks as follows:

Outcome	*Probability*	*Return*
Tail	50%	30%
Head	50%	-10%

Since there is 50% chance of each outcome, over a 2 year period, we would intuitively expect to toss one tail and one head. The expected outcome over a two year period would be $117 (calculated as $100*0.90 + $90*1.30). This amount implies a yearly return of 8.17% ($100*1.0817^2 = $117)[1].

Now imagine that yet another and similar coin is added to the portfolio and that the return of your portfolio is now determined by two coins that both have equal weights. In other words, to achieve a 30% return, both coins must now be tail. The matrix would look as follows:

Outcome	*Probability*	*Return*
Tail + Tail	25%	30%
Tail + Head	25%	10%
Head + Tail	25%	10%
Head + Head	25%	-10%

Since there is a 25% chance of each outcome, we would expect the end-value of the portfolio over a 4 year period to be $141.57 ($100*1.30*1.10*1.10*0.90). This corresponds to an annualised return of 9.08% - almost 1% higher than the one coin scenario. This is one of two primary purposes of diversification; by dividing your portfolio between two uncorrelated (one outcome is independent of the other) assets, you can increase your expected return.

Another, and more important, point is that the two coin portfolio also reduces risk as the volatility of returns (also named *standard deviation*) is now only 14.6% whereas it was 20% in the one coin scenario. Standard deviation is the most widely used measure of risk in the financial industry and is essentially a measure of how much year-to-year returns tend to fluctuate around the average return.

In the above, adding an uncorrelated asset increased returns whilst lowering risk. Unfortunately, reality is not always that simple. Asset classes generally have some degree of correlation with each other. Consider for instance small cap growth stocks versus large cap value stocks. Expected returns and standard deviations for those two asset classes are vastly different (you should expect greater returns from small cap growth stocks but also significantly higher risk) but if one class creates positive returns over a given period, so – in all likelihood - will the other. Therefore the two asset classes are closely correlated.

Now consider U.S. government bonds versus large cap U.S. stocks. Often, prices on U.S. government bonds behave differently than prices on U.S. stocks. This indicates less than perfect correlation between the two asset classes and provides the investor with an opportunity to diversify and hence optimize risk-adjusted returns[2].

To illustrate this dynamic, consider again the two coin portfolio with a perfect correlation (i.e. a correlation of one) between the two coins. In any given the year, the return of the first coin (the toss) will be matched by the same return of the second coin. This is essentially the same as the one coin scenario described above and offers no diversification.

At the other extreme, imagine a perfectly negative correlation (i.e. negative one) between the two outcomes. In any given year we would know for a fact that a head would be matched by a tail on the second toss. This would lock in returns at 10% and completely remove the standard deviation of the portfolio (no uncertainty regarding the outcome). In this portfolio scenario, the diversification effect is at its most effective.

Neither of the scenarios above is realistic in the real world, where the actual correlation between

[1] The above calculation is (in our opinion) the most appropriate measurement of portfolio performance and is described as the geometric average. The corresponding arithmetic average would be 17%/2 = 8.5%. It is important that investors always consider the geometric average of their portfolio. Imagine, for instance, a portfolio that generates 100% in one year and loses 50% the next. In this case, the investor has made no money, illustrated by a geometric average of 0%. A normal average, however, would suggest an average annual return of (100% + (-50%))/2 = 25% which is, of course, misleading.

[2] The term "risk-adjusted return" is used frequently. An optimized risk-adjusted return implies that an investor is placed on the efficient frontier where the investor – given that individual's desire for risk - can expect the highest possible return. Unfortunately, the vast majority of investors are not placed on the efficient frontier implying that their portfolio is subject to excess risk.

asset classes is almost always in between the two extremes. To illustrate, we now move beyond the very simplified two coin portfolio and consider a portfolio consisting of various levels of allocations between long-term corporate U.S. bonds and large cap U.S. stocks. To map out the expected return and volatility for this portfolio, we need (1) the expected return of both asset classes, (2) standard deviations for both asset classes and (3) the correlation between the two. In the table below, these data are outlined for the period 1926 to 1998:

	Large Cap U.S. Stocks	***Long-Term U.S. Corp. Bonds***
Aver. Return	13.2%	6.1%
Stand. Dev.	20.3%	8.6%
Correlation	0.26	0.26

