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The summer is over. Well, perhaps not quite yet. We have been enjoying spectacular weather in London over the past week, which, by the way, shall not be used as an excuse for getting this letter out about a week later than planned. However, sometimes things happen which force you to change plans. In this case, John Mauldin decided to spend a few days with us in London. For those of you who do not know John, he writes a weekly newsletter which has about 1.5 million subscribers.

The letter is free and can be found on his website (www.frontlinethoughts.com). We always enjoy reading John's letters which we find incredibly inspiring. Suffice to say, we can think of many inferior ways of spending ½ hour every week than in the company of John and his pen. John is also a highly respected investment advisor with a thorough knowledge of the hedge fund industry.

This month we focus on two items. In the first article, we take a closer look at the mixed signals we are getting from the bond market at the moment. Quite frankly, we are concerned about the discrepancies between oil prices and bond yields. For those of you too busy to read this letter from A to Z, we reach the somewhat uncomfortable conclusion that the recession risk is on the rise, perhaps significantly so.

The second article is dedicated to a theme that we often get questions one, namely the meaning of the term risk-adjusted returns. We touch on a lot of related terms, such as standard deviation, Sharpe ratio, etc. For those of you who do not feel at home with these terms, the article is highly commendable.

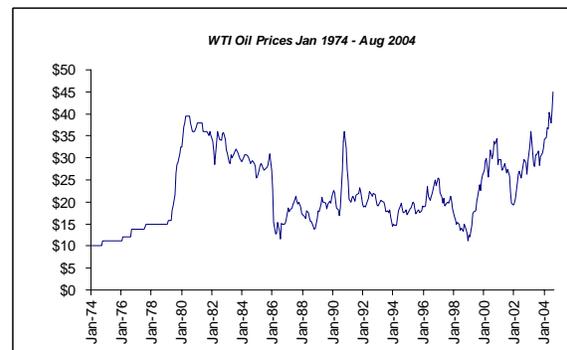
What Is the Bond Market Telling Us?

Something is not quite right. Oil prices are well over \$40 per barrel¹. Year-on-year, this makes for an increase of about 45%. As far as we know, oil prices have never risen 45% year-on-year before, without having at least some impact on inflation.

In other words, bond yields should be rising as well, as inflation expectations grow. But exactly the opposite is happening. After peaking in mid-June at 4.87%, 10-year U.S. Treasuries are now yielding

4.25%, and 10-year euro-denominated government bonds are currently yielding 4.13% after hitting 4.43% in June.

Chart 1 - West Texas Intermediate (WTI):



It could be a fluke. However, we do not believe in flukes. Bond markets tend to behave rationally, so bond investors must have concluded one of the following:

- (1) Oil prices will come back down and the current spike is of little concern longer term.
- (2) The rise in oil prices will only have transitory effect on inflation and hence should have limited impact on bond yields.
- (3) Oil prices at \$43 per barrel are inflicting much less damage than generally perceived, partly because inflation has taken its toll since we last hit these levels (spring of 1980), partly because most countries today are far more energy efficient than 25 years ago.
- (4) The economy is weakening faster and more dramatically than generally assumed, hence the yield curve is in the process of inverting.

This is a lot to cover in one letter, so please forgive us if our conclusions come thick and fast. Let's begin with the easy part. Why are oil prices so high? There are basically three reasons: The fundamental balance of supply and demand, psychology as well as speculation.

As far as the supply/demand function is concerned, it is now widely accepted that most observers

¹ WTI currently stands at \$42.78 (as at 03/09/04)

underestimated the Chinese appetite for oil at a time where supply was seriously constrained. This tipped a very finely balanced market. Furthermore, the refinery situation in the U.S. continues to be precarious with capacity utilisation rates running at about 95% on average. 90% of all oil consumption in the United States imports goes towards transportation. Many states have different refining standards, making it difficult (sometimes impossible) to use excess refining capacity in one state to meet demand somewhere else. This puts upward pressure on prices.

Secondly, as far as psychology is concerned, the fear of further terror action, has been, and continues to be, a major factor. With Iraq being as unstable as ever, it is little wonder that psychological factors have had a say on the pricing of this precious commodity.

Finally, with equity and bond markets providing little excitement, there is no doubt that speculators, including hedge funds, have had a field day, causing the price to overshoot on the upside. In a recent research report by Morgan Stanley, it is suggested that the fundamentally "correct" oil price is about \$33 per barrel². In other words, the risk premium caused by psychological and speculative factors remains \$10 per barrel, even after the recent drop in prices.

