



The Absolute Return Letter

October 2004

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Before we engulf ourselves in this month's main topic, the upcoming U.S. elections, we would like to take the opportunity to introduce you to our new, improved web site which was released over the weekend. You will find plenty of new content on www.arpllp.com. Unfortunately, during the final testing last week, we re-sent the September newsletter to a number of people on our mailing list. We apologise for this mistake.

Now to the main topic. This month, we focus on the U.S. elections which are scheduled for the 2nd November. We usually don't comment on politics, but given the profound effect this particular election is likely to have on all of us, we decided to dedicate this month's letter to the subject of politics. Going forward, we will, however, continue to provide food for thought on financial markets.

Below we argue that all is not over for Senator Kerry. Bush looks likely to win, but Kerry has got certain things going for him as discussed below. Perhaps surprising to some European readers, we also suggest that Bush, despite all the strong feelings he stirs around the world, is in fact better for financial markets than Kerry. Bush is also, deliberately or not, helping to reunite a Europe which has suffered badly in the aftermath of the war on Iraq.

In our second article, we bring the results of an interesting new survey on hedge funds. Consider this article an appetiser ahead of the launch of our new quarterly publication, 'Portfolio Strategy', which is due out in about ten days. In our inaugural issue, we argue why hedge funds belong in most portfolios, regardless of risk profile.

We finish with an essay on terrorism, from a game theoretical point of view. We argue why the War on Terror is a very different war to the ones we have fought in the past and we discuss how best to prepare for it. Enjoy the read.

It's Not the Economy, Stupid!

A couple of weeks ago, U.S. Secretary of State, Colin Powell gave a speech in which he was referring to the security situation in Iraq. Talking about the Iraqi rebels, he volunteered the following opinion: "Yes, *it's getting worse, and the reason it's getting worse is that they are determined to disrupt the election*". One wonders whether Mr. Powell was merely referring to the Iraqi

elections or perhaps to the U.S. elections as well.

Think about it for a minute or two. Osama bin Laden is still on the run. Americans working in Iraq are beheaded on TV. U.S. soldiers are killed every single day. It is not an exaggeration to suggest that the situation in Iraq is deteriorating quite badly at the moment. On the domestic front, the U.S. budget deficit is worse than ever and the current account deficit shows no signs of improvement. Many ordinary Americans still believe the economy is in recession because, to them, it feels like it, because their jobs are being exported to Asia.

Against this backdrop, you may actually be forgiven for thinking that Senator Kerry stands a very good chance against the incumbent president on 2nd November, when America decides who shall lead the country for the next four years.

Yet, it seems a forgone conclusion amongst political observers that Bush will win. Why is it that Bush has been able to shrug off everything that the world has thrown at him, only to come out stronger against an opponent who seems to have been in virtual freefall since the Republican convention a few weeks ago?

Kerry's main problem appears to be that Americans don't seem to trust him, just like most Europeans don't trust Bush. A recent Gallup poll indicated that only 38% of voters consider Kerry "honest and trustworthy". The early stages of Kerry's campaign were built around his Vietnam War credentials, a strategy which spectacularly backfired when accusations of lying were brought against him.

For Kerry to regain the momentum he had earlier in the summer, he needs to refocus his campaign. However, by doing that he provides more fodder for the Bush campaign which has successfully argued that Kerry cannot be trusted because his views change with the wind.

Bush, on the other hand, is delivering an incredibly simple message – "*War on Terror*". By keeping it simple, the American people (rightly or wrongly) feel they know exactly what they are getting, and what they are hearing they are comfortable with. As The Economist pointed out last week, most Americans have a soft spot for Bush but many also have a sneaking worry about his competence.

This, in theory, should put Kerry in a very commanding position. All he supposedly has to do is to convince the nation that he is a natural leader. But that is easier said than done. Either you have it or you don't.

Furthermore, the economy is doing just a little bit too well now to make that an election issue. Kerry has tried hard to win some sympathy, particularly in the Midwest, arguing that America needs to protect its jobs better. Parts of his election manifesto (if implemented) will put America on collision course with the WTO and leading industrialised nations. It is not unreasonable to label at least some of his ideas as outright protectionist.

