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The Ageing Disease

Two important concepts played a key role in the bull market of the 1990s. Both represent fundamental flaws in logic. Both are demonstrably untrue. First, many investors believed that earnings could grow faster than the macro-economy. In fact, earnings must grow slower than GDP because the growth of existing enterprises contributes only part of GDP growth; the role of entrepreneurial capitalism, the creation of new enterprises, is a key driver of GDP growth, and it does not contribute to the growth in earnings and dividends of existing enterprises. During the 20th century, growth in stock prices and dividends was 2 percent less than underlying macroeconomic growth.

Second, many investors believed that stock buybacks would permit earnings to grow faster than GDP. The important metric is not the volume of buybacks, however, but net buybacks less new share issuance, whether in existing enterprises or through IPOs. We demonstrate, using two methodologies, that during the 20th century, new share issuance in many nations almost always exceeded stock buybacks by an average of 2 percent or more a year.

With these words, Bill Bernstein and Rob Arnott begin their recently published, and most enjoyable, article in the *Financial Analysts Journal* called *Earnings Growth: The Two Percent Dilution*. Their conclusion is not pleasant reading. They find that earnings and dividends grow more slowly than economic growth. And, contrary to widespread belief, stock buybacks do not keep up with new share issuance, diluting earnings at about 2-2½ percent per annum.

Why is all this so important? Well, equity investors essentially achieve their returns from two sources, dividends and growth in earnings. U.S. corporate earnings (as measured by the S&P) stood at $23.75 in 1988, exactly 15 years ago. For the twelve months ending 30th September 2003, earnings had grown to $37.02, for a total increase of 56% over the 15-year period and equivalent to an annual growth rate of almost exactly 3%. Over the same period of time, however, inflation has taken consumer prices 52% higher. That translates to real earnings growth of just 4% over 15 of the most productive (or so they say) years in the history of corporate America, and through the biggest bull market of all times. We don't even care to calculate what that translates to per year!

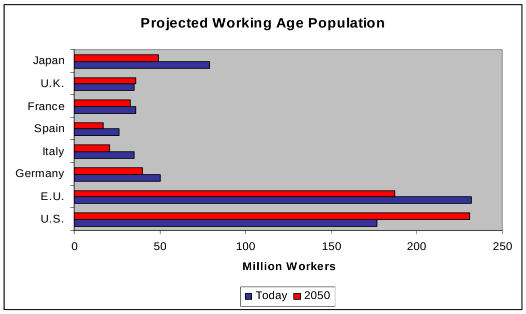
In the meantime, equity markets continue to trade well above their long term P/E averages. In the U.S. stock market, the long term P/E average is 14-15 times earnings. At the moment, investors are blessed with a multiple of about 27 times 3Q2003 reported earnings. A recently conducted study of all major bubbles in post-war history across a number of different asset classes (the author counted a total of 28 bubbles) suggests that all bubbles - with no exceptions - have come back to their trend line. We do not see any reason why this one should be any different.

Now, this adjustment may be achieved in two distinctively different fashions. The first, and clearly more painful, option is for share prices to drop until the correction has been completed. The other, and seemingly less painful, option is for the market to trade sideways for years whilst earnings continue to rise, gradually making up for lost ground. However, at the current level of earnings growth, it could take well over 10 years before the P/E multiple is back to its long term average, assuming flat stock prices.

In either case, investors eventually lose their appetite for equities and invest elsewhere. Only when general investor psychology reaches this level of apathy towards equities, has the bear market run its course and a new dawn can begin. This phenomenon is called a *secular* bear market. Secular bear markets run for about 12-15 years on average. We believe we are in a secular bear market and that we are 3½ years into it. In other words, it could take another 10 years or so to unwind the excesses that have been built up in recent years. We do not intend to predict, though, whether this will prove to be a bear market of "falling Ps" or "rising Es". Time will tell.

Adding insult to injury, we suggest that GDP growth in Europe is slowing, and will continue to slow for many years to come. Recent research into long term demographic trends conducted by the United Nations suggests that, of all the major OECD countries, only the United States is likely to experience significant growth in the working population over the next several decades. This is important to investors around the world because demographics drive economic growth and economic growth in turn drives growth in corporate earnings and hence stock prices.

Some may argue that this shouldn't cause any concerns within the investment community for at least a few decades. Wrong! The phenomenon is already unfolding with several European countries experiencing the lowest birth rates in history.



So what can be done about it? Longer working hours, increased immigration (both politically unacceptable), later retirement age (not very effective), and an increase in the female participation in the work force (already quite high in many countries) have all been mentioned in the ongoing debate.

