absolute return partners

newsletter december 2003

Get Long and Get Loud

It is a wonderful expression. It represents the oldest trick in the book. First you load yourself with the very best investment idea that you can find. Then you tell everyone (who cares to listen) that this is indeed the best idea you have ever come across. It happens over and over again and since we are all human beings, we often fall for it. Take China. We are struggling to find any bears on China (other than ABN-Amro Bank, Marc Faber and perhaps one or two others if we really push ourselves).

Why are we so concerned about China? Isn't it the land of opportunity? Isn't it the country that keeps the world from slumping back into recession? Perhaps, but there are signs on the horizon that the good days are coming to at least a temporary end.

Before we go there, let's make a confession. We do *not* trust the statistical data that come out of China for one second. They are arguably the most engineered numbers that the financial industry has to deal with, although it is difficult to obtain any hard evidence of this.

With this disclaimer, let's take a look at some of the numbers. Chinese GDP is running at an annual growth rate of about 8-9% at the moment (although most observers seem to agree that the real number is closer to 15%). The money base has been expanding by close to 20% in recent quarters (when annualized). Here comes the big one: Growth in fixed investments (factories, infrastructure, etc.) has grown about 30% annualized year-to-date.

What does all of this mean? For a starter, these numbers indicate that it is certainly not the Chinese consumer who is going crazy. More likely, this is a premeditated scheme, designed to reduce the country's dollar risk and shrink its trade surplus – a politically very hot potato at the moment. It works because high fixed investments require imports (lots of them) and dollars. Our thesis is supported by the latest import/export numbers from China suggesting that exports are currently running up 30% year-on-year whereas imports are up 40% year-on-year (if the numbers are to be trusted, that is).

The only problem with the Chinese scheme appears to be that you cannot grow your inventories forever. China is, in our opinion, an accident waiting to happen. If there has ever been a case of overheating, this is it (not to mention $700bn of bad loans in Chinese banks, a massive pension overhang and the political unrest that may follow as a consequence). To make things worse, a slowdown in China will have a spill-over effect on other markets. Credit spreads will rise, p/e levels in emerging markets, particularly those in South East Asia, will unquestionably fall, the rise in commodity prices will slow down, etc. etc.

Talking about commodity prices, they happen to be another case of *"Get long and get loud"*. We accept all the compelling reasons for being bullish on commodities (we have indeed been bullish ourselves for quite some time). It is, however, very hard to find many bears out there, and we have a feeling that the bull market in commodities is somehow linked to the Chinese growth story. Think back over the last 2-3 years. Have Western economies really been strong enough to explain the spike in commodity prices? No, China is a major reason why commodities have done so well in recent times.

If our projections on China are proven correct, it is our belief that the best times will soon be behind us as far as commodity prices are concerned, at least for a while. In this context, it is also worth mentioning that the vast majority of commodities are priced in dollars. It has been suggested that many commodities producers outside North America are not reaping the benefits of higher prices, as the fall in the dollar has largely offset the rise in prices of the underlying commodities.

Back to our favourite term: *"Get long and get loud"*. Gold is another beneficiary of this great phenomenon, and again we have to admit to being a groupie. Merrill Lynch has an excellent fund named the Merrill Lynch Global Gold Fund which, (surprise, surprise) has done very well this year as it has been riding the bull market in gold. We are removing the fund from our recommended list this month, not because Merrill Lynch is doing a poor job but because we are shifting our focus from gold to silver in our asset allocation model.

Gold has a huge following - by far the biggest of any of the precious metals. Gold also has a propensity for being inversely linked to the dollar (falling dollar equals rising gold prices), at least in recent years. As regular readers of this newsletter will know, we belong to that (very) small minority of the investment community who thinks that the dollar's trough is not as far away as most people seem to think, although we are prepared to admit that it is a view that does create sleepless nights on a fairly regular basis.

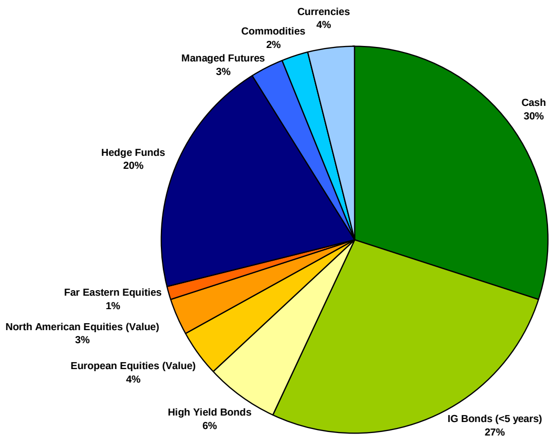
The Chinese also happen to like gold (funny how things are linked, isn't it?), and we believe that gold could suffer a set-back should China run into the infamous brick wall. Also, bear in mind that gold has been talked up big-time by the hedge fund community. If the trend reverses, edgy hedge fund managers won't be slow in taking profits.

Finally, we will offer a few reasons why silver could become the next big investment theme within precious metals. Firstly, and most importantly, demand has exceeded supply for 14 consecutive years. High stockpiles have so far made up the difference, but that is coming to an end. Secondly, most silver mines are shut down today due to the substantial gap between current prices ($5.40/oz.) and breakeven prices (above $7/oz.). It would take a sustainable rise in silver prices to north of $7/oz. before these mines come back to life. Thirdly, production continues to shrink. In 2002, worldwide production dropped by 277 million ounces to 586 million ounces, the biggest drop in production since 1994.

Oh – we forgot to mention the most important factor. The Chinese are not as keen on silver as they are on gold. Merry Christmas.

1 December 2003

Model Portfolios



<u>Very Conservative Portfolio:</u>

Changes:

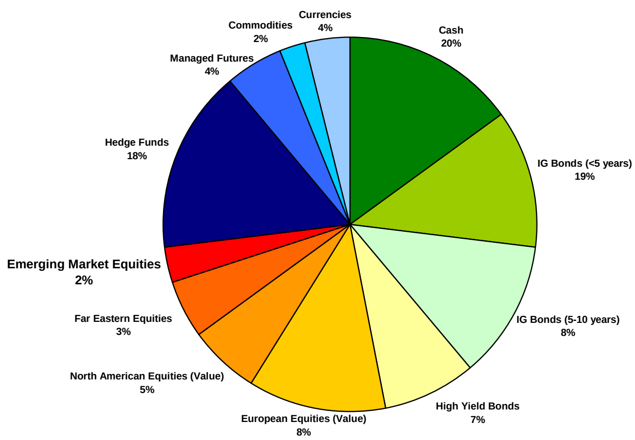
High Yield Bonds reduced to 6% from 10% previously.

Currencies added to model portfolio with a 4% weighting.

Comments:

This month, we have chosen to significantly reduce our exposure to high yield bonds as a result of the great bull market of 2003 that have narrowed credit spreads to well below their long term averages. In Europe, spreads are in fact at their lowest level ever.

At the same time we have added currencies to our model portfolios with a weighting of 4% across the board. The Goldman Sachs Global Currency Fund has been added to our Recommended List at the same time.



<u>Conservative Portfolio:</u>

Changes:

High Yield Bonds reduced to 7% from 10% previously.

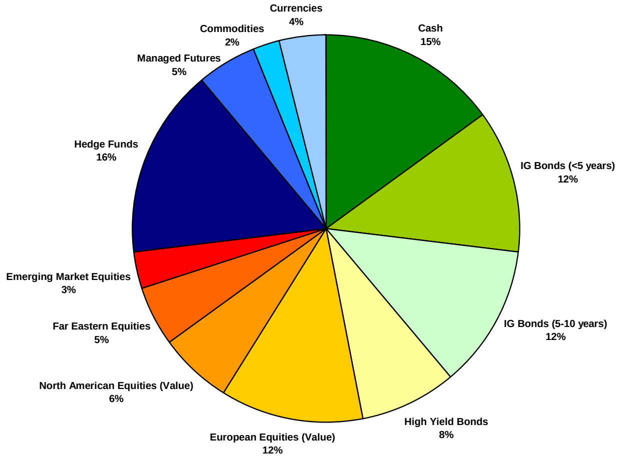
Emerging Market Equities reduced to 2% from 3% previously.

