The Absolute Return Letter — December 2004

Over the next few pages, we shall, as we usually do around this time of year, provide you with a brief summary of how we view next year's outlook for various asset classes. We will throw a lot of conclusions in front of you but fewer facts to support those conclusions. If we didn't do it this way, the document would be 30 pages long, and you would most likely lose all interest along the way. As usual, you are welcome to contact us, should you wish for us to elaborate on any of the content.

In our second feature article, we try to respond to a frequently asked question: "What is it exactly that you guys do?" We hope you will find it insightful.

We have added catastrophe bonds to our model portfolio this month with an allocation of 3%. We will review this exciting new asset class in a separate paper, to be released about a week from now. At the same time, we have reduced our allocation to investment grade bonds from 24% to 21%.

This newsletter is longer than usual and longer than we would like it to be. Please take our word that it shall be the exception, not the rule going forward.

With these words we would like to wish you and your family a Merry Christmas. This letter will return on or around the 1st February.

2005 Investment Outlook

Although oil prices are not headline stuff at the moment, we consider it *inconceivable* that a price close to $50 will not take its toll on economic growth next year. Asia, being the least oil efficient region in the world, may be hardest hit. It is worth reminding ourselves that every major spike in oil prices since the first oil crisis occurred in 1973 has caused a recession in North America as well as in Europe. No exceptions.

In the United States, with the Fed now firmly on a path of higher short term rates, it is worth bearing in mind that whenever the Fed reverses the interest rate cycle, it almost always ends in a recession.

In Euroland, the growth story in 2004 has been one of export growth driven by strong economic growth in North America, the Middle East as well as in Asia. Domestic consumption has been relatively weak (actually quite appalling if you want the truth). Our big concern for 2005 is that the export story is unravelling fast, mostly due to the sick dollar.

Even the European Central Bank is now recognizing that the 2005 outlook is deteriorating quickly. On 1 December, they lowered their GDP growth estimate for next year from 2.3% to 1.9%. We are prepared to bet almost anything that even the new estimate will eventually prove overly optimistic.

The UK is a story of its own. The economy escaped the recession of 2000-01 and is therefore at a more advanced stage of the economic cycle. There are now several signs of a slowdown with the residential property market being perhaps the most significant indicator. Expect a further loss of momentum in 2005. You do not have to be a genius to figure this out. Just look at the yield curve. It is now fully inverted which is about the strongest signal you can get that a recession is looming.

Meanwhile, China is caught in its own slowdown. The problem facing us is that the official Chinese data is dubious (at best). How is it possible for a large emerging economy like China to report economic data a few days after the end of the month without ever revising these numbers? Instead, we rely to a degree on anecdotal evidence. We hear stories that Chinese fishing boats are not going out, because the catch is worth less than the cost of fuel at the moment. We also hear that car dealers are drowning in inventory. We could go on and on.

The one important fact to remember is that recessions do not happen overnight. The first six months of next year will probably still show relatively robust GDP figures. The second half is likely to be considerably weaker. But it is possible that outright recession will not occur until early 2006. Predicting these things is a tricky business. We can't tell you for sure when it will hit us. But we can certainly see the storm clouds gathering on the horizon.

Bond Market Outlook

It is a fact of life that when the Fed embarks on the road of interest rate hikes, usually the road is both longer and steeper than most people expect at the outset. In recent months, we have heard many explanations why things are different this time around and why short rates in the US will not go to 4-5% as suggested by the more bearish observers.

To us 'things are different this time' is about the biggest yellow flag we can think of. Things are rarely that different. Only, human beings are eternal optimists. We believe that short rates in the US will be raised again on 14 December to 2.25%, and that we could see rates of 3-3½%, possibly even higher, before the end of 2005.

As an interesting side comment, it is worth bearing in mind that should the Fed Funds rate go to 4%, the current account deficit will deteriorate by about $80 billion from a base of approximately $600 billion today, purely as a function of higher funding costs.

At the long end, we expect a regular tug of war between, on one side, lower rates driven by the slowing economy and, on the other side, higher rates necessitated by the large budget and current account deficits. Which outcome will prevail is anyone's guess. However, as we have argued before, current account imbalances tend to work themselves out through foreign exchange markets rather than bond markets, so our bets are on a further flattening of the US yield curve next year.