However, according to students of demographic trends, the *only* viable solution is a significant, and sustainable, rise in birth rates. Unfortunately, the increase required is so dramatic that even the biggest optimists don't believe in it. In the meantime, investors may be drifting away from European equities towards other and more fertile markets.

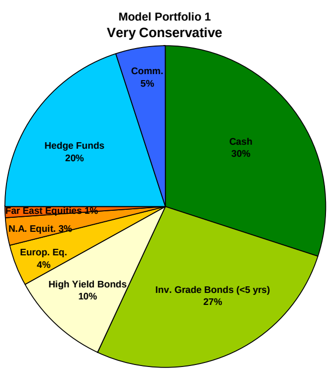
On a more positive note, it is important to recognize that, within a secular bear market, you are likely to encounter several cyclical bull and bear markets. And we continue to believe that the recent run in equity prices (which we characterize as a cyclical bull market) has not run its course yet.

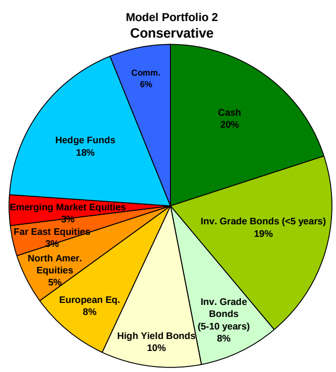
All of this helps to explain our fascination with alternative investments. We firmly believe that only by adopting a range of new asset classes into the portfolio can investors expect to achieve an acceptable return on their investments over the next decade.

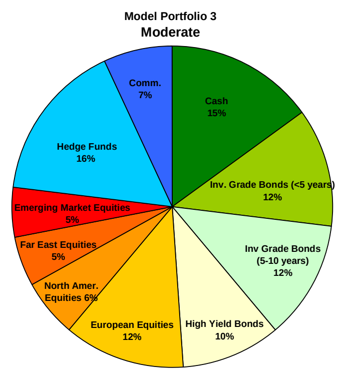
We started with Bernstein and Arnott. It seems fitting to finish with their conclusion as well:

The markets are probably in the eye of a storm and can expect further turmoil as the rest of the storm passes over. If normalized S&P500 earnings are $30-36 per share, if payout ratios on those normalized earnings are at the low end of the historical range (implying lower-than-normal future earnings growth), if normal earnings growth is really only about 1 percent a year above inflation, if stock buybacks have been little more than an appealing fairy tale, if the credibility of earnings is at an all-time low, and if demographics suggest Baby Boomer dis-saving in the next 20 years, then we have a problem.

Model Portfolios







Note:

We have not made any changes to our model portfolios this month.

The Academic Corner

Hedge Funds 101:

No other area of investing continues to be more misunderstood, wrapped in secrets and marred by extraordinary failures as well as great success stories. So let it be said right away. As far as we are concerned, the purpose of hedge fund investing is to generate returns with limited volatility and which are mostly uncorrelated with traditional asset classes. In short, a good hedge fund offers stability and diversification and should by no means be viewed as the ultimate roulette table for a chosen few.

There are certain characteristics that categorize the majority of hedge funds. Below, we will list some of these and contrast each of them to (what we consider) the characteristics of a good hedge fund. It should provide those of our readers who only have superficial knowledge about the industry with some basic guidelines as to how hedge funds work. Subsequently, in our December issue, we will enter into a more detailed discussion as to how hedge funds pursue various different strategies. However, for those of you with ample experience in hedge fund investing, feel free to stop here.

The majority of hedge funds aim to provide absolute returns (stable and positive returns with low correlation to traditional asset classes). Certain hedge funds offer large returns in some years and very poor returns in others. This is acceptable (in our books) if, and only if, these returns are lowly or negatively correlated with the returns of traditional asset classes, as such a return pattern will actually serve to reduce the overall volatility of the client's portfolio despite the seemingly volatile nature of the hedge fund itself. If, on the other hand, returns are positively correlated, large movements could amplify the overall volatility of the investor's portfolio, which is not at all desirable.

Return patterns must also be closely monitored for skewness. Some types of hedge funds tend to deliver a string of relatively modest positive returns combined with the occasional substantial drawdown. Such a return pattern can do considerable damage to overall returns and must be carefully managed.

Hedge funds have the ability to go long as well as short in the markets. The main benefit, from the investor's point of view, is that hedge funds have the ability to make money in any market environment, whether the market goes up or down, which in turn implies that hedge funds use a wide variety of financial instruments to pursue their strategies.