Currencies added to model portfolio with a 4% weighting.

Comments:

Likewise in our Conservative Portfolio, we have reduced our exposure to high yield bonds, although not by quite as much. Given the relative out-performance of emerging market debt versus corporate debt, and given the relatively favourable outlook for economic growth, we continue to favour corporate over sovereign paper.

Please notice that as of this month, we have separated commodities and managed futures into two asset classes. The combined weighting has not changed, though.



<u>Moderate Portfolio:</u>

Changes:

High Yield Bonds reduced to 8% from 10% previously.

Emerging Market Equities reduced to 3% from 5% previously.

Currencies added to model portfolio with a 4% weighting.

Comments:

Currencies have been added to our model portfolio as a separate asset class due to the favourable characteristics that makes it very suitable as a risk diversifier in an absolute return portfolio. Most importantly, the correlation is very low between currencies and the majority of the other asset classes in our universe (between -0.2 and 0.2 in almost all cases).

The Academic Corner

Hedge Funds – More than One Asset Class:

This article is a continuation of "*Hedge Funds 101*", published in our November 2003 newsletter. Today, our objective is to familiarize our readers with the more common types of hedge fund strategies. A general misconception - thanks in large to the likes of George Soros and Long Term Capital Management (LTCM) - is that all hedge funds take enormous directional bets on macro economic events. The truth is, however, that hedge fund strategies (and the inherent risk associated with these strategies) vary widely from fund to fund. In reality, the majority of hedge funds aim to reduce volatility (risk), preserve capital and deliver positive returns in all market conditions.

Before we get started, it is necessary to sort out a few definitions:

Short Selling: Shorting implies that the investor borrows a security from a broker/dealer. The investor then sells the borrowed shares and invests the proceeds in cash, predicting that the price of the shares will fall. The investor will later close this position by buying back the shares that he shorted and deliver the shares back to the lender. The investor is liable for any dividends over the period in which he is short the shares.

Options: An option gives the investor the right (but not the obligation) to buy or sell an asset within a specified period of time and at a predetermined price. A call options gives the investor the right to buy the asset in question. A put option, on the other hand, gives the investor the right to sell the asset.

Futures: Futures are standardised contracts between a buyer and a seller that specify payment, quantity and delivery date of a specified asset. Originally, futures came about because many people had a need to hedge their business risk (e.g. farmers selling crops). At the other end of the contract would be a counterparty with a similar need to hedge their business risk (e.g. a flour mill) or a speculator. The parties are matched by clearinghouses that also guarantee each contract.

Forwards: Forwards are similar to futures except for the fact that forward contracts are not standardised. Nor are they guaranteed by a clearinghouse. A forward contract will typically be between two parties with very particular requirements that may not be fully satisfied by a standardised futures contract.

Convertibles: A convertible is a bond with a call option attached. A converted bond may be exchanged for shares (at a predetermined ratio) at a given date and price.

With these definitions in place, let's move on to a review of some of the most common strategies:

Global Macro: This to some extent resembles the Soros and LTCM type hedge funds mentioned earlier. Global macro funds seek to profit from changes in global economies. For instance, they may short interest rate futures in anticipation of a forthcoming central bank decision to raise the discount rate, which in turn will affect currencies, bonds and stock markets. Global macro funds use various degrees of gearing to leverage their directional bets but they would also hedge some of the downside risk. We consider the risk profile of the average global macro fund as quite high.

Emerging Markets: This involves investing in less efficient markets where pricing anomalies occur more frequently. These markets include a number Eastern European, Asian and South American markets. Investing in these markets requires tremendous expertise in the region. In addition, the investment process can be complicated by the fact that some markets do not allow shorting. That makes hedging very difficult. We consider the risk profile of the average emerging market fund as very high.