In Europe, you can build a strong case for further rate cuts. One big one (½%?) would probably be more effective than two smaller ones. Our friends at GaveKal have argued convincingly for this policy, and we have taken the liberty to quote them extensively, as we couldn't have articulated ourselves nearly as eloquently:

"An ECB rate cut would have an electrifying effect on markets where most investors already believe that the euro is dangerously overvalued and buy it only because it is the one major currency not defended by its central bank. An aggressive ECB move would therefore send an avalanche of money out of the euro into both the dollar and the yen. A rate cut would also rekindle the recovery in house prices and consumption which was gaining momentum before the summer, but then fizzled out largely because of a collapse in exports.

In summary, an ECB rate cut is the only plausible policy response to the present turbulence in currency markets – and it would work like a dream. By boosting European consumption as well as exports, it would rebalance the global economy. It would be warmly welcomed not only by Europeans but also by Americans, Japanese, British and Chinese. Indeed it is hard to imagine anyone in the world who would possibly oppose it – apart from the 18 members of the ECB board."

The long end of the Euroland yield curve will in our opinion remain relatively stagnant. Inflation is likely to creep up as a result of higher energy prices. Meanwhile, slowing GDP growth will work the other way. If we had to put all our chips on one outcome, we would bet on flat to slightly lower long term rates by this time next year, but it is a close call.

In the UK, we are becoming increasingly comfortable with our prediction that we have already seen the last interest rate hike. No European economy is more sensitive to property prices than the UK, and this sector is slowing quite rapidly at the moment. The Bank of England could even lower rates in the first half of 2005, should it become worried about the scale of the property market slump.

Finally, a word of warning on emerging market bonds. Historically, these low quality bonds have traded at substantial yield premiums to AAA-rated US or European government bonds. As recently as the autumn of 2002, that spread was about 10%. The other day, this spread was only 2.95%, an all-time low. *If* the global economy weakens in 2005 and *if* the higher oil price does as much damage to emerging market economies as we think possible, there is no chance in hell that this spread will not widen.

Translated into plain English this means you could lose a lot of money. Investing in emerging market bonds has been one-way traffic in recent years. The party cannot continue indefinitely. We consider emerging market bonds one of the least attractive asset classes at current prices and would favour emerging market equities anytime, given current valuations.

Equity Market Outlook

Our long standing view that we are in a secular bear market has not changed and is not likely to change in the foreseeable future. Secular bear markets last many years (often 10-13 years) and are characterised by falling P/E (price relative to earnings) levels and low single digit returns. You can most certainly make money in secular bear markets, but it is a great deal more difficult than it is in bull markets. Some stocks go up. A few go up quite significantly, but for most investors a secular bear market is quite an uninspiring experience with annual returns of about 0-5%.

The problem with secular bear markets is that returns vary dramatically from year to year. So when we suggest that you will earn no more than 0-5% on equities over the next several years, that is an average over the whole period. Returns may be near catastrophic (think 2002) or they may be quite exciting (think 2003) or they may be in between (think 2004).

For 2005, we suggest that returns will be on the low side of average but not catastrophic. The year will begin relatively well, but things will get progressively more difficult. We recently came across some interesting research that suggested that in secular bear markets, the stock market performance is closely linked to the growth in industrial production, whereas there is no such link in secular bull markets. As we expect the global economy to gradually weaken as 2005 unfolds, we conclude that stock markets will struggle to deliver decent returns next year.

When P/E levels are falling, you do not want to own expensive stocks. Value is the place to be. And stocks that pay respectable dividends usually do relatively well. In the context of geographic regions, Europe certainly offers more value than the US. And many emerging markets are still quite inexpensive. Just watch the sensitivity to oil prices in these countries.

A further challenge facing equity markets is the high expectations from the investment community. In the US for example, whilst profit margins are at an all time high, a full 80% of analysts expect higher profit margins next year. In Europe, analysts are still upgrading the earnings outlook on more companies than they are downgrading. In the world we see in front of us, that makes no sense whatsoever.

Foreign Exchange Outlook

The easy way out is to predict a further dollar crisis. Economic fundamentals are supportive of this view and the whole world seems to be predicting it, so at least we look no worse than everyone else, should we be wrong. In a recent poll, 84% of European investment managers predict the dollar to be lower relative to the euro 12 months from now.

Before we throw the towel in and predict ever lower dollar prices, it is a worthwhile exercise to review the other side of the story. So what are the bull arguments as far as the dollar is concerned?

