The Absolute Return Letter — October 2005

Summary

The global liquidity indicators that we follow continue to deteriorate. This suggests a continuation of the recent uptrend for the U.S. dollar. Whereas most people intuitively believe that a large current account deficit will drive the dollar down, history suggests that there is at best a weak link between the size of the current account deficit and the value of the greenback.

In our second essay this month we take a closer look at the private equity sector. Not since the late 1990s have we experienced such inflows of money and we question whether recent returns, which have been excellent, can be maintained in such an environment.

Lastly, we review one of the best books we have read for a long, long time. "Freakonomics" takes a closer look at things in life that most human beings accept at face value. If you haven't already read it, we suggest you head straight for the nearest book store.

Enjoy the read.

The Liquidity Driven Dollar

Our essay last month on the deteriorating outlook for global USD liquidity caused quite a few of our readers to ask what the implications are for currency markets. Since the liquidity indicator we used in our analysis is USD based, we can only speak with conviction about USD but, in a nutshell, deteriorating global liquidity is bullish for the dollar. Here is why:

The majority of people we speak to are still extremely bearish on the dollar, and since this bearishness is often based on the large U.S. current account deficit, let's begin our discussion here.

The first point we would like to make, and we wish to make it rather emphatically, is that it is too simplistic to assume that a large current account deficit automatically leads to a weaker currency. For a small country this may very well be the case, but a large country such as the U.S. could probably live with a substantial deficit almost in perpetuity. In fact we would argue that as long as the U.S. dollar remains the primary reserve currency in the world, a large current account deficit is almost irrelevant. This finds support in several studies conducted over the years which show that the correlation between the dollar and the U.S. current account deficit is low.

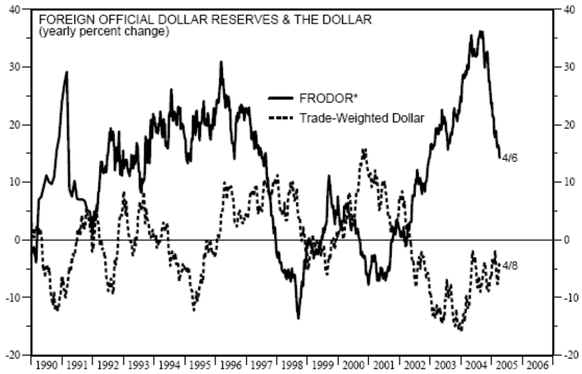
More importantly, contrary to what many people seem to think, countries don't freely choose which currencies to hold in reserve. These decisions are largely dictated by trade flows. Therefore in a world of rising energy prices (always priced in dollars) and increased trade between nations (most of which is traded in dollars), central bankers are forced to increase their holdings of dollars whether they like it or not.

So, unless the world agrees to price more goods and services in other currencies (Russia has made a case for pricing oil in euros), the greenback is very likely to hold onto its status as the main reserve currency of the world.

In last month's newsletter we also discussed the implications of deteriorating global liquidity. The famous economist Ed Yardeni (you can find examples of his high quality work on www.yardeni.com) has done a lot of work on global liquidity. He has, in fact, developed his own global liquidity indicator called FRODOR, and he has found a strong negative correlation between global liquidity and the U.S. dollar (see the chart below). In other words, when global liquidity grows strongly, the U.S. dollar tends to perform quite poorly. When growth in global liquidity slows down, the dollar starts to perform better. This is consistent with the recent robust performance of USD versus EUR, GBP and JPY.

Of course, global USD liquidity is closely linked with U.S. interest rate policy (higher rates slow down growth in the monetary base), which is another way of saying that during periods of rising Fed Funds rates (the last 15 months), the dollar is likely to be quite strong. On the other hand, when the Fed is easing (which will lead to stronger growth in global liquidity), the dollar is likely to show signs of weakness.

Global Liquidity (FRODOR) versus the U.S. Dollar:



Source: www.yardeni.com

During a period of rising USD rates, lower GBP rates and flattish EUR rates (an environment we find ourselves in at present) the underlying support for USD is very strong indeed.