Distressed Securities: These hedge funds buy equity, debt or receivables at deep discounts from companies facing bankruptcy or reorganisation. This market is considered less efficient as it is often difficult to correctly price securities in this environment. The strategy requires a rigorous study of the underlying assets of a business to determine whether the value of these assets is actually higher than what is implied by the market price of the securities. Most investors intuitively think of this strategy as extremely risky. However, as the securities are purchased at very large discounts, a diversified portfolio of distressed securities carries a moderate level of risk at worst.

Risk Arbitrage (or Merger Arbitrage): The most common strategy is a short position on an acquiring company combined with a long position on the company being acquired. As the merger or takeover moves towards completion, the target's share price will increase in value whereas the acquirer's share price usually drops in value, allowing the fund to make a profit on both positions. The main risk associated with this strategy is that the proposed merger falls through. We consider the risk profile of the average risk arbitrage fund as low to moderate.

Market Neutral[(1)]: This is an equity based strategy and can best be explained using an example: Imagine splitting the FTSE100 into two parts. One part would represent the 50 companies with the best prospects for capital gains and income (lets call these 50 companies the A shares) and another part which would represent the 50 companies with the worst prospects (the B shares). The fund now buys (goes long) all the A shares and it shorts all the B shares. Now, whether the market goes up or down, the fund will make money, provided it has correctly anticipated the growth and income prospects of the 100 companies in FTSE100 index. Overall, this strategy should be considered a low risk strategy with correspondingly lower returns.

Hedged Equity (Equity Long/Short): Very much like equity market neutral strategies, these funds would buy their best ideas and short the ones they like the least. However, unlike market neutral strategies, hedged equity funds tend to have a long bias. In practice, this means that for every $100 that the fund has invested on the long side, it may only have shorted $50 worth of shares. In other words, the fund will benefit from a general uptrend and be punished if the market is weak. This strategy is one of the most popular hedge fund strategies, probably because the majority of investors believe that equity markets will be up more often than down. Given its long bias, this strategy carries a risk above average but is usually less risky than a traditional long-only equity strategy (such as a mutual fund).

Convertible Arbitrage: Following this strategy, a hedge fund will look to benefit from mispricing between the shares of a company and its convertible bonds. Often, the fund will buy the convertible bond and short the shares. If the price of the shares goes up, the loss on the short position will (in theory) be offset by the coupon income and the fact that the convertible bond will also rise in value. If the share price stays flat, the fund will give up the dividend on the short position but in turn gain the coupon and price appreciation of the convertible. If the stock market falls in value, the short position will likely more than offset the loss on the convertible bond. In addition, you will receive the dividend income. Bear in mind that interest rates would also have an impact on profitability of this particular strategy as the value of convertible bonds are sensitive to changes in interest rates. This strategy may be considered a low risk strategy.

Short Selling: Hedge funds pursuing this strategy attempt to find overvalued shares to short. This is a difficult strategy in bull markets but a very profitable one in bear markets. As short positions can accumulate significant loses in strong equity markets, on a stand alone basis, this strategy may be considered extremely risky. However, most investors invest in these funds in order to obtain an appropriate level of portfolio insurance. Once mixed with other strategies, the risk level is far smaller.

Funds of Hedge Funds (FoHFs): Some FoHFs are style specific (the most common theme is equity long/short) whereas others operate across different styles. FoHFs allow investors to gain exposure to a vast array of different hedge fund strategies for a relatively small investment. As with any diversified portfolio of assets, this reduces the overall volatility of returns. In addition, the investor benefits from the manager's expertise in selecting superior funds and he would sometimes gain access to funds that are otherwise unavailable due to capacity constraints or high minimum investment requirements.

We hope with this note to have contributed somewhat to the demystification of the hedge fund industry. It is an industry that gets more than its fair share of bad press, mostly because it is so misunderstood. Used correctly, it serves a very important role for absolute return investors who are looking for relatively stable, predictable returns.

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(1) We consider the term "market neutral" somewhat misleading. Market neutral implies zero correlation with the overall stock market, which is a rarity. Market neutral, however, is the industry term.