For a starter, there is no evidence to suggest that the US budget deficit and the value of the dollar is correlated in any meaningful way. Secondly, although one can detect a link between the value of the dollar and the current account deficit, the correlation is only significant if you look at the relationship over many years. There is no evidence that you can use the current account deficit to predict the dollar over any 12-month period. In other words, the two arguments used by most people to support their bearish dollar view, are not terribly convincing.

Thirdly, one can argue that interest rate dynamics actually support a bullish view on the dollar. If we are proved right in our view that short term rates in the US a year from now will be 3½% or thereabouts, and short term rates in Euroland will hover around current levels, it may not be as difficult as predicted by many people to get foreign investors to buy US debt securities. They may just favour shorter dated paper to longer dated paper.

Finally, and this is not an argument for a higher dollar – just an observation, a lower dollar will not necessarily fix the structural problems the US economy is facing. 30-40% of all US imports and exports are inter-company movements of goods and are not very sensitive to foreign exchange movements. Furthermore, the US has substantial deficits with several countries whose currencies are pegged to the dollar (e.g. China). No move, however large, will eliminate this deficit.

We conclude that the dollar will probably be driven down further in the short term by sheer negative sentiment, but we are not so sure that it will be lower against the euro a year from now. Nevertheless, we strongly advocate fully hedged dollar positions, whether you are euro- or sterling-based. It is not worth taking the risk in our opinion.

Commodities Outlook

We have written extensively about oil prices and other commodities in recent letters, so please forgive us for offering only the most superficial of comments in this letter. We continue to be bullish on commodities in general, primarily driven by the Asian growth story. A global slowdown in 2005 will undoubtedly have some effect, so don't expect the same returns as in 2004.

One opportunity, which has never been discussed before in this letter, is gold. We find gold intriguing because it is a hedge against a lower dollar and higher inflation at the same time. Gold used to be a pure inflation hedge; however, in recent times gold has turned out to be an almost perfect dollar hedge. In other words, when the dollar has weakened, the price of gold has gone up and visa versa. We are considering adding gold to our portfolio for this reason, and we would urge you to consider the same.

Conclusion

Given our general cautious outlook, we are sticking to our guns in search of absolute returns. The return on global equities for 2004 so far is about 7% in local currency terms and much less in euros and sterling because of the weak dollar. Our model portfolio has beaten that with only one third of the volatility.

In 2005 we will continue to look for attractive asset classes with low correlations to traditional asset classes. In pursuit of stable returns and low risk we will be underweight equities and bonds. Instead we will again commit funds to alternative asset classes like commodities, currencies, managed futures and alternative fixed income and equity strategies.

This month we have added catastrophe bonds to our model portfolio, an exciting asset class with excellent risk-adjusted returns.

We are also looking to start allocating to property, predominantly through commercial property. We have recently identified a couple of attractive investment vehicles which can give investors participation without multi-year lock-ups.

You may say that we are late on property, but we believe we have identified managers who can deliver respectable returns even in difficult markets.

Even though gold, oil and base metals have all enjoyed a tremendous 2004, we still see attractive opportunities within commodities.

The Japanese central bank is currently looking at a loss of $8 billion every time the dollar drops a penny. We don't want you to be in a similar situation, so keep your dollars hedged.

Finally, we are again aiming to beat bonds and equities with a lower risk profile, and are targeting a return of 10-12% for 2005.

Jan Vilhelmsen & Niels C. Jensen

What Exactly Is It that You Guys Do?

About a month ago we had the pleasure of attending a partners' meeting at a Danish accountancy firm in Copenhagen. We had been invited to express our views on the current investment environment and to present some investment strategies suitable for this environment.

Upon completion, we were asked by one of the partners "*what exactly is it you do*?" We answered that "*we provide independent advice to people in terms of how they should protect their investments and make a reasonable return going forward*". The gentleman in question, however, wasn't satisfied. He was looking for something far more tangible and asked if we could describe what actually happens once we agree to initiate a relationship with a new client.

In the next few newsletters, we will use this column to answer that question in greater detail. Hopefully, we will offer some other insights along the way as well. Before we move on, however, we wish to make a general comment about the business that we are in. Many investment professionals will make frequent references to concepts that appear to be so complicated that no one bothers to explain these – even to investors that may have an interest in knowing more about these concepts (admittedly, some investors could not care less).

