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Not the Bubbles We Would Normally Prefer

There is precious little we can say about 2004 that we feel absolutely convinced about. The only thing we know with almost complete certainty is that 2004 will, just like any other year, deliver a few unpleasant surprises.

The dollar has been stealing the headlines in recent months. We believe that a lot of the damage is done at this stage, although the dollar is likely to go through some very rocky times, at least until after the U.S. presidential election, when it is expected that the U.S. administration will have to take much more drastic action to address its rather serious deficit problems (trade deficit as well as budget deficit). The dollar is so unpredictable at the moment, though, that we continue to advocate the hedging of any dollar exposure.

We do not agree with those commentators who want us to believe that the U.S. economic recovery is robust. It is, quite bizarrely, a recovery where jobs are created in Asia rather than in the U.S. That spells potential problems for President Bush. If job creation doesn't improve between now and election day, we would not be at all surprised if the Democrats do much better than what is in the cards at present.

For the same reason, we are less bearish on interest rates than most observers. The Federal Reserve Bank is not likely to raise rates significantly until job creation accelerates. The Fed also has private sector debt to worry about. American consumers are, just like the British, more indebted than ever before. Sharply rising interest rates could put millions of consumers into bankruptcy. How likely is that to happen in an election year?

This dynamic puts the European Central Bank in a very delicate position. The weak dollar is already doing considerable damage to European competitiveness. If interest rates in the U.S. are effectively capped for the reasons discussed above, it is difficult to imagine euro rates suddenly taking off.

The Bank of England is finding itself in a slightly different, but no less awkward, position. Domestic demand is more robust than what is the case in continental Europe, and the BoE appears to be in no mood to relax, as has been demonstrated in recent months. The UK consumer, however, is much more leveraged than his continental ditto,

leaving the BoE with a delicate balancing job. Bottom line, we expect the gap in short term rates between the UK and the rest of Europe to widen somewhat over the next 12 months.

In the world of investments, we have noticed that the sky contains very few clouds at the moment. An unusually benign investment climate in 2003 has created numerous bubbles that may or may not burst as 2004 progresses.

We see a bubble in the U.S. equity market. U.S. equities are currently riding a wave of optimism due to the economic recovery. We continue to believe that we are going through a cyclical bull market that is embedded in a secular bear market. Secular bear markets last for at least 12-15 years. This one is only 4 years old. The cyclical bull may continue to dominate for the better part of this year, but we would suggest that investors exercise extreme care when investing in equities.

We most definitely also see a bubble in credit spreads. Emerging market credit, in particular, is behaving as if the world has seen the last crisis. One thing we have learned from 20 years of investing is that emerging markets blow up at fairly regular intervals. We can't tell when and where, but we can assure you that spreads will widen when it happens.

We also see bubbles in consumer debt, property prices (particularly in the UK) and China. We think the biggest risk to the financial system is a burst of the consumer debt bubble. A more likely candidate, however, for the *2004 Burst of the Year Trophy* is probably credit spreads, as current spreads are at an all time low leaving ample room for disappointment.

In the following, we are highlighting the UK residential property market, as we have received numerous inquiries about this particular asset class from our faithful readers. There is no reason to believe that the eventual bursting of this bubble will be particularly nasty. Bubbles, as you may remember, can follow different patterns when bursting. The first (and clearly less painful) path is one of sideways moving prices for a considerable period of time until the excesses have been washed out. The second one is a different story altogether. Prices fall sharply over a relatively short period of time, which creates havoc in the market place. Unfortunately, it is impossible to predict which of the two paths the bursting bubble will follow.

UK Property Prices - A Bubble About to Burst?¹

20 years ago, the average UK home was priced at about £33,000. The latest price survey suggests that the average home is now changing hands at almost £134,000. This increase translates into an overall rise in property prices of over 300% over the last 20 years, or about 7% per year.

Over the same period, there has been one major bear market. This occurred between 1989 and 1995, when prices dropped by 17%. Adjusting for inflation, this corresponds to a *real loss* of 46% (so, yes, you can lose money in real estate). Most of the remaining years have delivered relatively steady price increases. In 13 of 20 years, prices have risen from one year to the next by 10% or more, and only in 4 of 20 years have prices actually fallen (and only in one year by more than 10%). Impressive statistics for any investment.

However, *real* price changes (i.e. inflation-adjusted prices) paint a somewhat different picture. Real prices have fallen in 6 of 20 years, in one instance by as much as 20% (1990), and only five times have real property prices increased by 10% or more. It is interesting to note, though, that four of those five years have occurred in the last five years. And that is exactly why we are tempted to call it a bubble.

So what has driven the UK property market into bubble territory? Ever since inflation peaked in 1990, the Bank of England has responded to the steady drop in consumer price inflation by continuously cutting interest rates. Lower interest rates have reduced the incentive to save money. Instead, consumers have effectively been encouraged to borrow and spend. Secondly, less expensive mortgages have increased demand for property, which again has driven up property prices. Thirdly, steadily increasing property prices have allowed the owners of these properties to monetize their wealth by assuming ever more debt, often to buy a second or third home. The bottom line: Total consumer debt in the UK has risen by 128% over the past decade. Property prices are up by 162% over the same period. Disposable income, meanwhile, has only risen by 64%.