Let's go back to the main focus of this article – why are bonds telling us a different story from that of oil prices? We will start with our first point above. Short of a world-wide recession, demand from Asia should absorb any momentary drop in demand from Europe and/or the United States caused by slowing economic growth. In other words, in order to see oil prices drop back to the \$20-30 range, supply would have to rise, since demand is not likely to fall enough to fix the problem.

The problem with this line of thinking is that oil supply is highly unlikely to rise meaningfully. Oil producing nations and oil companies alike have underinvested for many years. In the Middle East, there has not been a major new find for over 30 years. According to recent data from OPEC, member countries drilled 6.5% fewer wells in 2003 when compared to 2002. This is a staggering statistic, considering how well oil priced did last year.

The lack of appetite for drilling is a major problem for the industry. As a result, and as pointed out in earlier articles, we actually believe supply will start to fall within 5-6 years, even if considerable amounts of money were dedicated to new exploration tomorrow (which is not the case). In other words, we do not buy the first argument.

The second argument carries some validity. It is in fact the very argument used by Greenspan & Co for not worrying unduly about oil prices as they currently stand. The Fed takes the view, rightly or

wrongly, that the recent spike in oil prices will do little damage, both inflation-wise and growth-wise. Based strictly on anecdotal evidence (which is a level of research we can relate to), we hear different stories. We hear that corporate profitability on both sides of the Atlantic is getting squeezed – in some cases significantly so. We also hear that consumers are getting a lot more cautious. So the inflationary impact from higher oil prices may indeed be transitory, but it may come at a hefty price. Economic growth both in the U.S. and on this side of the pond may be about to slow considerably more than what most economists will admit to. The risk of this scenario is a word starting with "stag" followed by "inflation". Not the nicest word in the vocabulary.

The third point is very true. Oil prices peaked in 1980 at about \$42 per barrel. In today's dollars, it would be close to \$100 per barrel. At the same time, most countries have become significantly more energy efficient. In Germany and France, for example, they actually consume less oil today than they did 25 years ago, even in absolute terms. This is not true for the largest economy of them all, though. The United States consumed about 15 million barrels per day at that time. The daily consumption is now in excess of 22 million barrels.

The problem with this argument is that it creates complacency. *"We don't have to worry - the oil price isn't really that high."* I am sure you have heard this argument yourself. When people say you don't have to worry, it is usually the time where you have to worry the most. The other problem we have with this argument is the psychological effect all the talk about high oil prices is having on consumers and business people alike. A few examples of this:

In Britain, retailers talked about an *Armageddon August* after experiencing extremely weak trading conditions. The Halifax house price index also fell for the first time in almost two years, indicating that the UK housing boom may finally come to an end.

Across Euroland, retail sales are also weakening according to a new survey released by Bloomberg. The reason? Concerns about job losses. This threatens to put a premature end to a recovery that has hardly begun.

In the U.S., the statistics are telling very much the same story. Non-farm payrolls, real wage growth, consumer confidence, etc. all tell a story of slowing momentum. Also, we would not underestimate the significance of Intel's profit warning last week. The language was uncharacteristically subdued and signals difficult times ahead – not just for Intel but for U.S. industry in general.

In Thailand, department stores and petrol stations have been forced to close for business earlier than usual. Billboards will no longer be lit after 10pm. All of it to save energy. In some states in India, duties on gasoline and diesel have been reduced from 20% to 15% in order to reduce the pain.

² Morgan Stanley's model is based on normalised inventories.

We may have become more energy efficient in the West, partly because we now produce fewer goods in our part of the world. But the pain will be felt anyhow - directly or indirectly. Whether an oil price of \$42 is really only about \$17-18 in 1980 prices, is quite irrelevant if consumers put their brakes on spending, and companies experience a squeeze on profit margins.

The fourth and final point is probably the most difficult to deal with. However, we know from experience that an inverted yield curve³ is about the best indicator we have when it comes to predicting recessions. Rarely do yield curves invert without recessions coming about within 12-18 months. Obviously, it is too early to say whether the yield curves in the U.S. and Euroland are in the process of inverting, but we are certainly prepared to go on record suggesting that the bond market is far superior at telling us what is really happening than the combined pool of economists around the globe. Their track record, as far as predicting recessions is concerned, is average at best.