The story gets a little bit more complex if we instead look at the outlook for the U.S. dollar versus Asian currencies. Asian central banks have for years performed every trick in the book to prevent their currencies from appreciating against USD. When a central bank intervenes to keep the lid on its own currency, it usually buys USD against its own currency. This may cause a substantial rise in the domestic money base, which is neutralised through a so-called sterilisation process (nothing to do with the human anatomy!).

When a central bank sterilises, it issues government bonds in local currency to soak up (part of) the rise in the money supply caused by the interventions in the FX markets. Otherwise such interventions could be highly inflationary.

One of the 'safest' bets (if it is prudent to use the word safe in the context of investments) has long been considered short USD versus Asian currencies. Many Asian currencies are – after years of central bank intervention – almost grotesquely cheap relative to Western currencies, if one applies a traditional valuation approach based on purchasing power parities. In the past, we have in fact advocated ourselves for going short USD against Asia.

However, since the modest re-rating of the Chinese renmimbi earlier this summer, Asian currencies have been remarkably calm. We hear that interventions have been few and far between. This anecdotal evidence is further supported by the global liquidity indicator which we introduced you to in last month's letter (Merrill Lynch's version). If Asian central bank interventions this past summer had been sizeable, the growth in global liquidity would probably look better.

So what is happening? The one way traffic in USD versus Asia is not working as almost everyone expected it to. Could it be that the high oil price is starting to make a real impact on Asian economies? Only time can tell. One thing is for sure though. This is not the time to be short U.S. dollars.

Niels C. Jensen

A Bubble in Private Equity?

At Absolute Return Partners we constantly seek out new asset classes which are likely to offer our investors attractive returns combined with attractive diversification benefits. We run a multi-strategy fund which invests in a large number of these asset classes; however, one asset class we have not yet included in our investment universe is private equity.

The main reason is liquidity related. When investing in private equity, the typical holding period is 5-8 years. Furthermore, the investor does not know the timing of future cash calls. For institutions this is not generally a problem, but for private individuals it can be a challenge.

Putting this technicality aside, prospective investors should ask themselves if investing in private equity is as compelling an investment case as some would have you believe. Since 1984, top quartile private equity managers have returned more than 30% annually[1]. Even if you take out some of the very big years in the late 1990s that is, without question, an outstanding return. Our view is that life is not that simple and gaining access to those top-ranked managers can be very difficult indeed. Obstacles include lack of performance data, capacity constraints, high minimum investments and little public information (i.e. how do you find them?).

The investment decision-making process is also more complicated than simply looking at past performance. Firstly, if you include *all* private equity managers in the market, the returns have been very similar to those of listed equities. The obvious question to ask then is, why invest in private equity (with the long lock-up) when you can invest in liquid securities for the same return?

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[1] *Source: Thomson Financial Venture Economics/NVCA as of 30.9.2004*

Among institutional investors in the U.S., private equity is very popular. Currently, the average allocation is 7.5%, with some U.S. pension funds having more than 20% in private equity. In Europe, the number is considerably lower at 4% on average. However, because of its popularity we believe the nature of private equity investing is changing.

Funds are flowing aggressively into the sector. The huge inflow of cash is sponsoring increasingly larger deals. Recently, one of the major players in the market, Blackstone Group, raised $12.5 billion for their latest fund. This year alone (through July), private equity funds have raised $81 billion[2] globally, up 33% over the same period last year. Global buy-outs worth a total of $233 billion have been executed this year (through July), up 38% over the same period last year. Earlier this month Hertz was sold by Ford for $15 billion to three private equity groups, topping this year's biggest deals so far – Sungard Data System ($11.3 billion) and Wind Telecommunicazioni ($12 billion).

The massive inflow has not only resulted in bigger deals but has also taken private equity money to new markets. The big U.S. private equity groups are now all operating in Europe and have started to increase their allocations to more exotic markets. For example, this year Blackstone, Carlyle and Texas Pacific have all made significant commitments to India. In the search for the next big deal, we think the investment risks have increased.

Having said this, smaller private equity funds may be able to take advantage of the trend towards larger and larger deals. Because the big international players need very large deals to impact fund returns we understand that it is often possible for local private equity firms to pick up smaller deals for a fraction of the multiple paid for the larger transactions.

Nevertheless, strong capital markets provide an attractive foundation for the private equity industry. It's not exactly been difficult to raise equity. A primary market where Google can raise $4.2 billion at a market cap close to $90 billion must be a fairly healthy market. Not only are interest rates low, but creativity among bankers is thriving.

A new form of high risk lending has become a popular tool to lift the big deals. "Second-lien" loans are secured by the same collateral a company has already provided for its senior loans. This provides investors with an incremental yield of 3-4% in exchange for being paid second to the senior debentures. In Europe, this form of financing has grown tenfold this year to €2.8 billion and in the U.S. it is up 25% to $10 billion. In an environment with an abnormally low rate of company defaults, this form of financing works well. European high yield defaults were just 0.2% in the first half of 2005, but investors should remember that the same default rate was 25% in 2002[3].

It is currently a seller's market where buyers have ample cheap capital to play with and sellers can use expanding multiples to raise the bid. Some years ago, private equity managers would get a good deal simply by being charming at a social event. Now deals are put out to tender with the one creating the most aggressive financing package winning the deal.

We still believe institutions/professional investors have a good chance of doing well by investing in private equity. They typically have the know-how (and financial resources) to evaluate managers and performance. They also have the financial leverage to make them an attractive investor for a top-tier private equity manager.

However, most private investors lack the above so what should they do? Some are trying their luck investing directly. Statistics show the probability of a negative return to be 42% for direct investments in private equity[4], and the probability of a total loss of invested capital to be an unattractive 30%. The solution for private investors who want exposure to private equity is to buy into a well-run private equity fund, which focuses on local, small and mid-cap companies. By focusing on second-tier companies, the expected return increases as a result of the lower multiples being paid. Alternatively, there is a rising market for private equity funds-of-funds. This way, private investors can gain access to the same quality managers as the largest institutional investors for a reasonably sized investment.

If you wish to learn more, feel free to give us a call. We are in touch with a number of very well-run private equity funds. We have opted not to invest in private equity in our multi-strategy fund, although this could very well change in the future. Last month we reduced our allocation to equities and see no reason to add to our equity exposure in the form of private equity.

A few weeks ago the respected CEO of a large European company said in an article that in five years we will look back and say 2005 was a bubble in private equity. Only time will tell if he is right.

Jan Bendix Vilhelmsen

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[2] Source: Private Equity Intelligence

[3] Source: Fitch Ratings

[4] Source: VentueXperts

Freakonomics

As long-time readers of our newsletter will know, at Absolute Return Partners we try our very best to think outside the box and question consensus thinking. As a wise man once said, nobody has ever become rich from turning the same stones as everyone else!

Primarily for this reason I found Steven Levitt's book *Freakonomics* so compelling. Levitt seems to be driven not by political or financial motives but rather by a quest for truth. These days the definition of truth seems to be laden with the same relativity that we attach to moral values, but in Levitt's case it is driven by hard numerical facts and logic. In a relentless attack on conventional wisdom and the "experts" that preach it, Levitt tackles everything from cheating in sumo wrestling to why it is it that inner city drug dealers tend to live with their mothers.

Consider, for instance, a chapter called *Where Have All the Criminals Gone?,* where Levitt deals with the sudden drop in violent crime (murders, assaults and rape) in the U.S. during the 1990s, following years of escalating violent crime in the 1960s, 70s and 80s. By 1989, violent crime was at its peak and had risen 80% over the previous 15 years. It was headline stuff in the news, the national topic of conversation, and "experts" were warning that violent crime would spiral out of control. Then suddenly, violent crime plunged downwards and did not stop until it stood at the levels of 40 years earlier.

Levitt researched citations on the collapse in violent crime in the 10 biggest newspapers in the U.S. between 1991 and 2001 (yes, the rigorousness of his research is amazing). Below I will show the citations ranked in accordance to their frequency of mention followed by what Steve's research actually shows to be true. Only the top seven reasons have been listed here:

1. **Innovative police strategies**: *False*. Innovative policing strategies played out most dramatically in New York under the leadership of Mayor Rudolph Giuliani and Police Commissioner Bill Bratton. Crime, however, began to drop in New York in 1990 and Giuliani was not appointed Mayor (and did not install Bratton) until 1994 by which time violent crime had already dropped by a whopping 20%. In addition, crime dropped everywhere in the 1990s including the places that did not implement new strategies.

2. **Longer prison sentencing:** *True*. In the 1960s and 70s - and largely driven by an expansion of the rights of people accused of a crime – both sentencing rates and prison terms declined. Should one therefore be inclined to commit a violent crime, "incentives" were increasingly lining up in your favour. This trend was eventually reversed with tougher sentencing in the 1980s and 90s where prisons filled up with amazing speed.

3. **Changes in drug markets:** *True*. In the 1980s crack cocaine was a hugely profitable business. However, this was only true at the highest level of the food chain, making street dealers all the more desperate to advance, hereby increasing their incentive to kill competitors. In 1990-91, however, the price of crack cocaine collapsed, making it no longer worthwhile to kill or get killed for street territory.

4. **Aging of the population**. *False.* The change in the relative size of the age group committing the vast majority of violent crimes did not change anywhere near what would be required to credit demographic changes for the drop in crime during the 1990s.

5. **Tougher gun control laws**: *False*. Quite a lengthy topic. "Gun buy backs" and "cooling off periods" are useless given the vast black market for guns. In addition, the numbers of guns is not a cause in itself (Switzerland has the highest gun ratio per capita but is one of the safest places in the world). It appears that the only effective deterrent of gun crime relates to increased prison time if convicted of such a crime.

6. **Strong economy**: *False*. When analysing historical data, the only possible correlation between the economy and crime relates to financially motivated crimes (fraud, car theft, robbery and similar crimes). Incidents of violent crimes are not related to the health of the economy.

7. **Increased number of police**: *True*. There is evidence to suggest that increased policing deters crime. In fact, we can conclude that regardless of the many smart innovations in policing, the only one that really matters is how many police officers you put on the streets.

On the other hand, one of the major causes of the drop in crime in the U.S. did not receive a single citation. Research in European countries between 1930 and 1960 clearly shows that when a mother-to-be was denied an application for abortion, the child had a far higher chance of ending up a criminal. Readers can make up their own minds as to why this is the case.

In the U.S., abortion was only legalised in 1973 with the Supreme Court ruling on Roe v. Wade. In the first year following the ruling, 750,000 abortions were recorded, corresponding to 1 in 4 births. By 1980 this number had grown to 1.6 million (1 in 2.25 births). In effect, "safe" abortion was now available to all women rather than just to those well enough off to pay for an illegal procedure prior to 1973.

Now consider the European studies mentioned above. Also consider the fact that convicted criminals have a much higher chance of being from a single-parent home and/or living in poverty or relative poverty. Finally consider that (on the basis of abortion statistics in the U.S.) a foetus destined for abortion would have a 50% higher probability of being born into poverty or relative poverty and a 60% higher probability of being born into a single-parent household.

By 1990, the first generation of "Roe v. Wade children" would have approached their criminal prime. However, part of the criminal cohort-to-be was never born. The link is underlined by statistics showing that violent crime began to fall earlier in the 5 states where abortion was actually legalised 2-3 years prior to Roe v. Wade.

In addition, states with the highest relative abortion rates also experienced the highest relative drop in crime during the 1990s. In other words, Levitt makes the very convincing case that the never before mentioned citation of abortion has been a major cause behind the drop in violent crime together with tougher laws, a collapsing market for crack cocaine and more police on the streets.

As a result of his research, Steve Levitt has made enemies from left to right (literally) in American politics. But, from an investor's point of view, is there anything to learn from all this? I think the answer is yes. We cling frantically to conventional wisdom regarding investing; *"the stock market always goes up in the long run", "bonds are safe" and "real estate never really takes it on the chin".* None of the above is actually true if you care to analyse the data properly.

If conventional wisdom is handed down by "experts" we take it onboard without asking the important questions. Which incentives do the experts have to say what they say? What is the data actually telling us? As humans we evolve as we discover new truths. Today, we smile at the fact that our ancestors thought that thunder was caused by the thunder god Thor riding across the clouds in his carriage.

The question is whether future generations will smile at our belief in parts of conventional investment wisdom? What I do know is that those who are not afraid to challenge conventional wisdom more often than not will discover things that others do not. In investing (as in most other parts of life) we should therefore never stop asking these questions. I for one cannot wait for Steven Levitt to turn his piercing gaze to the financial services industry. That should make for an interesting read.

Mads Peter Hansen

Absolute Return Partners

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