For how long may the bubble continue? One often wonders how inflation can fall so much over a decade of (i) very healthy demand (retail sales have been rising steadily ever since 1992), (ii) constantly improving liquidity (as a result of falling interest rates), (iii) declining unemployment (from a level of 10.5% in 1993 to 4.9% today), (iv) healthy growth in disposable income (growth in disposable income has outpaced inflation in all but one year over the past two decades), and (v) declining savings rates (the savings rate has dropped continuously from 10.8% in 1993 to 5.9% today).

Globalisation holds at least part of the key to the answer. In the last decade, enormous resources have been re-distributed across the world, allowing many countries to enjoy strong growth with only minor inflationary implications. Secondly, and this point is rather more elusive, much of the liquidity generated by the mounting debt does not create consumer price inflation. Instead, it feeds back into the rising property bubble. And it is well known that asset bubbles often remain largely unchecked by monetary authorities, who appear to set the agenda for their policies based on more traditional measures of inflation such as consumer price inflation.

Sound logic tells us that there must be a breaking point; the point at which the consumer can no longer afford to service his debt. After all, only so much of disposable income can go into servicing and paying off loans. Bear in mind that UK consumers today spend a larger proportion of their disposable income on servicing debt than they did a decade ago, despite interest rates being less than half the level of 10 years ago. At a time of record low interest rates and unemployment levels, but also a time of unprecedented debt levels, what is left to sustain a rally similar to that of the past 10 years?

So is a price collapse imminent? One of the great dangers of the UK property market is its very direct link to interest rates. More than 60% of mortgages are based on variable interest rates. Put differently, were rates to rise by just 1%, the cost of servicing these mortgages would increase by more than 20% for over 60% of home owners in the UK. The Bank of England has already reversed the trend in interest rates with its recent decision to increase the repo rate by 0.25%. By the time you read these lines, it is not entirely impossible that a further hike has taken place. If banks and building societies respond the way they usually do (i.e. by passing on the full impact to their borrowers), home owners may be facing one or two unpleasant surprises in the months to come.

On the other hand, the Bank of England is, just like their colleagues at the Federal Reserve System, very much aware of the potential dangers of the ever increasing debt of their citizens. One might actually argue that such concerns may cause the monetary authorities to exercise some discretion, in order not to drive the nation into a potentially very dangerous situation.

Bottom line, we do not believe a collapse is imminent. Collapses do not usually happen at the level of interest rates we currently experience. Secondly, the importance of the financial services industry to the UK economy should not be underestimated. When the City has enjoyed a good year, and 2003 was indeed a very good year, bonuses often find their way into the property market. Therefore, unless we seriously underestimate the need for the Bank of England to increase rates, we would expect a soft landing rather than a crash. However, keep a close eye on

¹ All references to property in this note relate to the residential property market.

interest rates. The more they rise, the more concerned you should be.

A footnote on property in the context of portfolio management: In spite of the less than inspiring outlook for property prices in the UK, property investments do belong in a well-diversified portfolio (only, the UK may not be the best place to invest in residential property at the moment). UK property prices have in fact outperformed the FTSE 100 in 8 of the past 20 years. Furthermore, the correlation between UK property prices and UK stock prices has indeed been very low. This very much supports the notion of adding property to the menu of asset classes to be considered in any asset allocation decision.

A Note on Structured Products

Structured products have become increasingly popular in recent years. Ask your broker what a structured product is, and he may describe it as a financial instrument designed to meet specific investment objectives. These are often tax based or driven by regulatory or risk management related issues.

So what are structured products in fact? Simply put, they are financial instruments, usually bonds, where the value is linked to an underlying asset, often chosen by the purchaser. In other words, the world of structured products allows you to turn equities, hedge funds, commodities, etc., into bonds.

The most common type of structured products is known as guaranteed products. Originally, these consisted of a zero coupon bond and a call option on the underlying asset. The zero coupon bond was bought at a discount to par. Provided the issuer didn't go bankrupt, the bond would mature at par and hence secure your principal capital. The call option would allow you to participate in the upside of the underlying asset, e.g. a stock market index.

These structures have been popular as they provide investors with a degree of safety whilst still allowing for some considerable upside on the underlying asset. In reality, however, investors can easily replicate this structure on their own, thus saving expensive fees to the issuing bank. Furthermore, it is a general misperception that an investment of a £100 that ends up paying out £100 at the end of a given period is a zero loss investment. In reality, the investor pays an opportunity cost. Given the current level of UK interest rates, the opportunity cost of a 5 year guaranteed note is about 26%. This equals the return of a risk-free government bond over 5 years (assuming you can re-invest your coupon income at the same rate).