In our opinion, complication breeds mystery, which in turn allows some people to demand too much money for mediocre products. We believe that investors will be well served to understand some of these concepts, as they are not as complicated as they are sometimes made out to be.

To answer the question of *"what we do"*, the process is essentially as follows (assuming that we gone through the process of getting to know you, your risk profile, investment objectives, etc.):

Step 1: Construct a portfolio consisting of various products across a number of different asset classes (e.g. bonds, stocks, commodities, etc.) based on various data that we keep on those asset classes. You will often hear investment professionals refer to this as *portfolio optimization* or *strategic asset allocation*. Consider this a first draft of the final portfolio.

Step 2: Fine-tune the portfolio in accordance with our expectations going forward (the past and the future are often two very different things). For instance, we might recommend a lower allocation to equities and a somewhat higher allocation to commodities than the strategic model (step 1) would suggest. This is known as the tactical overlay.

Step 3: We have now identified a number of boxes (i.e. asset classes) in different sizes that comprises the total portfolio. We subsequently fill each box with what we consider to be the best managers within each of these segments.

Step 4: After the portfolio has been established, we watch the managers, and we occasionally propose changes to the portfolio as conditions change.

In this newsletter, we will focus on step 1 in the process - i.e. the construction of the "first draft" portfolio. The three building blocks that go into the portfolio construction are:

- *Standard deviation;*
- *Correlation;*
- *Expected returns.*

The first component is the so-called *standard deviation*. Some people also refer to this as *volatility*. The standard deviation is the central measure of risk in financial markets and has a reputation for being terribly complicated. By showing you the brief calculation below, we hope to show you that this reputation is rather unjust (if you are completely allergic to math, please join us on the other side).

Imagine a portfolio with the following set of returns over a 10-year period:

Yr	1	2	3	4	5	6	7	8	9	10
%	9	11	8	-12	4	22	12	-2	-4	12

The average (arithmetic) return can be calculated by adding up the return for each of the 10 years and divide by 10. The average return is therefore 60/10 = 6%. We compute the difference between the average return and the observation in each of the 10 years:

Yr	1	2	3	4	5	6	7	8	9	10
%	9	11	8	-12	4	22	12	-2	-4	12
Aver.	6	6	6	6	6	6	6	6	6	6
Diff.	3	5	2	6	-2	16	6	-8	-10	6

We now need to make sure that the negative values and the positive values do not neutralise each other (i.e. returns of -20% and 20% over two years would indicate that the *total* dispersion is zero which is not the case). We do this by squaring the difference between the return and the average.

Yr	1	2	3	4	5	6	7	8	9	10
Diff.^2	9	25	4	36	4	256	36	64	100	36

We add up all the *"(Difference)^2"* numbers to get an idea of the total dispersion in our set of numbers. This number comes to 570.

We now have a number for the total dispersion over ten numbers. To get an estimated dispersion for one number, simply divide by ten: 570/10 = 57[1].

Remember that we squared all the individual dispersion values to get rid of negative numbers. We now undo this process by taking the square root of 57 to arrive at our destination:

$\sqrt{57}$ = 7.55. This is the standard deviation. In plain English, we have calculated the total dispersion from the average in a series of numbers. We have then spread out the total dispersion over ten numbers to get an idea of "average" dispersion in any given year.

If you have skipped the math part it is now time to rejoin us. Let's take a look at what the standard deviation is used for. Obviously, the standard deviation is useful in the sense that it provides you with a general *idea* of how much something tends to move up and down (i.e. how volatile it is).

If we assume that returns follow a so-called "normal distribution" (we will explain in a minute what that means), the following can be said about the return pattern:

- *68% of the time we expect returns to be within 1 standard deviation of the average;*
- *95% of the time we expect returns to be within 2 standard deviations of the average;*
- *99% of the time we expect returns to be within 3 standard deviations of the average.*

Remember, the average return in the example above was 6%. The standard deviation came to 7.55%. This means that 68% of the time (i.e. about 7 years out of 10) we would expect a return between -1.55% (6% - 7.55%) and 13.55% (6% + 7.55%). Please look at the graph below, illustrating the distribution of returns.

This is a graphic illustration of a normal distribution. We also call it the *"bell curve"*. The largest part of the area under the curve is observed within one standard deviation on either side of 6% (68% to be precise). If you instead look at the area under the curve which is inside two standard deviations either side of the mean (6%), based on the rule above, you will now know that this area covers 95% of all outcomes. Therefore, in theory, only 2.5% of all returns (1 in every 40 years) will be worse than -9.1%, and another 2.5% will be better than 21.10%.

