The Absolute Return Letter November 2004

As this letter goes to print, Senator Kerry has just conceded defeat which means that President Bush has secured a second term in the White House. Although not exactly what most Europeans had hoped for, if we are to believe recent opinion polls, we have argued for a while that Bush is actually better for financial markets than Kerry.

However, this letter is not about politics but about the outlook for oil prices. We argue that oil prices could actually drop a little bit further in the short term, which should provide a welcome boost to equity prices. In the longer term, though, it is hard to see oil prices going anywhere but up, perhaps more than most of us can imagine.

In our second feature article, we take a closer look at the hedge fund sector. It is no secret that hedge funds have had a pretty mediocre year so far, at least by their standards. We shall discuss the reasons why this is, as well as why we believe you shouldn't give up just yet. In fact, we will argue that hedge funds belong in most portfolios, whether they are conservative, moderate or aggressive.

Has Oil Gone Off the Boil?

When the U.S. Energy Information Administration reported an unexpected rise in crude stocks, the oil price reacted immediately. Before the week was over, West Texas Intermediate (WTI - a light U.S. crude variety) had lost about 8% and settled around $51 per barrel. However, given the extraordinarily steep rise in oil prices in recent months, it was hardly surprising that traders reacted emphatically when faced with the first bit of bearish news for months.

In recent days, after further oil price weakness which has taken WTI down below $50 per barrel before regaining some of its losses, many people have put the question to us: Does this spell the end of the bull market for oil prices? Our response has been, and will continue to be, that it depends on the time horizon you look at. If you revisit the Absolute Return Letters dated March 2004 and April 2004 (both can be found on http://www.arpllp.com/newsletters.asp?section=00010022), you will see that we argued quite strongly back then that the world will likely face *much* higher oil prices in the years ahead.

None of the arguments we used in those letters have changed. In fact, we feel more convinced than ever that the world is on collision course as far as oil is concerned. Demand is rising faster than ever. Supplies are looking flat to down over the next 5-7 years. This can only mean one thing – higher prices to the point where substitution makes sense. Remember, people do not buy oil because they fancy it. They buy oil because it is a necessity; a necessity for industrial production and even more so for transportation.

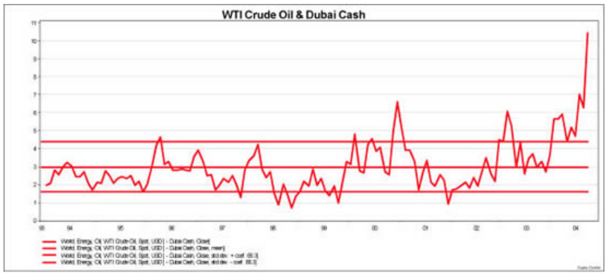
If oil prices were to exceed $100 within a few years, we can almost guarantee you that nuclear power will be back with a vengeance. Likewise, wind energy and other alternative forms of energy may suddenly be sustainable without government subsidies. So, when you speculate on higher oil prices, do not forget to include alternative energy sources in your portfolio, but that is material for another Absolute Return Letter.

Back to the question put to us. When we distinguish between the short term and the longer term, it is because something is troubling us, notably China. You may have noticed that almost everyone is blaming the rise in oil prices on China. We don't think it is that simple.

China (and with it, most of Asia) buys most of its oil in Dubai. Dubai Sour Crude is a lower quality crude than WTI (or Brent, our local variety from the North Sea). The spread between WTI and Dubai was about $5 at the beginning of the year. While WTI traded at about $34 per barrel, Dubai changed hands at about $29.

Now, here comes the punch line. Whereas WTI has risen 50% to $51, Dubai has gone up by only 34% to $39 per barrel. If China had been the main force behind rising oil prices, it is quite simply *inconceivable* that the spread between WTI and Dubai would have gone from $5 to $12 since the beginning of the year (see chart 1 below).

Chart 1: The Spread between WTI and Dubai Crude:



Source: GaveKal Research

In a brilliant article by GaveKal Research [1], another explanation is offered. Instead of China being the main culprit, oil prices have in fact been driven higher by "panic buying" by U.S. refineries. By the way, we have been so impressed by the work of GaveKal Research that we unreservedly recommend you to visit www.gavekal.com.

The argument runs along the following lines: U.S. environmental standards prevent U.S. refineries from buying their crude oil in the Middle East. They buy sweeter oil grades, primarily from domestic sources, Canada and West Africa. And, equally importantly, refineries cannot shut down. Not even for a minute. So, when U.S. refineries get worried about supplies, for example as a result of strikes in Nigeria or hurricanes in the Gulf of Mexico, they buy oil in the spot market to secure the all important supplies.