Hedge funds are often very secretive. The tendency to be secretive stems from the fact that many hedge funds trade on specific 'inefficiencies' in the markets. When a hedge fund manager locates inefficiencies, he often chases marginal profits by making the same trade repeatedly. Simultaneously, he boosts overall profits by leveraging the trade beyond the fund's own capital. The fund can normally only pursue such a strategy if no one else knows about the inefficiency. In other words, if everybody else makes the same trade, the inefficiency disappears rapidly. So do profits.

To understand this better, take a brief look at the greatest hedge fund failure of all times, the collapse of Long-Term Capital Management (LTCM) in 1998. LTCM was founded by a group of immensely successful traders from a reputable American investment bank in conjunction with Nobel Prize Winners Merton and Scholes. LTCM had identified inefficiencies in the market for US government bonds. The fund proceeded to exploit these inefficiencies and made tremendous returns thanks to the use of leverage within the fund.

However, given the size of LTCM's positions in the market, other market participants soon learned of the strategy and began to engage in the same trades which effectively reduced the opportunity to make ongoing profits. Subsequently, due to an unhealthy cocktail of greed and ego, LTCM moved into other areas of the market in order to pursue the same level of returns. LTCM soon made bets in markets where they had no virtual advantage (no inefficiencies had been identified) and in the summer of 1998, LTCM found themselves involved in a series of trades that were heavily exposed to the widening of credit spreads that came about at the time as a result of the Russian debt crisis. As the fund (in search of extraordinary returns) was leveraged by more than 100 times, the fund collapsed within a few weeks which sent chock waves through the world's financial systems.

One of many lessons to be learned is that excessive leverage will often create excessive risk. But what is excessive leverage? Clearly, LTCM used excessive leverage at more than 100 times their own capital in a market they did not fully understand (the latter fact actually being more important than the former). Determining the appropriate degree of leverage should be a function of the nature of the hedge fund manager's activities, the consistency of his returns over a reasonable period of time and his risk management approach in general. In short, consistent returns, boosted to a reasonable degree by prudent use of leverage, is (in our opinion) perfectly appropriate. In fact, you would be hard pressed to find any listed company that is not leveraging its balance sheet to some degree.

At the end of the day, the most important factor is that the manager is indeed disciplined enough to follow his strategy without straying from his area of expertise whilst focusing on protecting the down-side risk through various hedging mechanisms. In fact, modestly negative returns in years of great difficulty is an indication of the manager having proper risk management (hedging) tools in place in order to prevent substantial losses during adverse market conditions.

Hedge funds, and funds of hedge funds, almost always charge performance fees. These usually range anywhere from 10% to 25% of returns after management fees, which are normally 1-2%, although higher fees are charged occasionally. We believe that consistent performance should be rewarded, although we do advise potential hedge fund investors to take a closer look at benchmarks and high watermarks. A benchmark sets the hurdle rate for when the fund will start charging a performance fee. A frequently used benchmark is the risk-free rate of return. Often LIBOR (or EURIBOR in €-denominated funds) is used as a proxy for the risk-free rate of return. Bear in mind that, at current levels of interest rates, this is not an onerous hurdle rate.

The presence of a high watermark is effectively offering the investor "fair play". It ensures that losses made in one period (typically a calendar year) must be recovered before the hedge fund manager is entitled to a performance fee in subsequent periods.

When reviewing performance, it is important that returns are measured after all fees. Most managers follow this practice although some produce numbers both before and after fees, which may lead to confusion.

Hedge funds often impose a lock-up period. This could, in extreme cases, be as long as 5 years, but is usually no more than 1 year. Lock-ups are sometimes necessary because the manager invests in illiquid instruments (e.g. distressed debt securities). Subject to investor preference and fund strategy, we usually do not recommend funds with a lock-up period of more than 1 year.

The good hedge funds are often hard to find and a large number of them are closed to new investors. Hedge funds are usually hard to find for the simple reason that they cannot actively market themselves to potential investors. As a result, hedge funds often grow their assets through word of mouth, although this practice will almost definitely change over time as regulators take another look at the rules that govern the industry.

As far as accessibility is concerned, many hedge fund strategies are quite limited in terms of the amount of money that can be put to work. Consequently, many hedge funds have experienced diminishing results as funds under management have grown. The self-imposed limit on assets under management serves to counter this problem.

We hope that this brief introduction has shed some light on the world of hedge funds. In our December newsletter, we will explore in further detail the most common strategies adopted by hedge funds. With that we intend to argue the case that investors should not think of hedge funds as just one asset class which is a widely held opinion today.