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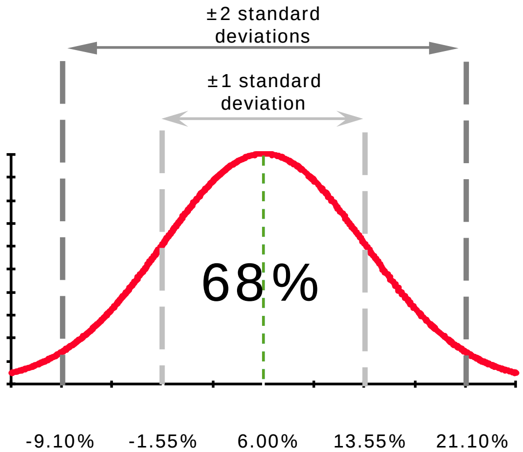
[1] This is the variance (σ^2). The standard deviation (σ) is the square root of the variance.



Finally, let us look at some of the limitations of the standard deviation that we, as professional advisors and you as investors, should be keenly aware of:

1) The world is not a bell shaped place. Neither are the returns on your investments. Notice the shape of the curve in the figure above. It is a perfect bell shape, which is also called a normal distribution. You would get a perfect bell shaped distribution, if you mapped the sum of two dices thrown enough times. In the middle you have the most frequent outcome. On either side you have the less frequent outcomes.

Unfortunately, many things in life are not normally distributed – including investment returns. And if the returns are not normally distributed, returns that in theory should occur very infrequently (e.g. large losses) may actually happen more regularly than theory suggests.

One example of this: Given that the daily volatility of the Dow Jones since 1/1/1987 is roughly 1.22%, the 22.61% drop on 19 October 1987 is more than an 18 standard deviation event. That day in 1987 should occur only once in many thousands of years and yet we were there to experience it. So much for the nice bell shape when it comes to the real world.

2) Extreme outliers have a large effect on the standard deviation: The most extreme year in the example above was Year 6 with a return of 22%. Imagine it had been -22% instead. That would have made it a 3 standard deviation event (1 in 200 years). A negative return of this magnitude - so visibly out of sync with the other numbers - would have had a large impact on the standard deviation. The question is whether or not we should disregard such outliers as abnormalities? In terms of investments returns, we categorically state that *"no, we should not"*. They are a very real part of the risk you take when you invest.

3) Historical data are not necessarily adequate measures for the future. Consider the following statement: *"I have done a study on George Bush Senior. He was born in 1924 and has been alive for some 29,000 days. On the basis of 29,000 observations I can safely conclude that George Bush Senior is in fact immortal and that the string of data has no standard deviation"*. This is obviously nonsense but highlights an important point in assessing past data. Just because you haven't seen it doesn't mean that it doesn't exist. Eventually George Bush Senior will die. Or put differently, past data is not necessarily an indication of the future. Secondly, if we did not know that the ongoing study related to a human being we would eventually conclude that the outcome would always be the same as it had been so 29,000 days in a row. Hence the need to combine statistics with common sense.

There is a lot more to be said on this as it relates directly to assessing the performance of investment products. How much is down to luck which will eventually run out and how much is genuine skill? Or, as we put it: Let's not confuse bull market with genius. A lucky performance over 1, 2 or 10 years will always sell to investors who mistake the past for the future. Attempting to distinguish between luck and skill is a very difficult task for anybody and one we take frustratingly serious.

4) There is no distinction between "good" and "bad" standard deviation. Nobody complains about standard deviation when it is "good" standard deviation (i.e. you find yourself to the right of the mean on the bell curve above). Experience has taught us, however, that high upside standard deviation rarely comes alone. It is usually accompanied by large losses from time to time. In other words, if you are looking for high returns in the financial markets, you will eventually suffer large losses. There is no way out.

Hopefully, this provided some clarification on the benefits and limitations of the standard deviation and better yet, maybe it provoked a few thoughts. Despite its shortcomings, this remains one of the most effective risk management tools available. In the next newsletter, we will tie the standard deviation together with the concept of correlation and look at the "first draft portfolio"*.*

Mads Peter Hansen

Absolute Return Partners

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Model Portfolio as at 30/11/2004: