The Absolute Return Letter

November 2005

Summary

Inflation has been dominating the headlines over the past few weeks. Many commentators believe we should be worried about inflation. We worry about many things at the moment, but inflation is not one of them. As a result, we do not believe the yield on long bonds will rise as much as has been suggested by some.

In our second essay we review the concept of value investing. We are often asked how it is possible to incorporate a traditional equity strategy into an absolute return philosophy. It is all about managing the downside risk. Good value managers do exactly that.

Lastly, we make some important changes to the Absolute Return Multi-Strategy Portfolio this month, which we share with you on pages 3-4. These changes are a consequence of our ongoing concerns regarding the global liquidity outlook.

Enjoy the read.

Inflation and Interest Rates; Should We Worry?

Foreword: *Many of the conclusions we reach below have been inspired by the thinking of Woody Brock and his recent research note called "The Yield Curve Conundrum that Isn't". Mr. Brock is an economic adviser to Absolute Return Partners. Examples of his work can be found on www.sedinc.com.*

The press has always loved a good story and the financial press is no different. At the moment they just cannot resist the temptation to run horror stories on how inflation is, yet again, going to make our lives miserable.

Admittedly, the numbers do not look very encouraging. After all, *headline* inflation (that is, including food and energy) is now running at 4-5% in many countries. Although *core* inflation (i.e. exclusive of food and energy) is still relatively well contained at 2-2.5% in most OECD countries, so-called experts are telling us that it is only a question of time before core inflation catches up with the headline number.

Yet we find it hard to get too worried. Maybe we are complacent. We certainly hope not. Let us start with our thoughts on inflation and then move on to our view on interest rates.

Inflation is, as we keep reminding ourselves, first and foremost a monetary phenomenon. When oil prices started to rise dramatically in early summer last year, most of us expected them to filter through to consumer inflation eventually, because that is what happened last time we had a real oil price scare (in the 1970s).

We forgot, however, that if central banks everywhere take money out of the system (which is pretty much the case away from Europe), rising commodity prices need not be inflationary. Instead, they act as a tax on the economy. Put differently, if you are forced to spend more on petrol and heating, your budget constraint forces you to spend less on other items. In this scenario, inflation would not necessarily rise.

The 1970s supply shock had the dramatic effect it had, partly because central banks prescribed the wrong medicine (they printed money like crazy to pay for high public deficits) and partly because unions were much stronger back then than they are today. They managed to force through pay rises to fully compensate their members for lost purchasing power.

So are there examples of supply shocks not being inflationary? Yes, there are. Supply shocks were not that unusual during the period 1865-1965, yet inflation was very well contained throughout this period. What if the current period turns out be more like 1865-1965? What if productivity continues to improve as a result of improved technology? More importantly, what if the trend towards increased globalisation continues to gather momentum? And - you must not forget - only 18 months ago, the world was having panic attacks about deflation. Here we need to make another observation. There is bad deflation and there is good deflation. The last time the world experienced deflation (the 1930s), it was clearly a case of bad deflation. However, in the latter part of the nineteenth century, the world went through long periods of falling prices. Yet, the central bankers of the time didn't even consider dropping $100 bills from helicopters.

GaveKal has coined this sort of economic environment a "deflationary boom". In a deflationary boom, as opposed to a deflationary bust, volumes rise faster than prices fall, so you still enjoy rising corporate profits, positive GDP growth and appreciating asset prices. This is broadly what the world experienced 100-140 years ago.

Perhaps we are entering a new phase in the long and eventful history of this planet. Perhaps the next few decades will bring conditions akin to a deflationary boom during which the overall economy will do quite well.

Which brings us to the outlook for interest rates. No one can deny that bond yields have not behaved well in recent weeks. However, before you despair, do not lose sight of the fact that bond yields are only back up to the levels we experienced in March of this year. So the move has not exactly been groundbreaking. We think there are two reasons for the recent bearish sentiment in bond markets. To begin with, all the talk about rising inflation has done bond yields no favours. However, as already pointed out, we see many clouds gathering on the horizon; rising inflation is not one of them.

At the same time, bond markets (as opposed to equity markets) seem somewhat uncomfortable with the choice of Bernanke as Greenspan's successor. So much has been written about Bernanke in recent days that we have little to add other than to say that we very much doubt that, under Bernanke's stewardship, things will be radically different at the Federal Reserve.

So what do we expect from bond yields? If our premise about the inflation outlook is correct, then it makes sense yet again to go back to the period 1865-1965 - before central banks started to print money at will. For most of this time, 10-year bond yields were in a range of 3.0-4.5%. In other words, today's rates are not abnormal at all (with the possible exception of Japan).

Bond yields on both sides of the Atlantic will probably go up a little bit in the short term. The Fed is not likely to stop tightening anytime soon, and the ECB will most likely start in the first quarter of next year at the latest. Ongoing concerns about inflation may also carry yields moderately higher. We would, however, be very surprised to see yields move significantly higher. The combination of contained inflation and decelerating economic growth next year will effectively put a lid on yields.

One potential risk to our benign bond yield outlook is the rampant expansion of the monetary base in Europe. At this point in time, we are not overly worried because, after all, Europe did need a dose of adrenaline, and they are certainly getting it at the moment. The net result is there for everyone to see in European property and equity markets. Bear in mind, though, that recent ECB rhetoric has turned a great deal more hawkish. The boys in Frankfurt are clearly preparing the market for higher rates, although we do not see overnight rates exceed 2.50% anytime soon.

This will inevitably slow down the growth in the European monetary aggregates, although 50 basis points will not be enough to kill the so-called carry trade, responsible for a decent part of the growth in the money base. Therefore, if EU inflation proves to be more stubborn than we predict, do not expect the ECB to stop at 2.50%.

Finally, we need to alert you to one more factor, which undoubtedly has played a critical role in driving down bond yields. Let's call it *changing asset preferences*. The largest stock market on earth has been generating miserable returns for the past seven years despite excellent growth in corporate earnings. With large numbers of baby boomers approaching retirement, both pension funds and private investors are growing increasingly frustrated with equities and are chasing yields to secure their pension needs/obligations.

According to our economic adviser Woody Brock, changes in asset preferences have a *much bigger* say on asset prices than changes in economic conditions (almost by a factor 10:1). In other words, if you wish to predict tomorrow's bond yields, forget about whether the economy will be growing at 2% or 3% per annum, or inflation will be 1% more or less. Focus instead on what your fellow investors are buying and selling. With the demographic outlook pointing towards more and more middle-aged and old people, we know where we want to put our bets.

Niels C. Jensen

The Concept of Value

When we manage our multi-strategy fund or alternatively construct a portfolio for a client, it is uncompromisingly with an absolute return strategy in mind. If we managed only equities, we would probably be value investors.

In the 1990s equity investors were more or less exclusively pursuing growth. Investors looked for high revenue growth and did not mind buying companies with negative bottom lines and balance sheets boosted by expensively acquired goodwill. The thinking was - if the company can sustain the high top line growth, all earnings and balance sheet problems will disappear over time.

History has proven that this is not always the case, even though a few high profile companies are still living the dream. Google is a prime example; with a market cap of nearly $90 billion it trades at an earnings multiple of over 70 and a revenue multiple of about 18. The highest concentration of value stocks are usually found in basic industries, utilities and financials, while growth stocks are concentrated in high-tech, pharmaceuticals and telecom.

Value investing is an ambiguous concept; however, some famous investors are closely associated with the term. Warren Buffet is probably the most famous active value investor. Some wrote him off and called him an anachronism during the bull market in the late 1990s. Buffet has successfully been faithful to the ideas Graham and Dodd outlined in their book "Security Analysis" in 1934. The book has been revised a number of times and is still an important tool in its field.

The objective of value investing is long-term superior return on equity, subject to protecting the invested capital. The objective is to find the *intrinsic value* of the company – what is it really worth? Graham and Dodd defined the following four valuation factors as major components of the intrinsic value for a going concern:

- Level of normal earnings power and profitability.
- Dividend stream and the sustainability of it.
- Expected (realistic) future earnings growth.
- Stability and predictability of projections.

In order to identify mis-priced stocks, the value of a company is compared to its stock market price. The value investor will only buy the stock, if he can identify a *safety margin.* In other words, he will only buy the stock at a significant discount to its intrinsic value. Typically, the safety margin ranges from 20% to 50%.

Throughout history, fund managers have used different methods to identify good value investments. Some investors use price-to-book or price-to-earnings. Others will construct a discounted cash-flow model or try to derive the net asset value to identify cheap stocks. Most will use a model combining the above.

In our search for good equity managers we have come across a large number of different value approaches. Some are very religious about the discipline and others have built-in growth features in their models to ensure a reasonable performance in all market environments.

Value investors should be aware that they will experience periods, such as the late 90s, where value underperforms growth. However, numerous studies show that over time value has outperformed growth significantly. One theory why growth stocks underperform value stocks is that investors get over-excited about the growth prospects of companies with fast growing earnings and bid them up to unsustainable levels.

We like value investing for obvious reasons. The methodology fits well into an absolute return strategy. The stock market will always go through ups and downs, which occasionally makes the value discipline more difficult to pursue. But, at the end of the day, the discipline makes you buy cheap stocks. Benjamin Graham, the father of value investing once said: "An investment operation is one which, through analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative".

To us, that is absolute return investing.

Jan Vilhelmsen

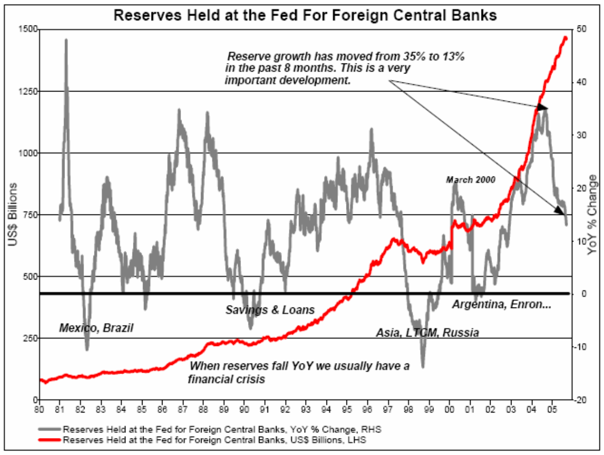
Important Changes to the Absolute Return Multi-Strategy Portfolio

We have written a fair bit about deteriorating global liquidity in recent months. To briefly summarise, deteriorating global USD liquidity usually causes pressure on riskier asset classes, such as emerging market bonds and equities, as well as commodities. It will also likely lead to a rise in credit spreads (so be careful with your corporate bonds), rising volatility in equity markets and more often than not, to a stronger U.S. dollar, which is why we strongly recommend not to be short U.S. dollars at the moment.

With the exception of the ECB, every central bank in the world seems to be determined to remove liquidity from markets. And, as we discussed in the earlier article about inflation and interest rates, it is now only a question of time before the ECB also jumps on the bandwagon.

Moreover, as far as we can see, the liquidity situation shows no signs of improvement; in fact, the rate of slowdown (the grey line in chart 1 below) is accelerating.

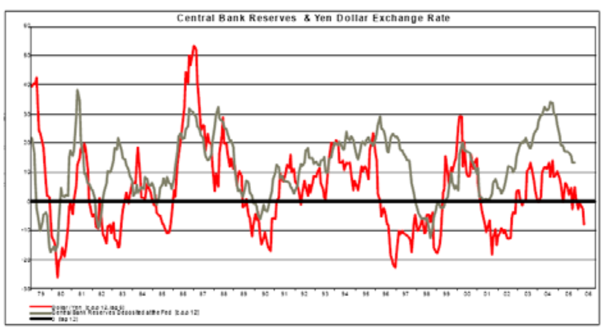
Chart1:



Source: GaveKal Research (www.gavekal.com)

GaveKal have recently pointed to an interesting link between the JPY/USD exchange rate and US dollar reserves held at the Fed for foreign central banks (which is a widely used measure of USD liquidity). According to them, the Yen leads global liquidity by approximately 6 months (see chart 2). Given the recent weakness of the Yen, the only conclusion we can reach is that global liquidity is likely to deteriorate further before any improvement can be expected.

Chart2:



Source: GaveKal Research (www.gavekal.com)

Consequently, we are reducing our exposure to some of the riskier asset classes in the Absolute Return Multi-Strategy Fund and increasing our allocation to areas where we believe we can find some protection against the gathering storms. Note that only qualified investors may invest in the Absolute Return Multi-Strategy Fund.

Model Portfolio Weights:

Asset Class:	***New:***	***Old:***
Cash	14% (↑)	12%
Inv. Grade Bonds	10% (↑)	7%
Cat. Bonds, etc.	6%	6%
OECD Equities	9%	9%
EM Equities	2% (↓)	3%
Alt. Fixed Income	15% (↑)	12%
Alt. Equities	20% (↓)	25%
Managed Futures	6%	6%
Commodities	6% (↓)	8%
Currencies	7% (↑)	5%
Property	5% (↓)	7%
TOTAL	100%	100%

Niels C. Jensen

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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Absolute Return Multi-Strategy Portfolio

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