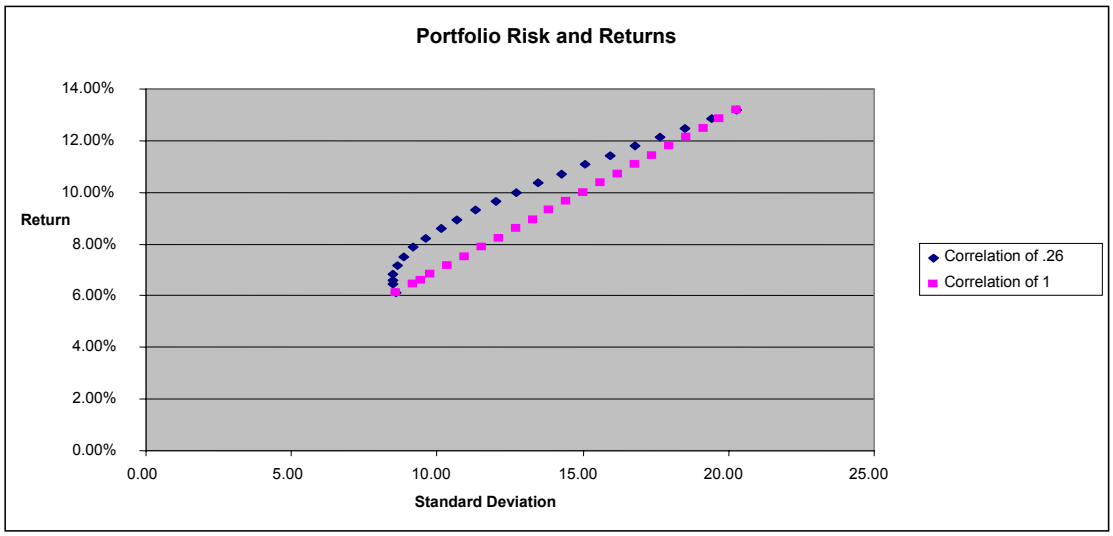
The graph below depicts risk and returns for different portfolio compositions. The pink line represents perfect correlation (i.e. one). In this case, the return and standard deviation would simply be calculated as a weighted average of the portfolio in question. The reality, however, is vastly different and incorporates the benefits of less than perfect correlation (in this case 0.26). This scenario is depicted by the blue line. Because stocks and bonds are not perfectly correlated, each combination of the two provides less volatility than the weighted average of its components. The space between the two lines can be thought of as the actual benefit of diversification.

An important point arising from the graph is that the portfolio with the lowest risk (standard deviation) is *not* a 100% bond portfolio, which is what most investors would intuitively think. In fact, adding a small percentage of stocks decreases the risk even further whilst increasing returns at the same time. The most conservative portfolio (looking at just these two asset classes) should allocate 93% to bonds and 7% to stocks. Actually, an investor with an all-bond portfolio would be exposed to exactly the same level of risk (measured as standard deviation) by moving 15% of the portfolio into stocks. Investors should, however, be aware that correlation is not a fixed number. The correlation between stocks and bonds changes over time and may affect results.

The graph illustrates the power of diversification but also brings us to our next topic – the notion of the efficient frontier. In fact, the blue line above *is* the efficient frontier in a world consisting of only two asset classes, large cap U.S. stocks and long-term U.S. corporate bonds. If an investor only had the option to buy these two asset classes, he could determine his appetite for risk, compose the portfolio to match this level of risk willingness (represented by the standard deviation on the x-axis), and buy the desired amount of stocks and bonds.

Now imagine adding more asset classes to the investment universe. The added asset classes and their different correlations with each other pushes the blue line further out as we now benefit from increased diversification. As we continue to add asset classes we will eventually identify a point where the expected return cannot be increased any further without also increasing volatility. In other words, we cannot move further up the y-axis without also moving further out on the x-axis. At this point, we have created the efficient portfolio.

And that is a large part of what we do for a living…


Portfolio Risk and Returns
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Return
0.00
5.00
10.00
15.00
20.00
25.00
Standard Deviation
Correlation of .26
Correlation of 1