The Absolute Return Letter

April 2005

Summary

The recent collapse of the investment company Phoenix Kapitaldienst in Germany has been a painful lesson for many investors to not get blinded by seemingly excellent performance. Many checks are required before passing money to an investment manager. In our first article this month, we discuss some of the more important issues that investors should consider when selecting managers for their assets.

We conclude that Phoenix failed on even the most basic of tests (and so do some other investment managers who are not the least bit fraudulent). However, only about 5-10% of the entire hedge fund universe is truly world-class and deserves our money. The trick is to find them before they close for new investors.

In our second article this month we put the spotlight on Germany. The German economy continues to underperform most other nations, and we argue that there is no easy solution available to German policymakers.

We conclude that Germany suffers from a string of problems but focus our discussion on an often overlooked issue, namely the slippery demographic slope that Germany finds itself on.

As usual, we hope you enjoy the read.

The Lessons from Phoenix

Following the recent collapse of the German investment company *Phoenix Kapitaldienst*, we have decided to write a few words on basic due diligence prior to investing in the alternative investment space. Phoenix was closed last month by the German financial authorities on suspicion of fraud amounting to some £500,000,000. Before we get started, however, I wish to make a few things clear.

Firstly, we are not experts on Phoenix as they were disqualified for failing to meet even the simplest of tests in our initial due diligence. However, Phoenix was *not* a hedge fund. It was a German registered investment company regulated by the German financial authorities.

Secondly, to the defence of those unfortunate enough to have placed money with Phoenix, we would argue that if a group of empowered individuals in a firm wishes to engage in foul play, it will be difficult for you to detect it in time. It may happen anywhere, even in the largest firms on the planet and I am sure we do not need to remind you of the massive frauds that have occurred in the traditional investment space over the past few years.

Thirdly, I wish to make it *very clear* that we do not consider it our mission to promote or defend hedge funds or other alternative investments, and we do not want to take part in the overly simplified "for or against" hedge funds debate. There are bad hedge funds and there are bad long-only products. We want nothing to do with either of them.

So funds may be traditional or alternative; we only care about directing our clients towards the best managers available while keeping a close eye on the managers and products we have already selected. What is crucial is that we know exactly what we are recommending and why we are recommending it to our clients.

Below we have listed a number of questions a potential investor should always ask before investing with a manager. The true extent of the due diligence should go further, but hopefully our readers will find it useful all the same.

Q1: Is there an independent valuation of the underlying assets? Everyone should be able to see that if the investment manager provides the valuation himself, it is a case of the fox watching the hens. There should always be an independent valuation from a reputable source.

Q2: Do you know the firm of accountants?

A big accountant is no guarantee (Arthur Andersen), but small independent accounting firms may be easier to pressurise than large international ones. If the firm is small, make sure that it has at least been around for a long time and has some reputable firms amongst its clients.

Q3: Who holds the money? The depository must be a known and respected name.

Q4: Do the people running the money have a clean history? If at all possible, obtain references from trusted sources. You can also google investment managers on the internet for past problems, or you can check them out on the appropriate regulatory authority website.

Q5: Who are the owners and are they actively involved? This will include questions on whether the individuals who have created past results are still tied to firm, whether the investment product relies solely on one person (what happens if his plane goes down?), and whether the firm has lost any key staff?

Q6: Do the managers put their money where their mouth is? It is important to us that the manager is willing to invest his own money in the fund he manages.

Q7: Are we comfortable with the strategy and is the manager sticking with it? Some funds follow very specific strategies that we expect them to stick with in order for our overall portfolio allocation to be effective. Other funds need to adapt to changing environments and will have multiple trading strategies. We need to know what these are and what triggers reallocations among them. This is largely a function of knowing how the managers think and what makes them "tick".

Q8: Are redemption terms and fund liquidity compatible? A redemption feature without (significant) notice is all fine and dandy, but if the underlying assets in the fund do not have the required liquidity this may impact your ability to sell at a reasonable price.

Q9: What are the capacity constraints of the fund? Occasionally a manager's investment strategy is very narrow. He is essentially trading the same good idea (or set of ideas) repeatedly. This sort of fund will usually be quite capacity constrained and too much money under management will likely depress returns.

In a recent paper on capacity in the hedge fund industry, Watson Wyatt Worldwide made some interesting observations that we tend to agree with. For one, relative value strategies (e.g. fixed income, statistical, convertible and merger arbitrage strategies) have received excessive amounts of money in recent years, pushing these strategies to the limit in terms of capacity.

