Absolute Return Partners LLP

The Absolute Return Letter February 2006

Summary

Following the consensus view is one of the easiest things to do when investing, but it is not necessarily the route to prosperity. In this month's letter we discuss the importance of not following the herd, and we look at some of the biggest consensus trades of 2006.

If history repeats itself, more than half the consensus trades we discuss will prove to be money-losing propositions. Check your portfolio and make sure you are positioned appropriately.

In the second article we take a closer look at the lacklustre returns hedge funds have offered in recent years, and we offer some suggestions as to how this problem may be overcome.

In co-operation with John Mauldin, we are currently working on a new product which is designed to overcome the performance problems that many hedge funds are suffering from. The rules prohibit us from discussing this product in more detail, but feel free to give us a call if you believe such a product may be suitable for you.

Enjoy the read.

Challenging the Consensus

When embarking on a new investment, it is always advisable to take the temperature on the market, also called the *consensus view*. Most of us probably recognise the comfort it gives us when our friends and colleagues confirm our views. Few people can honestly say that they are immune to this.

However, this is *not* the reason the consensus view is important. Quite frankly, it is important to know the consensus view, because it is more often wrong than right. Why is that? Are we suggesting that the majority of investors are stupid? Not at all. It would not only be arrogant to suggest that but also factually incorrect.

In order to understand why the consensus view is often (but not always) wrong, it is important to understand how it is formed. It shouldn't surprise you that the best investments are usually those that not everyone has discovered.

When a new investment trend is borne, it usually begins with some really smart investor sticking his neck out long before the rest of us can see the light.

Once he has established his position, he starts using the oldest trick in the book. We call it *Get Long and Get Loud.* He will be the person at the dinner party whispering in your ear that you should buy shares in this oil company in the Falklands Islands that *nobody* has ever heard of. The problem is, at this stage, your reaction is likely to be indifferent at best, because it is not yet a widely held view.

Now imagine what happens next. A few people, who know the track record of the person in question, actually buy into his recommendation. Slowly but surely, the idea spreads. Two years later, the worst kept secret in the world is that you should fill up your portfolio with small oil exploration companies in far fetched corners of the world.

At this point the really smart guy sells his shares. No prize for guessing who makes the most money. And the poor soul who bought it last is likely to lose his shirt. Along the way the theme became the consensus view. And, precisely at that time, it went from being a money-making to a loss-making proposition.

Therefore, more often than not, it is not commendable to follow the consensus view. The odds are stacked against you. Instead, you want to invest in themes which are not yet consensus views. That is how the truly great fortunes have always been made. Unfortunately, it is also the more difficult thing to pull off.

We shall now look at what we believe are some of the biggest consensus trades for 2006. The bad news is, if you recognise every theme as being in tune with your current portfolio, you may be in for a rough time in 2006.

Just one final health warning before we go through the list. The consensus views expressed below represent our views and our views only.

Please forgive us if we missed one or two important ones. And now to the list:

 # 6: The Euroland economy to recover

You may ask, what economic revival? Fair question. The signs of revival are not yet very robust, but the strong surge in European share prices last year is testament to the fact that many investors expect better times ahead for the lethargic nucleus of Euroland, France, Italy and Germany (the FIG countries).

As a result of stronger growth expectations, the market also expects European interest rates to rise modestly. The overnight rate appears to be heading towards 2.75%, and the 10-year bond is heading towards 4% from 3.48% currently. That is if you believe the consensus view.

The risks to this view are many. We will highlight just one. If the governments of the FIG countries continue their current line of economic policies, we will bet a great deal that economic growth will disappoint yet again, not only in 2006 but also in 2007. Therefore we think the risk to long bonds in Euroland is on the downside as far as yields are concerned.

 # 5: Commodity prices to carry on rising

This view is largely attached to the general belief that strong economic growth in Asia, and particularly in China and India, will cause commodity prices to rise for years to come. One interesting aspect about commodity prices is that, although many are bullish, not so many have in fact positioned themselves accordingly.

Take the pension fund industry. It is our understanding that many pension funds are still struggling to come to terms with this asset class. How do they get their exposure? etc. etc. Partly for this reason, the odds may be tilted in favour of the consensus view in this instance.

However, the consensus conveniently ignores the fact that commodity prices are *extremely* sensitive to economic up- and downturns, so although the underlying trend may be up, investors could very well be in for a rough ride, if the global economy softens later this year.

 # 4: Gold prices heading higher

Gold usually does well when inflation expectations are on the rise. Likewise, a weak U.S. dollar is often linked with a rise in the precious metal. The recent run in gold prices should therefore tell us something about inflation expectations and the consensus view on the dollar (which we will get to in a second or two).

A fact often ignored by the gold bulls is that demand for gold is very seasonal, and we happen to be at the tail end of the peak season. For us, the jury is still out. We will be a lot more impressed if gold can sustain its rally into the spring and summer.

 # 3: The Fed has almost done the job

It is now widely accepted that the Fed is almost done with its series of rate hikes. We have one, maybe two, hikes to go, taking the Fed Funds rate to 4.75% at worst. The very weak GDP report released last Friday only reinforced this view.

The equity bulls use this argument to build a case for buying U.S. equities. For the first time in years we have actually seen prominent European fund managers advocating an overweight in U.S. equities relative to European equities.

The main risk to the view on Fed policy is inflation. The impact from higher oil prices has been subdued so far, but do not ignore the fact that last Friday's GDP report also included not so good news on consumer inflation in the U.S.

We *know* that the Fed governors are concerned about the inflation outlook. We saw in last week's report that this concern may be justified. The risk to the market is obvious. The Fed may not be as close to the end of this cycle as many expect. If the Fed Funds rate has to go 5.50% or perhaps even 6%, in order to take the air out of the looming inflation bubble, things could get pretty ugly.

 # 2: U.S. imbalances are unsustainable

This is a big one. It is an opinion held almost universally, and we cannot do the subject any justice in a paragraph or two. The view itself is straight forward. A large (and growing) trade deficit combined with a spiralling budget deficit is a disaster waiting to strike.

Sooner or later, the view goes, interest rates will have to go up, and the U.S. dollar will have to fall, in order to address those imbalances. Well, in our opinion, things are not that simple. Historically, imbalances have been adjusted through exchange rates rather than bond yields, so history suggests that we should worry more about the dollar than the 10-year treasury yield.

The dollar, however, is not just a function of trade patterns. Other capital movements are important to the value of the dollar. Which currencies do the central banks hold much of their reserves in? Where do the Indians and Chinese invest their savings? The outlook for the dollar is, in our opinion, not as one-sided as many people seem to think.

 # 1: Japanese share prices to go up and up

This is probably the biggest consensus trade of them all. We have been struggling to find anyone *not bullish* on Japanese equities. Is it because we don't speak to domestic Japanese investors?

Apparently, they are not (yet) very bullish. Or that is at least what the bulls are telling us.

We have to make a confession here. We like Japanese equities too. Partly because we believe the Yen is undervalued. By buying Japanese shares and not hedging your currency risk, you have an interesting two-way bet, although we cringe when using the word *bet* in the same sentence as discussing investments.

What could go wrong? In our opinion, there are two big risks to this consensus view. The war against deflation may in fact *not* be over yet and, secondly, Japan's economic wellbeing is frightfully dependent on growth elsewhere, as much of the revival has been export driven. The U.S. economy hit a brick wall in the fourth quarter of last year as reported last Friday. Japan is dependent on the U.S. economy both directly and indirectly. Indirectly, because China is now Japan's largest export market, and China's biggest export market is the United States.

Other Consensus Themes

The list above is by no means complete without a brief mention of some of the other important investment themes that seem to dominate the world.

House prices have proven such a powerful fuel for the spending spree that consumers in the Anglo-Saxon world, Spain, Scandinavia, etc. have enjoyed in the last few years. Most people seem to believe that a soft landing for house prices is the most likely outcome. One wonders what would happen if the outcome is not so benign.

The inverted U.K. yield curve suggests a high probability of a recession looming in the UK, but the consensus view appears to be that the UK economy is heading for a more modest slowdown. Has the yield curve lost its predictive powers or is the market ignoring the obvious?

The small adjustment last summer of the renminbi was, in the opinion of a large majority of the market, hopelessly inadequate, and the consensus view seems to be that there is only one way to go for the Chinese currency – further appreciation. This view completely ignores the fact that the value of the Chinese currency is dictated by the policies set by the Chinese leadership. Do not be surprised if the change in value of the renminbi over the next few years proves to be very minor indeed.

Conclusion

Obviously, some of the consensus themes above will turn out to be spot on. Others will perhaps be proven correct eventually, but the timing was off. And some will turn out to be embarrassingly inaccurate.

If history repeats itself - and it often does when it comes to market psychology - more than 50% of the consensus views discussed above will prove to be money-losing propositions in your portfolio in 2006.

It would therefore be an interesting exercise to create a portfolio consisting of ideas which go against all the big consensus themes. You would be far more likely to make a good return on that portfolio than if you were just to follow the herd. It requires courage, perhaps even a regular dose of Imodium, to do so. But the odds will now be in your favour.

Niels C. Jensen

In Search of Hedge Fund Returns

It was not supposed to be like this. In the glory days of the hedge fund industry, hedge funds actually delivered what they have always promised, which is 10-15% annual returns and much lower volatility than equities. Now, if you look at the recent past (see the table overleaf) it is evident that the sparkle has all but disappeared. In recent years, only 2003 delivered the sort of returns that most investors expect from hedge funds.

Does it mean that hedge funds have gone off the boil for good? We don't think so, but you may have to approach hedge funds differently going forward, if you are looking to achieve the consistent double-digit returns that hedge funds used to be associated with. Here is why and how.

There are many reasons why hedge funds have struggled to live up to expectations. We believe two reasons stand out. Firstly, too much money has gone into hedge funds in recent years. Globally, hedge funds are now a $1 trillion dollar plus industry. The huge inflow has had a detrimental effect on returns, as fund managers are struggling to find enough good ideas for the very large pool of money they have available.

Secondly, the attitude towards risk has changed in recent years. Back in the 1980s and 1990s, when the majority of hedge fund investors were to be found amongst high net worth individuals, hedge fund managers did not mind a bit of volatility in the portfolio. Neither did investors, so long as returns were satisfactory at the end of the year.

Then, in the late 1990s, institutional investors started to throw money at hedge fund managers, and with that the attitude towards risk changed. Low volatility appeared to become the objective

Hedge Fund Performance 2000-2005 (selected strategies):

	2000	2001	2002	2003	2004	2005
Equity Long/Short	9.09%	0.31%	-4.71%	20.53%	7.69%	10.67%
Fixed Income Arbitrage	4.78%	4.81%	8.77%	9.35%	5.99%	5.54%
Global Macro	1.97%	6.87%	7.42%	21.44%	4.64%	6.05%
Merger Arbitrage	18.04%	2.76%	-0.86%	14.39%	4.08%	5.37%
Global Hedge Fund Index	N/A	N/A	N/A	13.39%	2.69%	2.72%

Source: Hedge Fund Research indices, measured in USD

in itself. This trend is best documented through the significant drop in leverage applied by many hedge fund managers since the 1998 collapse of Long Term Capital Management.

Now to the tricky part. How can you as an individual investor get around this and achieve returns akin to those we got used to in the 1990s? We suggest the following "road map":

Rule # 1: Do not consider hedge funds one asset class. There is a myriad of different asset classes available to investors, offering vastly different risk/return profiles.

Rule # 2: Think of hedge funds as small businesses which means that you need to identify – and be comfortable with – the one or two people critical to the long term success of the business.

Rule # 3: Do not be afraid of investing in high volatility strategies. If you structure your portfolio correctly, much of this single-manager volatility can be diversified away.

Rule # 4: Do not limit yourself to equity long/short funds, arguably the largest hedge fund segment. The problem is, many equity long/short funds are long-only funds in disguise. They will go up and down with equity markets. Why pay 20% in performance fees if you can achieve virtually the same with a high quality traditional equity manager?

Let's spend a little bit more time on this final point as it is very important. Investing in equity long/short funds is essentially a zero-sum game[1]. In other words, for every manager outperforming the stock market, by definition, someone else must underperform. The industry has a word for this. We say that a manager generates *Alpha* if he outperforms. A market in which total outperformance equals total underperformance is said to be a *Zero Alpha Pool*.

Do you really want to fill up your portfolio with *Zero Alpha Pool* strategies? If you do, the performance of your portfolio will depend very much on your ability to pick managers who can consistently outperform the market and, of course, on the market itself. Trust us - few portfolio managers are capable of consistently outperforming the market.

Here is one example of a hedge fund (based in New York) which falls firmly into this category. It offers finance to small- and micro-cap companies looking to make acquisitions. This market is not well served at all by the banks, so the hedge fund in question has carved out a niche where they provide finance to the acquiring company. Returns have historically been north of 15% and quite stable.

Another example: A hedge fund based in London specialises in providing weather related insurance to companies and organisations to whom adverse weather may be detrimental to business. Imagine the cost to the organisers of the Wimbledon tennis tournament if it were to rain solid for the two weeks the tournament lasts. Or imagine the cost to a retailer like Next or Gap if an Indian summer erupts at the time their winter collection comes out. Companies such as these have a strong interest in buying protection against adverse weather conditions.

Investing in funds with *Positive Alpha Pools* requires in-depth knowledge of the hedge fund industry. They are harder to find than plain vanilla equity long/short funds, but it is worth the extra effort you have to put in. The returns are better protected from the erosion that more traditional hedge funds are suffering from, and we would also expect them to hold up better during a general bear market.

At Absolute Return Partners, we specialise in identifying such strategies for our investors. We are indeed working on a new product designed to overcome the performance problems discussed in this article, but the rules prohibit us from discussing this in further detail, as hedge funds are not suitable for everyone. But for the right investor, and used appropriately, hedge funds bring a lot of value-added to a portfolio which cannot be achieved through more traditional investments in bonds and equities.

Niels C. Jensen

[1] *If one includes transaction costs, the zero-sum is in fact negative.*

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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The Absolute Return Multi-Strategy Portfolio
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