This fact is the main reason we are paying more than just a passing attention to the phenomenon - falling bond yields against rising oil prices. The market is trying to tell us something. Unfortunately, we will have to wait a bit before we find out exactly what it is, but the feeling is not good. The risk of a recession hitting us in 2005 is rising by the day.

The contributors to this newsletter are divided as far as the wider repercussions are concerned. One camp believes very strongly that the deflationary ghost has not been put to rest and that it is only a question of time before it rears its ugly head again. The other camp takes a somewhat different view, believing that rising commodities prices will keep us from drifting back towards deflation again. About the only thing we agree on at the moment is that things are not quite right. Whatever that means.

Risk-Adjusted Returns

Every morning, I take the early bird to Vauxhall Station. From there I run across Vauxhall Bridge (which offers beautiful views of London), along the Thames and then up through Pimlico, Belgravia and Hyde Park, before arriving at our offices in Davies Street, Mayfair. London is more peaceful this time of day, and the run clears my head and prepares me for a long day at the office. However, the run also provides some insight into the mysterious workings of the human mind – in particular regarding people's view of risk and reward.

As I exit the station, there is a pedestrian crossing with cars coming from two directions – one of which is a blind corner, often rounded by your average amateur Michael Schumacher at high speed. At any

given time, some 10 to 20 people are waiting eagerly to cross the road. More often than not, one or two pedestrians will trigger a flood of other pedestrians to run across this very busy road.

There are two interesting observations on offer here. First, it is intriguing that the actions of one or two people can trigger an immediate reaction from many others. The pedestrian bodies jerk instinctively as soon as the first adventurer starts running across the road. A host of others immediately follow the lead. The notion seems to be that "if he does it, it is probably okay to do the same, even though I have no idea if a car is actually coming around the corner". Obviously, there is a lesson here regarding investor behaviour, but that is a topic of a book in itself⁴.

The second interesting observation is that people often show very little understanding of the concepts of risk and reward. Think about the setting described above in terms of risk and reward. The reward collected by pedestrians crossing the street is that they may get to work some 5 to 7 seconds earlier. The risk is that they are hit by a high speed car. Does a reward of 7 seconds in added office time justify the risk of being hit by a car - even if that chance is relatively small?

Granted, life is full of risks that we simply have to take to lead normal, healthy lives. However, some risks are simply not worth taking. This is as true in everyday life as it is in investing. Sometimes the rewards do not justify the risk. In other words, our risk-adjusted return is unsatisfactory.

There are numerous ways to measure and define risk-adjusted returns, but think of it as the reward you get for each unit of risk that you take. For instance, if your reward is 10% and your risk is 20%, you get 10% divided by 20%, or 0.5% return, for every unit of risk you take.

In the world of investing, standard deviation is the most frequent measure of risk. The standard deviation has an unjust reputation for being a complicated term (probably because quite a few investment professionals who have never calculated a single one in their lives will use it indiscriminately).

The truth is that standard deviation is actually a very simply measure of how much individual results differ from the average result in any given period. You calculate the average of a series of numbers. Then you calculate the total deviation from the average and divide by the number of observations to get an estimate for the deviation of any given data point.

This is a simplistic description, but hopefully it provides an intuitive understanding of what the standard deviation is. Please note that if your portfolio offers exactly the same return every period

³ A yield curve inverts when the yield on long bonds fall below the yield at the short end.

⁴ If you are interested in this topic, look for books in the area of behavioural finance.

(most investment professionals use monthly returns for this purpose), the standard deviation is zero. The more the return of your portfolio deviates from the average, the higher the standard deviation is.

You will sometimes hear us talk about a one or even two or three standard deviation event. Think about your returns as data points. One year you are up 8%. The next year you are down 3%. A one standard deviation event is industry slang for saying that, statistically, in about two years out of three, your return will be within a range of say -3% to +8%.

Likewise, a two standard deviation equals 95% of the time and a three standard deviation 99%. So, when someone says to you that it requires a three standard deviation event to lose money on this investment, it actually means that only in about one of two hundred years are you likely to experience a negative return.

Now, let's move on to an example that illustrates all of this. We have created two hypothetical portfolios, both with a five year investment history. However, the returns of Portfolio A are a lot more volatile than those of Portfolio B.

Annual Returns for portfolios A & B:

Year	1	2	3	4	5
A	11%	25%	5%	-19%	13%
B	6%	9%	8%	1%	6%

Which one would you rather have invested in? Let us look at some simple statistics:

Portfolio A:

Simple average annual return: 7%
 Standard deviation: 14.5%
 Risk-adjusted return: $7/14.5 = 0.48\%$ per unit of risk
 Total return over 5 years: 33.35%

Portfolio B:

Simple average annual return: 6%
 Standard deviation: 2.8%
 Risk-adjusted return: $6/2.8 = 2.14\%$ per unit of risk
 Total return over 5 years: 33.59%

Now, what can we conclude regarding risk-adjusted returns, bearing in mind that the total return of the two portfolios after 5 years is roughly the same?

Firstly, unless you are an adrenalin junkie who enjoys the thrills of highs and lows, you should prefer Portfolio B over Portfolio A. The total returns are virtually the same, but Portfolio A is likely to give you an ulcer in year 4. Portfolio B offers considerably more stability, more or less the same end-result, and therefore higher risk-adjusted returns.

Secondly, as far as Portfolio A is concerned, you know that your simple average return is 7% and that your standard deviation is 14.5%. Would you

have the stomach to stay in this investment, should you run into a two standard deviation year – i.e. a loss of 22%⁵? A two standard deviation event in Portfolio B would still keep you in positive territory.

Bottom-line, if you are willing to take large risks (i.e. high standard deviation⁶), should you not at least have a portfolio that ensures the highest expected return for that risk? Or to go back to my original point – if you take the risk of being hit by a car – should you not be rewarded accordingly for that risk? At *Absolute Return Partners* we certainly think so.

And here is a final clincher for you. Even though the simple average annual return is higher in Portfolio A, Portfolio B would actually make you (slightly) more money over the 5 year period. Why? Because large losses do more pain to portfolio returns than most people realise. If you lose 10% in year one, you need to make 11% to break even. If you lose 19% (as in the above example) you will need a 23.5% return to break even.

Imagine that you lose 50% in one year and earn 100% the following year. The average return⁷ is thus 25%, but in the real world you have not made any money at all. You are only back at break even, as it takes a return of 100% to recover from a loss of 50%.

Therefore, should you forget everything else in this article, at least remember the following two points:

1. Only if you optimise your risk-adjusted returns are you properly rewarded for the risks you take.

The risk-adjusted returns in your portfolio can probably be enhanced. Why not reduce the risk without sacrificing the expected return or, alternatively, increase your expected return to properly match the risk you are prepared to take?

2. Stable, positive (i.e. absolute) returns without significant losses are key to good results.

Given our expectations for equities, we believe this will be truer than ever over the next decade.

A quick word on the Sharpe ratio:

You will often see the so-called Sharpe ratio reported by investment managers. The purpose of the ratio is much the same as in the above – to provide a measure of risk-adjusted returns. The one difference from our simple approach above is that the Sharpe ratio involves the so-called risk-free rate of return.

Think of the risk-free rate of return as the return that involves neither credit risk nor interest rate risk. Three months LIBOR is often used as a proxy for the risk-free rate of return. Since you choose to invest in other assets, the return you earn from

⁵ This is calculated as the average return less two times the standard deviation.

⁶ Obviously, volatility risk is just one of many possible measures of risk.

⁷ This is also called the arithmetic return.

these assets should (in theory at least) be measured as the excess return over and above the risk-free rate of return. This excess return is also known as the risk premium, as it is the premium you expect to collect by taking risk. The Sharpe ratio is therefore calculated as:

$$\frac{\text{Return on Asset X} - \text{Risk-Free Rate of Return}}{\text{Standard Deviation on X}}$$

As usual, feel free to call or write with any questions or comments.

Other News

We are pleased to announce that Jan Vilhelmsen has joined Absolute Return Partners as a Partner with effect from 1 September 2004. Jan has 16 years of experience from the financial services industry. In his last job in the City, Jan was an Executive Director of Lehman Brothers with responsibility of marketing the firm's equity products into the German market. The appointment of Jan will strengthen our investment management capabilities significantly, and we are proud to have him amongst us.

New Publication

Around 1 October, we will be launching a new quarterly publication named *Portfolio Strategy*. The intention is to provide our clients with more specific ideas on how our thoughts can be put effectively to use in the markets. Please let us know, should you be interested in receiving this publication.

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