Secondly, Watson Wyatt found that only 5-10% of the world's hedge fund managers are skilled enough to justify their fees (not too far off our own experience). Given general capacity constraints with these managers, the money flowing into hedge funds far exceeds the capacity available with the truly outstanding managers. These will therefore become increasingly difficult to gain access to.

Thirdly, and primarily for the reasons mentioned above, funds of hedge funds will need to work harder at maintaining acceptable returns (and not all will be able to).

Q10: Is the level of gearing appropriate? The use of gearing is always associated with controversy. For some investment strategies, we see little reason for leveraging the equity capital. Several of the equity long/short managers on our recommended list deliver impressive returns without using gearing at all. Gearing is not necessarily a prerequisite for good investment results. Neither is it true that all hedge funds use a heavy dose of gearing in order to further enhance returns.

So when is it acceptable to use gearing? We tend to accept some gearing in certain – mostly conservative - fixed income strategies. Relative value based strategies may also benefit from some gearing. As far as equity long/short strategies are concerned, only modest gearing is acceptable in our books.

The use of gearing should also be seen in the context of the cost of borrowing. When short-term rates are low, as they have been for the past few years, one may be prepared to accept a higher degree of gearing.

Q11: Does the investment "feel right"? An investment that passes all the due diligence checks with flying colours still has to feel right. Sometimes a "no" comes down to an arrogant investment manager (arrogance is a truly destructive human quality) who, one fears, will not know when to cut his losses. Occasionally you walk away from an opportunity thinking the set-up just doesn't seem right.

Finally, let us spend a moment on performance. Strong historical performance will blind some investors. Much more goes into selecting a good manager than a string of numbers. Therefore, basing your investments solely on past performance is a dangerously flawed – although tempting - approach for several reasons. Most notably, Lady Fortuna may have played an excessive part in creating a given performance.

By way of example, if 1000 monkeys pick one stock every week for the next 5 years by throwing a dart at the Financial Times, a few of those monkeys will look very smart by statistical fact alone. However, your desire to invest with them will likely diminish after the first meeting and a little operational due diligence. We can never truly distinguish between the monkey and the genius, but we can do our best to try.

Secondly, if a manager was in the top 1% last year, there is a good chance he took on a lot of risk. That risk could turn against the manager and flip performance upside down during adverse market conditions.

There will always be a ton of investors trying to invest with last year's number one. Many investment strategies become much less effective as assets under management increase and these performance-related issues are not limited to hedge fund strategies. Some long-only managers suffer from the same problems.

You should also view the performance in relation to the variation in returns (or volatility as it is frequently referred to). If a fund's NAV falls from 100 to 60 between January and June but ends the year at 140, can you comfortably say that you would have had the nerves to stick around, or would you have sold at 60 (as many undoubtedly would)?

Finally, even if you have found a great manager in a specific asset class, the question remains if the manager has a place in your overall portfolio. Intelligent portfolio composition continuously seeks to limit the downside risk without giving up the upside potential. The manager may represent a strategy that will not help you achieve this. Simultaneously, this vindicates small allocations to volatile managers (with most of that volatility on the upside, thank you very much), as they might be just what the portfolio doctor ordered.

Some readers will be aware of our relationship with the American investment legend and author John Mauldin. In John's latest book, Bulls Eye Investing, there is an entire chapter on investment manager due diligence. You can find a link under "Recommended Literature" on our website www.arpllp.com, or you can go directly to John's own site www.frontlinethoughts.com.

So back to Phoenix which failed our due diligence checks on Q1, Q2 and Q3. We didn't need to go any further. It is precisely in order to avoid disasters like Phoenix that investors use us to help them identifying attractive investment products. Obviously we are not immune to mistakes, but experience and hard work takes you a long way in the right direction. Feel free to contact us should you wish to learn more about the investment products we recommend.

Mads P. Hansen

Is Germany Kaputt?

If you can spare a minute or two, take a quick look at www.jobdumping.de, a German website that offers jobs to those willing to work for the least pay. Launched about six months ago, the website's creator, Fabian Loew, aimed to make Germany more competitive by driving down employment costs. Apparently, the website has been phenomenally successful.

The concept is simple. An employer looking to fill a job will post a job description together with the maximum hourly rate he or she is willing to pay. Jobseekers compete for the job by underbidding, with the job going to the person willing to take the job for the least amount of money.

Needless to say, Fabian Loew has made some enemies along the way. The website has been branded 'immoral' by many. Some have even called it a 'slave market'. Fabian Loew himself argues that it is about time Germany wakes up to the harsh realities of globalisation.

We are not going to judge Fabian Loew. Whether moral or immoral, it is, however, indicative of an increasingly desperate situation in Germany with 12% of the workforce now out of a job, bringing back sad memories of the early 1930s.

Observers have not been slow in blaming the rigidities of the German labour market for the mess. High labour costs, job protection schemes and bureaucracy in general have all been blamed for the lack of job creation. We think the answers to Germany's problems are more complex than that. That is what this article is about.

Let's jump straight to one of our key observations. We believe Germany is suffering from nothing less than four structural problems, most of which are chronic. The first one we have already briefly touched upon. The lack of flexibility in Germany is being further exposed by the fact that Germany continues to be highly dependent on its manufacturing sector, where competition from Asia is intense.

The second problem relates to East Germany. The reunification offered Germany a unique opportunity to create a viable alternative to the Asian economic miracle due to the attractive combination of a skilled labour force and low wages. However, the government gave in to union pressure and offered East German workers packages at par with West German salaries. At some level, Germany is still paying for this policy.

Thirdly, Germany's inclusion in the European Monetary Union continues to cause headache. Already a special case because of the problems caused by the reunification, it is becoming increasingly clear that Germany would have been better off outside the monetary union. The

European Central Bank has to consider a multitude of factors when setting monetary policy. This leaves Germany with interest rates too high at a time when the economy desperately needs a kick start.

All these issues are well understood and thoroughly analysed. Unfortunately for Germans, they are also quite difficult to overcome, unless some difficult decisions are taken that may prove exceedingly painful in the short run. For advice, Chancellor Schroeder may wish to call Lady Thatcher.

The fourth problem Germany is facing has caught the attention of far fewer people for reasons we do not quite understand. It has to do with demographics. In December 2004, the Federal Statistical Office in Germany announced that the German population actually shrank that year – by some 30,000 people.

110,000 more people died in Germany last year than were born. Meanwhile, net immigration amounted to 70-80,000, leaving a deficit of 30-40,000. Not the end of the world, you may say. Perhaps not, but the problem facing Germany (and a number of other European countries for that matter) is that every modern economy is based on population growth. Without it, everything changes.

For example, a declining population will almost inevitably result in vacant real estate. The Germans are already facing this problem in the old East Germany, where many villages and towns are struggling to cope. In the Anglo-Saxon world, we are also familiar with this phenomenon. The U.S. Midwest has experienced a declining population since the 1920s with people migrating to both the East and the West Coast. In Britain, just go to places like Preston to see the depressing effect vacant real estate has on the local economy. Both the US Midwest and parts of Northern England are finding it hard to attract their fair share of new investments, leading to the local economy underperforming the national average.

Another inevitability of an ageing population is what mainstream economists have dubbed 'the pension crisis'. As the ratio of retirees to workers increases, the tax burden on actively working people will escalate to a point where the welfare system collapses. Different economists have calculated that the tax rate in some European countries would have to rise to over 80% in order to maintain current benefits. It is highly likely that our children and grandchildren will never experience the benefits we enjoy[1].

[1] *If you find this area of particular interest, we encourage you to take a second look at an article called "The Burden on Our Children" which may be found in our May 2004 Newsletter.*

Students of demographic trends have known for years that Germany would hit the population wall within the next decade. The problem now facing German leaders is that it appears to have happened ten years earlier than planned.

In a modern society like Germany, every woman needs to give birth to 2.1 children for the population to remain constant (assuming no net immigration). Germany's fertility rate has been steadily falling for many years and is now standing at 1.35 (i.e. the average German woman gives birth to 1.35 children). We would argue that it will difficult (but not impossible) for an economy to show growth if the population is shrinking. Consider the following equation:

Total Output = Number of Workers x Output per Worker

In other words, total output can only grow if either the number of workers is rising or if productivity (output per worker) can be improved. With a dramatic drop expected in the number of workers over the next couple of decades, we seriously question if Germany can compensate for this through higher productivity.

In a situation where the number of newborn babies is insufficient to secure future generations of workers, our political leaders have at least four options:

For starters, they can force the workforce to work beyond their normal retirement age. Within 10-15 years, we expect the retirement age to have been raised significantly in most European countries.

Secondly, they can encourage more women to come into the workforce. However, this is a less of an option in most Northern European countries, including Germany, where a majority of women are already working.

Thirdly, they can create a business climate - primarily through de-regulation - that allows corporations to export more (more about this later). This line of thinking is exactly what drove the German government to launch their latest job creation initiative just before Easter. By lowering the corporate tax rate, the government intended to improve overall business conditions. In our opinion, the proposed tax reduction on its own will do little to improve the business climate in Germany. Sooner or later, the German government will have to confront the unions, attacking the social security and welfare programme, including the famed German job security.

Finally, they can let in more immigrants. Consider these numbers. Last year, the US government allowed more than 4 immigrants into their country for every 1000 people (not including all the illegal immigrants). In Europe, the same number was less than 1. If one instead calculates how many immigrants Europe would need to accept in order to keep the total population at today's level, it becomes painfully clear how daunting the challenge facing us really is.

Instead of the approximately 400,000 that Europe took in last year, the number is just under 2,000,000 every year. And if you would like to see the age group 15-64 (the working population) remain constant, we would have to raise the number of immigrants to a whopping 3,250,000 per year. All this information and much more you can find on the United Nations website www.unpopulation.org.

In Germany, like in many other European countries, there continues to be widespread resistance to opening up the gates, but the fact of the matter is that Germany and other countries with low birth rates will need to allow in many more immigrants in years to come, if current living standards are to be sustained. Otherwise, who is going to look after us when we become a nation of old people? Although we are acutely aware that this view is not going to get us many votes, at Absolute Return Partners we continue to believe that the way forward for Europe is more (educated) immigration – not less.

Unless Germany's fertility rate starts to improve, according to some estimates, the German population, which stands at about 82 million at present, could drop to 25 million or thereabouts by the end of the century.

Nobody fully understands the consequences of such a dramatic demographic change, since we are dealing with a situation unlike anything we have ever experienced. It is a fact, however, that fewer births result in fewer customers for business going forward. It is almost unimaginable that a country going through such a sharp decline in population numbers can grow the economy at a meaningful rate.

In any economy, there are effectively four growth engines:

- Consumer Spending
- Capital Spending
- Public Spending
- Exports

In an economy with a declining number of people, consumer spending will almost certainly be a drag on overall growth. Public spending is curtailed by an already high deficit, so the only way to drive the German economy forward is through higher capital spending and/or exports.

As the human race has a remarkable ability to adapt, we believe that we will also learn to deal with falling population numbers, although it may take some time. And the silver lining in this particular cloud is that there will be plenty of growth to target for countries with exportable products, as new export markets materialise in Asia and other places.

In the meantime, do not despair. Germany's miserable situation will create investment opportunities close to home. With Germany being one of the key engines of European economic growth, we think it is a fairly safe bet to assume that European interest rates will remain quite low for a long time to come. Cyclical changes in business climate will, of course, continue to occur, driving interest rates up and down as usual. But the upside risk is, in our opinion, capped for the time being.

Since reunification, the annual German GDP growth rate has averaged 1.5%. We expect this trend to continue, effectively putting a lid on European interest rates for years to come. It would in fact not entirely surprise us, if European interest rates turn out to be lower three to five years from now than they are today. In the short term (0-3 years), cyclical factors such as rising commodity prices could, however, drive yields modestly higher.

It also means that German (and certain other) equities are perhaps not quite as attractively priced as current P/E levels suggest. Maybe the market has already discounted a much lower growth rate for corporate earnings going forward?

The other way to think about it is the following. Europe, despite its near homogenous monetary policy, which is set centrally in Frankfurt by the European Central Bank, is far from one synchronized economy. Regional differences are substantial. Smaller economies such as Ireland, Finland and Scandinavia continue to perform really well and should, strictly speaking, undergo some monetary tightening (read: higher interest rates). These countries benefit immensely from the fact that the main locomotives in Europe (Germany, Italy and France) are all struggling.

So, if you wish to own European equities in your portfolio, do not buy German, French or Italian shares. Buy instead the markets that should enjoy healthy growth with the prospect of continued low interest rates.

Germany may not be kaputt yet, but it is certainly in danger of sliding into some terminal decline that will prove rather painful. Far more dramatic measures than those recently introduced by Schroeder's government are required. In the meantime, we prefer to invest elsewhere.

Niels C. Jensen

Absolute Return Partners

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Model Portfolio
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