In recent years, banks have moved away from these simple zero coupon structures and are instead applying a method called dynamic hedging. Instead of buying zero coupon bonds to secure the principal, the bank will actively manage the risk by moving funds back and forth between bonds and the underlying asset, subject to price movements.

The bottom line does not change, though. The investor is still facing an opportunity cost. The main advantage of dynamic hedging over the zero coupon approach is that it allows the bank to allocate a higher percentage to the underlying asset, thus offering the investor greater upside participation.

Before we go any further, it is important to clarify one crucial fact. A guaranteed product is always a structured product. However, *a structured product is not always a guaranteed product*. In fact, a structured product without a guarantee can look vastly different from what we described above. Often, structured products without guarantees may be used to gain access to asset classes that are otherwise out of reach for tax or regulatory reasons. A Danish investor, for example, would be faced with a punitive capital gains tax rate when investing in a hedge fund. If he instead asked his financial advisor to package a hedge fund as a bond, the tax rate would be much lower.

How does the issuer make money? The issuer of a structured product generates his profit from three sources: *Gross spreads, hedging profits and trading profits*. Gross spreads are added to the price of the product to cover legal and administrative costs as well as remuneration to everyone involved in the issuance and subsequent sale of the product. Hedging and trading profits are profits that, at no cost to investors, can be generated by the issuing bank if it manages the risk management process successfully.

What are the risks associated with structured products? Well, first and foremost, it depends on the product in question. There are, however, a number of risk factors that potential investors should be concerned about.

Excessive fees: It is effectively impossible for all but the most sophisticated investors to assess what the true cost is, because it is embedded in the price. The difficulty lies in valuing the option component of the structure, as the issuer usually does not share the underlying assumptions with investors. One such assumption has to do with volatility. The greater the volatility, the more uncertain the future price, and the more you have to pay for the option. The issuer can (potentially) make some rather unreasonable assumptions about volatility, which will drive up the price you have to pay. As mentioned, unless you have access to complex option modeling tools, these components are difficult to evaluate.

Most products are dressed up to look good but many of them are in fact mediocre: Recently, we stumbled upon a guaranteed product with the following characteristics: After six years, investors get a minimum of £121 back for every £100 invested or alternatively 50% of the growth in the FTSE 100 (whichever is greater).

At first glance, this appears to be a rather sound investment, but let's take a closer look. Worst case,

the investor earns a 21% return on his investment at the end of the six year period; however, should the market rise by 50% (or higher), the investor would receive £125 (or more). The former corresponds to an annualized rate of return of 3.2% and the latter to an annualized rate of return of 3.8%. Compare this to the current yield on a UK government bond held for the same period of time. The yield is roughly 4.75%.

In other words, in order for this product to generate the same return to its investors as would be the case by investing in UK government bonds, the UK equity market would have to rise by 64% over the next six years. That may not seem an impossible task considering the performance of the last 12 months but is in fact well above its long term growth rate. The lesson is that it pays to do a little math. Benchmark the return against an investment in a risk free government bond with the same maturity.

The guarantee may not be quite what you think it is: When buying a guaranteed product, always read the small print. Often the guarantor is not actually the issuer. Or it is a subsidiary of a well known brand (such as a large insurance company or bank) based in some obscure jurisdiction with a balance sheet less than what you hold in cash in your bank. Remember, a guarantee is only as good as the quality of the balance sheet that backs it.

Lack of liquidity: Many structured products offer poor liquidity. In other words, unless you are prepared to hold the security to maturity, you may find it either impossible or, at the very least, prohibitively expensive to get out of the product.

The product may not be exactly what you want: Many issuers launch structured products based on a so-called lead order. One of their clients has a particular need, and a product is structured around that need. In order to improve the profitability, the product is subsequently marketed to a much wider section of clients. Be ware that many banks will structure bespoke products for as little as \$5-10 million. Doing it this way, you have a much better chance of obtaining the terms that you actually want.

A final word of advice: Do not read this as a general health warning against structured products. We are in fact great believers in using structured products as long as they are used appropriately. However, seek *independent* advice when evaluating a product that is marketed to you. Shop around when obtaining prices. The market is certainly getting more competitive, and a bit of homework may save substantial amounts of money.

We are pleased to announce that Absolute Return Partners has engaged Strategic Economic Decisions (SED) to provide economic and strategic research to the firm and its clients. SED is under the management of the famous American economist Dr. Horace W. Brock – better known as Woody Brock.

Dr. Brock, who is the founder of SED, has for more than 20 years researched structural changes at both the macro and micro level of global economics. His research has often had profound implications for financial markets and we are proud to be associated with Dr. Brock and SED.

Our access to one of the leading independent economists in the world will provide us with yet another dimension in our decision process, and we are convinced that our co-operation with SED will bring considerable value to Absolute Return Partners and its clients.

We are delighted to announce that Nick Rees has joined Absolute Return Partners as our new Business Manager, with responsibility for risk and overall business management. He is joining us from the Bank of New York where he has been involved with implementing risk management and control systems. Before that, he worked for Goldman Sachs on the capital markets side.

No changes have been made to the model portfolios this month.

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