As a footnote, and for that reason alone, we would argue that Kerry as president is more problematic for financial markets than a re-elected Bush would be. Markets can certainly live with wars. They can also, to a degree, live with terrorism. But financial markets DO NOT like protectionist policies, full stop.

Even if we dismiss Kerry's protectionist singing and dancing as pure rhetoric to mobilise the blue collar workers of the rust belt, it is difficult to get a real sense of his economic programme. For example, when questioned on his plans to reduce the escalating budget deficit, his answers have been extremely vague. There appears to be no plan, quite frankly.

In some ways, when difficult decisions have to be made regarding economic policies, it is better to end up with a president who sits his second term (because he cannot get re-elected anyway). In other words, one can make a convincing argument that Bush is far more likely to address the imbalances of the U.S. economy than Kerry is. Should that happen, financial markets are likely to react quite favourably.

Now, if Kerry cannot play the economic card, as Clinton did so eloquently years ago, and the message needs to be simple, what can he do? Well, as is evident from the last couple of weeks, he has chosen to play the Iraq card, arguing that he can do a better job than Bush in that regard.

The problem with this strategy is that the average American tends to think that the Republicans are much better suited to lead the country through difficult times such as these. Kerry is facing an uphill task convincing his countrymen that he would be a better wartime president than Bush.

But perhaps it is not all over yet for Kerry. Kerry evidently did quite well in the first televised debate last week. According to most political analysts, he scored better than Bush and has managed to reinvigorate a floundering election campaign.

The focus that night was very much on national security and Iraq. There are signs coming out of the Kerry camp that he will now attempt to move the debate away from foreign policy towards domestic policy. We question whether he will succeed with this strategy, partly because the Republicans won't allow the subject of national security to be dropped (it is their strongest card) and partly because the economy

is doing too well for the strategy to work (as discussed above).

Secondly, people who oppose Bush do so with a vengeance. For that reason, the turnout is expected to be higher than usual, and that will almost certainly favour Kerry. A recent Gallup poll supports this line of thinking. Asking regular voters who they favoured, Bush had a comfortable 13-point lead. When asking all registered voters, though, the contest was virtually 50/50.

In the meantime, Europeans are watching with more than passing interest. The president of the United States is, after all, more important to our security here in Europe than virtually any other human being on this planet. And, for once, Europeans seem to hold strong opinions on both candidates, but in particular on Bush, whom the majority of Europeans are strongly against.

In Germany, only about 20% of the electorate prefers Bush, and in France the support for Bush is an appalling 5%. Even in Britain, usually considered the most loyal supporter of the United States, a clear majority of voters would vote for Kerry, according to a recent poll.

Ironically, the strong feelings against Bush in countries such as Germany and France appear to be working in his favour as American voters rally behind him in the face of international opposition. Also, as a European diplomat suggested in the Financial Times a week ago, a Bush win is actually not as bad as every European seems to think. *"If Bush wins again", he said, "We will both start with thoroughly low expectations of each other. That is not a bad place to begin from".*

Also, within Europe, the opposition against the U.S. led war in Iraq has had a surprising side effect, according to people in Brussels. The conflict has effectively created a divide between "Old Europe" and "New Europe", which has done considerable damage to inter-European relations. Supposedly, both sides of this divide have shown a real willingness to put such differences behind them in recent months, as they started to realise the damage it did to everyone. A Bush victory should, quite ironically, further this process, leading to a more united Europe at the end of the day.

However, transatlantic relations face big challenges going forward. Politicians, being the sorts of animals they are, often look at polls before they form an opinion. In a recent poll, published in the Financial Times last Monday, 60% of Americans said 'yes' when asked: *"After Iraq, should the US/EU partnership become closer?"*, whereas less than 30% of Europeans thought so. With opinion polls like that, it may be tempting for some European politicians to further distance themselves from America. And, as we noticed from the terror bombings in Madrid, that is the same as inviting Osama bin Laden's people into our own backyards.

