Absolute Return Partners LLP

The Absolute Return Letter

May 2005

Summary

This month's newsletter is a little bit different from our usual format. We will be sharing with you three charts that all tell an interesting story. We are usually not big fans of investing based on charts, but sometimes charts can help to point out things that the naked eye may not catch.

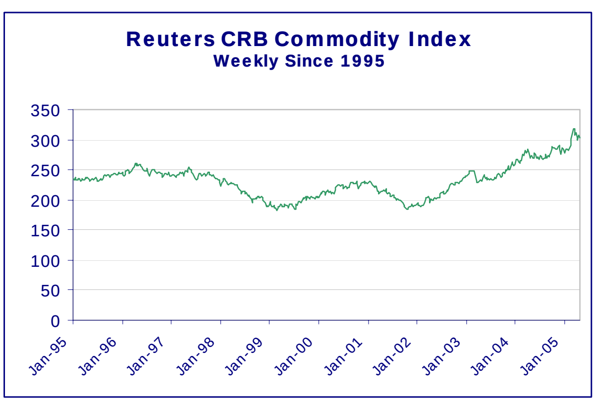
In the second part of this letter, we discuss the concept of absolute return investing and some related subjects and make our case why you should run your portfolio according to this investment philosophy for the foreseeable future.

Enjoy the read.

The Chart Room

Is the Commodities Party Over?

The first chart raises one of the most important questions to be addressed by investors today. *Is the bull market in commodities coming to an end?* The Reuters CRB Commodity Index is down about 7% over recent weeks and closed yesterday (03/05/05) at 299.69. The Reuters CRB Index is unique in the sense that all components carry identical weightings – in other words, the price pattern of oranges is as important to the overall index as is the oil price. This tells you that the recent drop in commodity prices has been broadly based.



In order to answer the question above, we need to distinguish between the short term and the long term. Commodity prices are characterised by long lasting bull and bear market cycles, with the last major bear market lasting approximately 21 years - from late 1980 to late 2001 (we call such a long lasting bear market for a secular bear market).

The reason for these long lasting trends is obvious. Commodity producers often have to make enormous investments in order to increase capacity, which requires a great deal of confidence in the future. In the fickle minds of most human beings, confidence builds only slowly, and so most of us would need to see a trend being confirmed for several years before splashing out the company's cash on new capacity.

A good example is the refining industry, which is running at close to capacity in several countries, including the largest market of them all, the United States. Refiners are up against not only their own mindsets (should we or shouldn't we?) but also against environmental activists, bureaucrats, etc.

When a refining company is finally convinced that the world is running out of refining capacity, it may take another five, six or even seven years to execute the decision due to all the difficulties associated with obtaining permissions, etc., let alone actually building a new facility. The bull market may be close to its tenth anniversary before any additional capacity is added.

Furthermore, the sheep mentality will ensure that all the operators will arrive at their decision to add capacity at approximately the same time. In other words, when the new capacity is finally up and running, the market will go from being capacity squeezed to suffering from overcapacity in a relatively short period of time.

Adding to this aspect, we continue to believe in the Asian growth story. Asia in general, and China and India in particular, will require enormous resources over the next decade in order to satisfy the needs of their people. This can only be long term bullish for commodities.

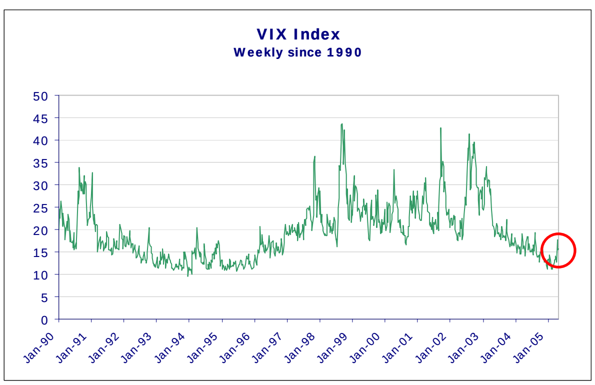
For these reasons, we are absolutely convinced that commodity prices will continue to do well for many years to come, although certain commodities will do a lot better than others. Focus on those that are in demand from Asia.

On the other hand we must stress that even the strongest secular bull markets will experience occasional set-backs. We have written about the possibility of a temporary slowdown in China before. However, given China's dependence on export led growth, we should probably look to the United States for early signs of a Chinese deceleration.

Even a modest Chinese slowdown could have a significant effect on many commodity prices. And we have an inkling that China is indeed slowing down. In other words, the next 6 months may be turbulent times for commodity prices, but at least it will offer those who are not yet exposed to this asset class an attractive entry point. Buy on weakness.

Volatility Is Rising Again

The second chart illustrates the volatility of the U.S. stock market, using the so-called VIX index as a measure for stock market volatility[1]. As you can see from the chart below, volatility has recently spiked after trending downwards since the autumn of 2002.



Why does volatility matter?

Because increased volatility makes it more likely that you will experience negative returns in your equity portfolio. In his recent book "*Unexpected Returns*", Ed Easterling has done a detailed study of the relationship between volatility and stock market returns.

He divides the last 480 months (40 years) into quartiles based on volatility. Those 25% of the months with the lowest volatility fall into the first quartile, etc. In the first quartile there is only a 31% chance of experiencing a month with negative returns. In the second quartile the probability rises to 37% and in the third quartile to 43%. In the quartile with the highest volatility, the chance of a down month is 57%[2].

Furthermore, volatility not only increases the probability of negative returns, but the magnitude of those losses increases as well. In other words, *when volatility rises, you will lose more often and the losses will get bigger*. As many investors will know from experience, it is incredibly hard to recover from large losses.

Say you lose 25% in a really bad year for equities (this happened as recently as 2002). In order to recover those losses, you need for your portfolio to be up not 25% but 33% (the law of maths). Say you have two really bad years and find yourself down 50%. Now, in order to get back to zero, you need for your portfolio to appreciate by 100%. We do not need to remind you how difficult that is.

Since 1990, the volatility index has shot above 30% at least six times (not counting a few twin peaks). The recent increase cannot yet be characterised as a major spike, but the conditions are in place for one. In terms of equity market performance, the odds would turn against you if it were to happen.

If the volatility index continues to rise, we therefore suggest you resist any temptation to add to your equity positions on weakness; it is not worth the risk. If, however, the current spike turns out to be temporary, the odds are turning in your favour again. Stay tuned.

The Real Driver of U.S. Bond Yields

The final chart comes from our friends at GaveKal Research in Hong Kong (you can learn more about GaveKal on www.gavekal.com). Recently, they made us aware of a surprisingly strong correlation between the Japanese equity market and the yield on U.S. treasury bonds. In fact, since the mid 1990s, the correlation has been 0.9 or higher.

The logic is as follows. The rapidly aging population of Japan is saving like never before. However, domestic investment opportunities are few and far between - the property market has been in a slump for more than a decade and so has the equity market. Meanwhile, bond yields are at or close to zero.

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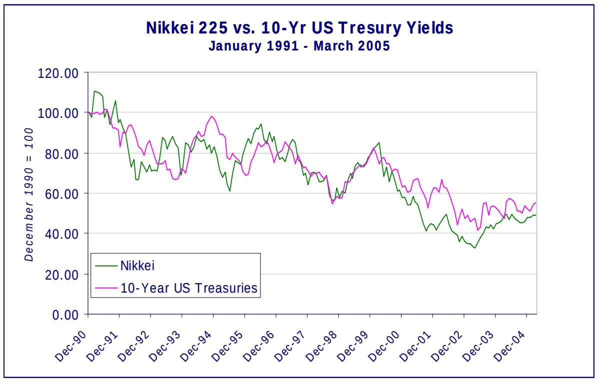
[1] The VIX Index measures the volatility of the S&P500 index. Volatility (in this context) is a statistical measure of the price variations of the S&P500 index. The bigger the daily swings, the higher the VIX index is.

[2] "Unexpected Returns: Understanding Secular Stock Market Cycles", by Ed Easterling, 2005.



So what do the yield starved Japanese do? They buy U.S. dollar assets. Last year alone, they bought almost half a trillion dollars worth of U.S. treasuries. In a research report named "Of Bonds and Zombies" dated 10th March 2005, GaveKal reaches the following conclusion:

"Global asset prices [...] will remain severely distorted as long as the main suppliers of excess savings to the world economy – the Japanese private investors – continue to live in a zero-rate environment. If the returns available to Japanese investors domestically remain at or near zero, they will continue to invest in dollar and even euro assets at what seem to be ridiculously low rates."

If this theory is correct, two of the biggest risks to U.S. (and therefore also global) bond yields are:

1) If (when) Japanese interest rates become attractive to private investors again; or

2) If (when) Japanese equity or property prices start appreciating in value again.

A meaningful rise in Japanese interest rates is quite unlikely at this juncture. We would instead suggest investors keep an eye on Japanese equity and property prices. They may offer some surprising insight into which direction U.S. and European bond yields are heading.

Niels C. Jensen

Absolute Return Investing

We have received quite a few e-mails over the past couple of months, addressing several of the topics discussed in the two articles named "What exactly is it that you guys do", part I and II. Thank you by the way – comments and questions are always welcome. Allow me to summarise what we do. There are basically three legs to our business model:

1. *Wealth Management:* We offer advice on asset allocation and we help our clients select the best managers in each asset class. Sometimes we do this for a client's overall portfolio, whilst sometimes it is just for a subset of the client's portfolio. Our business model is such that our interests are aligned with those of our clients. The key to this process is diversification and open architecture (best of breed). Our focus is on absolute returns but we will work within the framework the client requires.

2. *Individual Manager Selection:* Some of our clients do not require the overall wealth management service described above. They are instead asking for specific advice in one or several areas of the market. Often the client is looking to invest in a new asset class and is coming to us for product selection. This part of our business is focused on alternative investments, but we do recommend a few long-only products as well.

3. *Fund of Funds:* We run our own fund of funds covering a majority of the funds we recommend on our platform. For regulatory reasons these funds are not available to all investors and therefore I cannot go into further detail on the nature of the fund but for readers interested in knowing more, feel free to call or write for more information.

Central to our investment philosophy is the principle of absolute return investing. Absolute return investing, as opposed to relative return investing, has consistent profitability as its key objective. The focus is not on benchmarks but rather on generating attractive returns in all market environments. Avoiding the loss of capital during difficult times is a key element of this investment philosophy.

Relative return investors, on the other hand, relate their investments to a benchmark. They typically use a local or a global stock index when assessing the performance of their portfolio. If your benchmark index – e.g. the Dow Jones Industrial – is up 10% over a given period and you are up 12%, you have done well. However, if you are up "only" 8%, you have not done so well.

Generally speaking, relative return investors do better in bull markets, whereas absolute return investors excel in bear markets. Equity investors around the world enjoyed an eighteen year bull market from 1982 to 2000. For this reason, the majority of investors are still relative return investors at heart. Why change something that worked for so long?

So why are we not relative investors like most other people? Firstly, it is a question of the target market we first set out to pursue when we started the business. Wealthy people do not need to take large risks with their money. In the words of my friend John Mauldin: *"If you have won the race, why do you keep running?"* Focusing on not losing money and on making steady returns should be the agenda for the bulk of a wealthy investor's assets (and most other investors for that matter).

The Stock Market Outlook is Gloomy

Secondly, it is a function of the environment. Long-term readers will know that we have been concerned about the outlook for global equity markets for a long time, a position we maintain to this day. Therefore we advocate the pursuit of absolute returns rather than jumping into stocks at this juncture, thinking it will do wonders to your portfolio over the next decade (chances are that it will not).

Some investors will argue that relative return investing has served them well over the last couple of decades. I agree but would suggest you consider the following points: For starters, the 1982-2000 bull market is over, whatever way you look at it. We are now in a different environment. When the times were good, even a blabbering fool could make money. All he had to do was to stay fully invested at all times.

We observe that P/E values continue to fall (we call it a valuation bear market) and that positive earnings surprises are not rewarded the way they used to be. In other words, it is not dead easy anymore. We believe that we are in for several more years of this sort of treatment. You may enjoy really good years every now and then, but the good years will most likely be offset by bad ones. The net result? Quite unattractive returns compared to the risk you take when investing in equity markets.

The markets are riddled with uncertainty that can be reduced by focusing on absolute return strategies. A well diversified portfolio across numerous asset classes with top quality managers should easily beat the stock market over the next few years.

Finally, and I believe this summarises most of the points made above, if equity markets are down 15% and you are only down 10%, do you really have a reason to be happy? Relative return investors could quite possibly be facing near zero returns on their equity portfolio over the next 5-10 years. With a bit of bad luck, those returns could turn negative. To counter this, we strongly recommend an absolute return approach. Protect the bulk of your money and compound it at a reasonable rate. That is the essence of our business model.

The Counterintuitive World of Hedging

A few weeks ago, we hosted a lunch presentation with John Mauldin in our offices in London. During his presentation, John made the point that investors should prepare themselves for only modest returns over the next few years.

As a result of this, a sterling-based investor asked John if he wouldn't be better off keeping his money in the bank, given the fact that the overnight rate in sterling is close to 5%.

The question initiated a longer discussion; however, one critical element was never debated, hence these lines. Because of the interest rate differential between sterling and U.S. dollars, a British investor could actually hedge his dollar risk (using currency forward contracts) and pick up some additional yield in the process.

If the sterling based investor invested in U.S. dollar assets and subsequently sold his U.S. dollars one year forward, he would earn an extra 1.25% over investing in sterling assets yielding the same notional return. This yield pick-up is calculated as the one-year rate on sterling (4.95%) less the one-year rate on U.S. dollars (3.70%).

If the sterling based investor instead invested in euro denominated assets, the yield pick-up would be even more attractive because of the bigger interest rate differential (4.95% - 2.20% = 2.75% per annum).

Therefore, in response to the question raised at the meeting, the British based investor should not compare the expected notional return on U.S. dollar (and euro) assets with the return on sterling deposits. Instead he should compare the excess notional return over the risk free return in the currency of the investment. By hedging his currency risk, he can deliver this excess return as a premium to the risk free rate in his domestic currency and expect to enhance his net returns accordingly.

As usual, please write or call if you have comments or questions.

Mads P. Hansen

Absolute Return Partners

Absolute Return Partners LLP is a London based private partnership. We provide *independent* asset management and investment advisory services globally to institutional as well as private investors, charities, foundations and trusts.

We are a company with a simple mission – delivering *superior risk-adjusted returns* to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our *open architecture* platform.

Our focus is strictly on *absolute returns*. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our *transparent* business model and we offer *flexible* solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

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