This would normally lead to increased *backwardation*. Backwardation is a term used primarily by commodities traders and describes when spot prices trade higher than contracts for future delivery. Backwardation is the normal condition for commodity futures such as oil and is a function of factors such as the cost of carry (the cost of warehousing the commodity until the day of delivery), the risk of supply interruptions (hurricanes, strikes, etc.) and seasonality (increased use of heating oil in the winter). If the market is very nervous, you would expect the spot price to rise much faster and further than future delivery prices.

Now, with the oil market being as nervous as it is, you would certainly expect backwardation to be quite substantial at the moment. Research performed by GaveKal suggests that WTI backwardation is two standard deviations from the norm. In plain English, two standard deviations means that we are dealing with a "1 in 40 years" event. In other words, the current backwardation is not only sizeable. It is extreme!

The tricky part of this analysis is not so much the conclusion (i.e. China receiving the blame for something they probably do not deserve) but how to interpret it. ***If*** oil prices have been driven up not by China but by U.S. refineries securing short term supplies in a nervous market, then a further drop in the price of oil is quite possible. And ***if*** the backwardation argument holds water, then one would expect prices to drop to the point where backwardation falls into its normal range again. All this suggests that WTI could possibly fall back to the low to mid fourties again, as the current supply driven concerns recede.

The problem with this line of thought is that markets have been rattled to their bones over the rapid and unexpected rise of the oil price, and this nervousness will not easily disappear. Furthermore, whether China is to blame or not, it is hard to ignore the naked facts about the Chinese economy. China is today a very oil inefficient economy. When compared to the average OECD country, China consumes 2.3 times as much oil per unit of GDP produced.

Oil consumption per capita in China is about 1.7 barrels per year. The equivalent number in the United States is 28 (courtesy of the SUV culture amongst other things). Other highly industrialised countries such as the EU, Japan and Korea all consume between 15 and 20 barrels per year for every man, woman and child there is.

We do not suggest for one second that China will reach Korean or Japanese standards anytime soon, but spare this statistic a thought or two: If China were to reach the consumption levels of, say, Mexico (7 barrels per year), total oil consumption in China would rise from the current level of 5-6 million barrels to about 24 million barrels per day [2]. Today, the world produces 80 million barrels of oil daily, so the challenge is there for everyone to see, as China's appetite for oil grows.

Based on these observations we would certainly agree with most market observers that the current oil price spike is primarily demand driven, as opposed to previous crises which have all been supply driven. This is important because it means that the damage to the world economy is likely to be somewhat smaller this time.

However, there is one element in the whole equation which has been pretty much ignored by everyone, and that is the link between commodities prices and monetary policy. With the risk of sounding arrogant we think this area is relatively poorly understood. In fact, little

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[1] *You can read the article in its full length by going to http://www.arpllp.com/show_item.asp?itemtype=commentary&ignorepaging=1&section=00010028&id=164*

[2] *Source: Marc Faber: "How High will Oil Prices Climb?", October 2004.*

research has ever been conducted into this particular field.

We are at risk of opening a Pandora's Box here, so suffice to say that whatever research *has* been conducted in this area suggests that periods of "*easy money"* (i.e. when real rates of interest are low) tend to fuel a rise in commodity prices and visa versa. We can probably all agree that the last couple of years have been characterised by extraordinarily easy money.

With the Fed and the ECB in no apparent rush to bring rates up to where they "belong" as per traditional monetary thinking (where neutral monetary policy is considered to be about 2% over the rate of inflation, i.e. about 4% in today's environment), we can expect the current regime of easy money to continue for a while yet. One can only imagine what this will do to commodities prices.

Based predominantly on the backwardation argument, we conclude that the oil price is at risk of falling a bit further in the short term, as backwardation makes its way back to more normal levels. However, even moderate setbacks will probably be used by oil purchasing managers all over the world to increase their stocks, making it unlikely that we will see WTI in the thirties again anytime soon (if ever). Longer term, it is hard to see oil prices going anywhere but up, perhaps more than most of us can imagine.

Finally, what does all of this mean for equities and bonds? Goldman Sachs has just issued a report[3] where they argue that something's got to give. Basically, in a world of rising energy prices, a producer of goods can either try to pass on the increased cost to the consumer or he can take it on the chin (or it can indeed be a combination of the two).

In the first case, inflation will rise. Goldman Sachs suggests that a sustained increase in oil prices of 10% will result in increased inflation of 0.2-0.3% in each of the first two years. Remember, we are now dealing with an increase of 50% in our part of the world. In the latter case, profit margins will take a hit, quite possibly a substantial one.

The problem Goldman Sachs is alluding to is that bond markets are behaving as if profit margins will bear the brunt of the impact and equity markets are behaving as if it is the other way round. Obviously, they cannot both be right. If we were in the betting industry (which, I suspect, we are to a degree) we would be betting on bonds being on the mark and equity markets getting it wrong.

Unless oil prices fall dramatically from current levels, we believe that companies will wake up to a new reality in 2005 with corporate profits being under considerable pressure. This will undoubtedly reduce overall economic growth. As mentioned in last month's letter, things could actually turn so nasty that it will necessary to dig out the R word again (R for recession for those of you not used to our jargon), if not for 2005 then possibly for 2006. If we are right about this, equity markets will face a difficult 2005.

Then, on the other hand, should oil prices come back to the low to mid fourties, equities will almost certainly enjoy a temporary relief rally, which could last several weeks, even a few months. With the election uncertainty now behind us, the chances of a short lived rally in equities have actually increased substantially. We suggest you take profits if this were to happen, as we think there is more bad news to come as far as equities are concerned.

Bottom Line: Bonds will probably outperform equities next year, but a rally in equities over the next few months is a distinct possibility.

The next Absolute Return Letter, which will be published during the first week in December, will review in more detail our expectations to 2005 for all the major asset classes. As usual, we will get some right and some wrong but it should make for some interesting reading nevertheless.

Hedge Funds – Should You or Shouldn't You?

This article is a condensed version of an article by the same name, which can be found on http://www.arpllp.com/core_files/Hedge%20Funds%20031104.pdf

Why are hedge funds not delivering this year?

2004 will probably go down as one of the less inspiring years in the relatively short history of the hedge fund industry. Many reasons have been suggested by various sources. We believe three stand out:

1. *Low volatility;*
2. *The unwinding of the carry trade;*
3. *Supply/demand imbalances.*

Volatility, as you may know, is a measure of price fluctuations. When prices do not move a lot, it becomes a great deal more difficult to make money as the market "lacks momentum". No doubt, the majority of hedge fund strategies require momentum. They look for events, whether good or bad, to create volatility, because that is how they make money. In 2004, the hedge funds doing the best are the ones

[3] *Global Economics Weekly, 27 October 2004.*

driven by fixed income strategies and short-sellers. In virtually all other areas, it has been a rather eventless year. So much for the bad news. The good news is that volatility usually doesn't stay this low for very long. Something (good or bad) will happen sooner or later. The problem is nobody knows when.

The second point (the carry trade) relates to the leverage (gearing) applied by many hedge fund managers. The carry trade is an expression that describes the situation where investors borrow at the short end of the market (at a relatively low cost) only to invest in either longer dated bonds or other securities at a higher expected return than the cost of borrowing. Even if the hedge fund manager operates with small profit margins (as many do), returns can become quite attractive when using gearing. The problem arises when the cost of borrowing goes up, as it has done this year (at least when measured in $ or £).

The third point (supply/demand) has to do with the amount of capital flowing into the hedge fund industry. Only two years ago, the industry managed less than $600 billion in total. Today, the number is fast approaching $1 trillion. The growth in assets under management has been particularly strong in categories such as Convertible Arbitrage, Hedged Equity and Equity Market Neutral, creating a real problem for managers finding enough good ideas to invest in.

Should you be concerned about any of this?

Of the reasons listed above, one (low volatility) is probably short-term in nature, one (the carry trade) is a concern for the medium-term (i.e. for as long as short-term interest rates are on the rise) and one (supply/demand) is a genuine long-term issue.

If history is any guide, volatility *will* return to financial markets. It is only a matter of time. The problem created by rising short-term rates is a function of the economic cycle and managers will most likely adapt to this relatively quickly. From the investor's point of view, the issue is relatively easily dealt with, as there are many excellent hedge funds that apply only modest amounts of leverage (and also some really good ones that do not use leverage at all).

The supply/demand problem is by far the hardest nut to crack. You can reduce the effect this may have on your returns by investing in those hedge fund categories that are less capacity constrained and/or see lower inflows of capital. Over time, however, investors will start to redirect funds into those hedge fund segments showing higher returns (assuming they behave rationally), and results will probably start to suffer.

On the basis of this analysis we conclude that hedge fund returns over the next few years will likely be lower than those returns achieved over the past 10-15 years. There is now a lot more money chasing the same pool of investment ideas. The great bull market in equities is over and interest rates have entered a new cycle as well, where the cost of borrowing will be rising, at least for a while.

Should you invest in hedge funds at all then?

You may be forgiven for thinking that, if returns are likely to be lower going forward, does it make sense to invest in hedge funds at all? Why not just stick to what has served all of us well over the past couple of decades, i.e. shares and bonds?

Again, we offer three good reasons why you should consider hedge funds despite the lower expectations we have for hedge fund returns in general:

1. *Many hedge funds offer better risk-adjusted returns than you can achieve in bonds or shares.*

It is too simplistic just to look at returns when comparing different investments. Amongst other factors, one must also look at the risk involved. In short, you should focus on risk-adjusted returns. There are two reasons for this.

Firstly, high volatility is not for the fainthearted. Most people do not have the stomach to watch their investments swing wildly up and down. Therefore they react adversely – and irrationally – to volatility. Whereas they should be buying when prices are low and selling when prices are high, *they do exactly the opposite.*

Secondly, you should be rewarded for taking risk. A fundamental rule in finance is that risk and reward go hand in hand (bar the occasional exception). You should always choose the investment opportunity with the highest risk-adjusted return. If you choose a high volatility strategy, make sure you position yourself for the highest possible return.

2. *Don't expect returns on bonds and shares to be anywhere near the levels offered to investors over the past ten years, so even if hedge fund returns are falling, they will remain competitive.*

You should expect an annual return of no more than 6-7% on European equities over the next 5-10 years (best case). In the U.S. and Asia, you may be rewarded with slightly higher returns due to higher GDP growth. These estimates assume flat P/E levels. We actually expect P/E levels to come down, which is why we are openly speaking about 0-5% returns on equities over the next 5-10 years.

Bonds, meanwhile, have enjoyed a bull market as big and powerful as equities have. As mentioned in our September *Absolute Return Letter,* we are not terribly bearish on the bond market. We think economic growth both in Europe and North America will disappoint over the next 12-18 months, and bond yields should behave relatively well if that proves to be correct. But it is hard to imagine a big bond market rally when rising oil prices are putting upward pressure on producer and consumer prices.

Now, if bonds are set to deliver 4-5% annual returns and equities anywhere from 0% (worst case) to 7% (best case), hedge fund returns could still prove very attractive. If one assumes that, going forward, hedge funds can, for all the reasons discussed above, generate only half the returns they have achieved in the last decade, many hedge fund categories should generate annual returns of 6-8%. On a risk-adjusted basis, that is not bad at all. And if we do our job and identify the best managers, your actual returns could be higher than that.

3. *Including hedge funds in your portfolio helps diversifying overall portfolio risk.*

Assuming you own a portfolio of half bonds and half equities today, by introducing hedge funds to your portfolio, you can expect the same return on your portfolio for little more than half the risk. *This is the most important lesson from this paper!*

In our example (which, as mentioned earlier, can be viewed in full on our web site), we add three different hedge fund categories to the portfolio. The effect on the overall volatility is dramatic. ***This is the second important lesson.*** It is not always what the naked eye can spot that is the right thing to do. Sometimes you need to add components to your portfolio that do not look terribly attractive on a stand-alone basis.

Other Risk Factors

We must emphasize that volatility risk is not the only risk worth considering. There are other issues that must be taken into consideration before investing in hedge funds. We have listed some of the more important concerns below:

- *Many hedge funds are not regulated.*
- *Lack of transparency makes it difficult for investors to assess what they actually invest in.*
- *Infrequent redemptions and/or lock-ups may create liquidity crises.*
- *Higher fees hurt investment returns.*
- *Leverage (gearing) may amplify negative returns.*
- *Operational risk is generally under-estimated.*

Conclusion:

If the objective is to reduce risk, you should aim to spread your investments over a large number of non-correlated asset classes. So, following this philosophy, if your current portfolio is full of, say, UK equities, you should probably not be investing so much in, for example, Emerging Market and Hedged Equity funds as the correlation with UK equities is quite high in both cases. You should instead look at, for example, managed futures or fixed income arbitrage, where correlations are close to zero.

You should also never ignore the fact that the correlation between many asset classes increases dramatically during times of crisis. Think back to the days of the Russian debt crisis during the summer of 1998. During the peak of that crisis, asset classes that in theory (and also in practice for long periods of time) should be almost uncorrelated, suddenly moved more or less in tandem - and that was mostly down, to the regret of many investors.

Therefore, we do not suggest that correlations remain stable over time. They can in fact change considerably. But they still offer one of the better starting points for a proper approach to risk management. And the trick remains the same as always. If you wish for your portfolio to yield relatively consistent returns without the occasional big losses that stock markets tend to deliver from time to time, the best way forward is to invest in far more asset classes than what most investors tend to do today.

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

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The Absolute Return Partners Model Portfolio - 31st October, 2004