Secondly, there is a school of thought in America that countries such as Germany and France matter less and less as far as U.S. foreign policy is concerned,

whereas the energy should be spent on building bridges with “frontier” states such as Pakistan and Egypt. If this philosophy prevails, and it is more likely to prevail under Bush than Kerry, then we can expect the new administration to care less and less about antagonising Europeans. And that is not good news.

Projected Outcome:

Bush to win but with a lower margin than currently predicted.

According to Buysseasons, a costume company, sales of Bush Halloween masks are outselling Kerry masks by 57% to 43%. Spookily, sales of Halloween masks have correctly predicted the results of the last six elections.

Source: CNNmoney.com

Dispelling the Hedge Fund Myths

The topic of hedge funds is as timely as ever. Everyone seems to have an opinion on the subject, even people who very obviously do not know what they are talking about.

The last few months have seen some high profile articles debating the subject from a negative angle. In May, Forbes featured a cover story under the title “*Hedge Funds: the Sleaziest Show on Earth*” and last month Bill Gross, the CIO of Pimco, titled his monthly investment outlook “*Lemonade for Sale*”. Both articles offered a very subjective but negative view of hedge funds.

For a more balanced view it is worth taking a look at the results of the Hennessee Group’s 10th Annual Hedge Fund Manager Survey. Whilst surveys will also contain an element of subjectivity, this one includes responses from 789 hedge funds from 174 management companies with more than \$144 billion of assets under management. We believe it to be a comprehensive study which offers some perspective to counter the negative views of certain observers.

Are we seeing a hedge fund bubble building? According to the survey, assets grew 34% to just under \$800 billion during 2003, accounting for less than 2% of global financial assets. Of the 34% growth, only 14% came from inflows, the remaining 20% was performance driven.

The total number of hedge funds grew by 23% to approximately 7,000 funds. It is worthwhile noting that more than 50% of all hedge funds have less than \$25 million and 17% have less than \$5 million under management¹.

Hedge fund returns have been measured and criticised on more than one occasion. Hennessee has tracked the performance of hedge funds since 1987, and their results indicate an average return of 15.34%

versus the S&P500’s 12.11% for the period 1987-2003. The average hedge fund return was generated with 40% less volatility than that of the S&P500.

In this context, it is interesting to note that mutual fund managers often have difficulties meeting their benchmarks. It is widely known that more than 75% of all mutual fund managers underperform their respective benchmarks each year.

The survey also found that individuals and family offices account for 44% of assets under management whereas pension funds only account for 9% of the total.

The issue of fraud, which we come across regularly, was brought up again in the Forbes article. Many observers are of the opinion that the hedge fund industry has a major problem with fraud. The Forbes article lists 8 frauds which total just over \$1 billion. By looking closer at the numbers it appears that two funds (Lancer and Safe Harbour) account for 97% of total losses from frauds. When comparing this to the magnitude of losses stemming from the hundreds of billions of dollars lost in corporate scandals like Enron, Worldcom, Tyco, Parmalat etc., it suddenly appears less of an issue. Not to mention the problems we experienced in the mutual fund industry last year.

The final point we wish to make here is rather more difficult to quantify. We believe that structural changes in the industry have made some of the most talented portfolio managers leave the large banks to set up their own shop. The investor will now have to search more carefully to get exposure to the best talent which is now often found at smaller independent investment management boutiques – often hedge funds.

Our conclusion is inevitable. Hedge funds belong in a balanced portfolio. With proper due diligence, mistakes can be avoided, but that is always the case, be it traditional or alternative investment products. In our inaugural edition of our new quarterly publication, *Portfolio Strategy (due out mid October)*, we will provide some examples on how hedge funds can help you to achieve higher risk-adjusted returns.

If you need to brush up your fundamental knowledge about hedge funds, why not visit our web site? (www.arplp.com). In the newsletters dated November 2003 and December 2003 you will find two feature articles providing basic background information on all the major hedge fund strategies.

The War on Terror

In the following, we attempt to provide a few thoughts on the situation in Iraq and the War on Terror. We will lean heavily on Dr. Woody Brock’s recent essay “*A Game Theoretical Perspective on Terrorism*”. For those of our readers who do not know Dr. Brock, he is our Chief Economics Advisor and head of Strategic Economics Decisions (SED).

Absolute Return Partners has arranged for Dr. Brock to speak in Copenhagen on the 7th of December at 10 am. Here Dr. Brock plans to address the state of the

¹ Source: Capco Institute (*The Journal of Financial Transformation*)

world economy. Please contact us at info@arpllp.com if you would like to attend this event.

Dr. Brock uses John Nash's "*Theory of Optimal Threats*" to discuss the global War on Terror. In Nash's game, the players select an "optimal threat". This selection is based on a simple, yet terrifying, concept: Maximise the damage done to the opponent minus the damage done to you.

So which hand would you rather play in this game – the hand of the terrorist or that of the "Great Power"? Whether or not you are a game theory expert (we are certainly not), it is obvious that the situation favours the terrorists over the Great Powers for a very simple reason. They can impose enormous damage on us at little cost to themselves, because they have nothing to lose.

Terrorists have shown greater capability and resolve than we would have thought possible only a few years ago. The Great Powers, on the other hand, are in more of a predicament. You can destroy your opponents when you locate them but how do you find dozens (or even hundreds) of tiny cells around the globe? As we have seen repeatedly, just one of these cells can do immense damage. And how far are we prepared to go to protect our citizens? Just think of the cost (and hassles) of airport security.

Dr. Brock argues that most events in history are by definition unpredictable – even world wars or, more specifically, the scale of these as they unfold. And the War on Terror is in effect World War IV (with the Cold War being World War III). Our best line of action during these times is not to dwell on "*why it happened?*" but rather to ask ourselves: "*What are we learning about our enemy and ourselves and how should we best respond to what we are learning?*".

Importantly, we have already learned that Iraq is not the main story in the War on Terror. This war is being fought cell-by-cell around the world. Secondly, we now know that implementing democracy is an extremely difficult process of trial and error in which there is no guarantee of success. The war in Iraq has created the unlikely alliance of Saddam loyalists and religious fundamentalists. In other words, the challenge is not – as virtually everyone thought - to satisfy different ethnic groups in Iraq.

Thirdly, and most importantly, we are learning some fundamental facts about the nature of the enemy that we should all keep in mind. Allow us to quote Dr. Brock "*We are learning what it is these groups seem to want the most: A most Taliban-style theocracy that is utterly opposed to democracy, to education, to science, and to women's right. We are learning this is not only in Iraq, but also in Afghanistan, Egypt, Indonesia, Chechnya, the Philippines, Saudi Arabia, North Borneo, and elsewhere. Nothing else will seemingly satisfy these nihilists. And learning that changes everything*".

Finally, as Dr. Brock points out, we have witnessed a surprising level of grass root support for the terrorists' "cause". Given the comfortable lives most of us in the free world enjoy, it is difficult to comprehend the

misery of so many millions. From their point of view, it is all about whether they believe tomorrow will offer better opportunities than today's world does. In places with little hope of a better tomorrow, support for radical action breeds.

So what can we learn about ourselves and what is required of us in the future? Dr. Brock argues that this is a great time for all of us to realise what we are willing to do about terrorism. From a game theoretical point of view, most countries get a free ride from the U.S. since it is assumed that the U.S. will eventually do the dirty work. In other words, the question is only truly answered, if the U.S. pulls out of the War on Terror and leaves the rest of us to figure it out.

In terms of the future, the importance of "binding agreements" is evident. These cannot truly occur in societies where new governments abolish existing agreements (as the newly appointed Spanish government so blatantly did). The solution to this is obviously a complex one, since we are not prepared to abolish democracy for the sake of a promise. It involves incentive - and consensus - building and the continued reinforcement of coalitions. In other words, a more nuanced view than the prevailing U.S. policy view ("*if you are not with us you are against us*") is necessary.

From this will arise the true combat of terror - an intelligence network of unprecedented size, trained to infiltrate and destroy the enemy. As Dr. Brock ends his essay: "*We should stop arguing about whether we can afford to enlarge the army by two hundred thousand soldiers. No such army will be needed because, in the future, full-scale invasions like that of Iraq will probably go the way of the dodo.*"

As usual, comments and questions on any of the articles above are very much welcomed.

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