



## The Absolute Return Letter

June 2006

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### **Summary**

*This month we take a look at the recent rise in volatility and the factors behind this turn of events. We argue that investors have become overly complacent in recent months and that what we experienced in May is only a return to normality. We do not accept the argument put forward by some market observers that volatility has been structurally reduced through increased central bank transparency.*

*In the second article we look at some of the reasons why younger hedge funds tend to do much better than their more established peers. Factors such as size, complacency and risk aversion all play a role, we believe.*

*Enjoy the read.*

### ***The Bulls, the Bears and the Pigs***

There is an old saying in our industry that investors do not only consist of bulls and bears. One needs to include the pigs as well. The bulls usually find themselves in trouble when share prices fall. The bears lose out when share prices rise, which is most of the time. And the pigs? Well, the pigs always get slaughtered.

Why a reminder of this age old aphorism? Because the pigs have fallen on hard times in recent weeks, getting overly enthusiastic about the run in equity and commodity prices only to see themselves getting well and truly whipped by market forces, once the invisible hand decided enough was enough.

The pigs are guilty of one of the most frequent mistakes made by investors. They always believe that this time things *are* different which, in truth, they very rarely are. Investment behaviour is, and has always been, driven by greed and fear. Or, as our economic advisor, Woody Brock, stated in a recent essay<sup>1</sup>, *"it is the changes in consensus beliefs (e.g. from optimism to pessimism) about future returns that generate the dynamics of market valuations"*.

To set the frame for our discussion this month, let's begin with a quote from GaveKal Research, taken from an interesting research piece, produced a couple of weeks ago on the subject of fear<sup>2</sup>. The following two paragraphs from that essay sums up their views pretty well:

*"The central banks of the world are doing their utmost to ensure that participants in the financial markets are never surprised. And, as we see it, such a course of action allows the "fear" element to disappear from the market.*

*For Japan, this policy might make sense (since the country suffered 15 years of markets paralyzed by "fear"). But does it make sense for all central banks everywhere? When the "fear" element disappears, capital tends to be wasted, a fact which over time tends to lower returns on invested capital."*

If fear temporarily diminishes or disappears from markets, one likely result is reduced volatility. If you have nothing to fear, why should you sell on bad news? And it is indeed the occasional selling pressure which causes much of the volatility.

Lower volatility (until a couple of weeks ago, that is) is precisely what equity investors have benefited from in recent years. We have calculated the stock market volatility for each of the past 8 decades, using data from the United States<sup>3</sup>. For comparison, we have then calculated the volatility for the past 2 years only. The numbers which you will find in table 1 make for some interesting reading.

For the purpose of this exercise, we should probably ignore the first two decades. The late 1920s and the 1930s were impacted by the stock market crash and the subsequent depression which hit the U.S. economy. However, since the 1940s, the volatility of U.S. stocks has been remarkably stable – in a range of 13-17% based

<sup>1</sup> *The True Sources of U.S. Asset Inflation – Debunking the "Liquidity" Story. Strategic Economic Decisions, Inc., May 2006.*

<sup>2</sup> *Does Transparency Kill Fear? GaveKal Research, May 2006.*

<sup>3</sup> *Our European price database only goes back to 1970, but results since then are remarkably similar, so you can probably assume that our U.S data is representative of Europe as well.*

on monthly returns (with the occasional spikes which you cannot read out of this table).

**Table 1: Stock and Bond Market Volatility**

Monthly Returns	US Stocks (S&P500)	US Bonds (10-yr gvt.)
1926-35	40.52%	4.96%
1936-45	24.91%	3.95%
1946-55	15.60%	3.15%
1956-65	13.08%	4.64%
1966-75	16.32%	9.07%
1976-85	16.28%	14.13%
1986-95	17.30%	10.91%
1996-05	17.23%	9.89%
Last 2 Yrs	8.73%	7.88%

Now, compare that number to the volatility of the last 2 years which we have calculated to be 8.73%. This translates into a reduction in stock market volatility of 30-50% for no apparent reason.

If you believe the situation is substantially different in Europe, think again. Volatility over the past 2 years in Germany has been 10.45%, 7.65% in France and 6.53% in the UK versus long term averages of 15-20% in those countries. No wonder investors started to believe they could walk on water.

Bonds, on the other hand, had a spike in volatility during the high-inflation period of the 1970s and 1980s. Volatility has been trending down ever since the world's central banks got inflation under control again. If one believes that today's inflation environment more closely resembles that of the 1926-1965 era (as we tend to do), a strong case for a further reduction in bond market volatility can be made. But that is not what this month's letter is about.

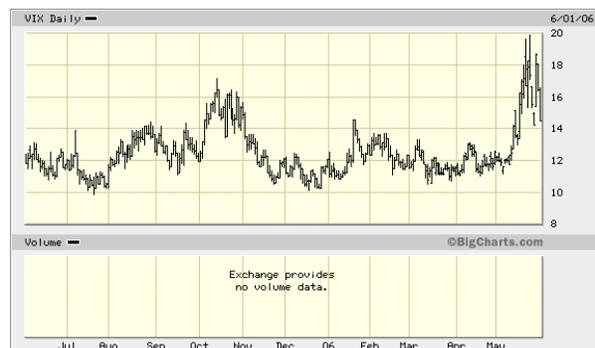
It is indeed a very interesting theory that the openness on monetary policy offered by central banks in recent years to a large degree explains the reduced volatility. There can indeed be no doubt that central banks have done their utmost to advertise even subtle changes in monetary policy in order to reduce the surprise element.

However, as we last saw in 1994, central bankers do actually get it wrong from time to time. They have no monopoly on the truth. The result in 1994? A serious correction in both bond and equity markets.

Take a look at chart 1 below which measures U.S. stock market volatility (the index is called VIX).

As you can see, volatility has spiked recently, after trending down over the past 2 years. However, as you can also see, spikes are regularly recurring events. It happened twice in 2004 and again twice in 2005. Usually, spikes in volatility are associated with sell-offs.

**Chart 1: Volatility Index (last 2 years)**



Source: BigCharts.com

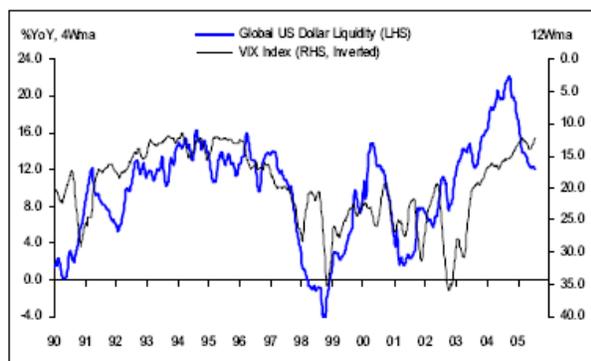
So, despite what you may think, recent events are not at all unusual. They represent an almost self-regulating mechanism whereby all life is squeezed out of the pigs. It always happens when things get too easy.

So where are we going with this? A number of important observations can be made:

1. Volatility is not a function of central bank transparency but of human behaviour. Greed has dominated fear for a while now, but reduced fear is a temporary phenomenon. It is *never* permanent. Eventually (and that may or may not have occurred 2-3 weeks ago), when the element of fear regains its normal position in peoples minds, volatility will gradually reverse to more normal levels.
2. Fear has been temporarily suppressed in the minds of most investors because central banks all over the world have pursued an ultra-lax monetary policy for a while now. This policy has raised the appetite for riskier assets and caused many investors to believe that there was no risk. If you can borrow at 2-3% and invest at 6-8%, how can it possibly go wrong? Famous last words.
3. Increased central bank transparency fooled most of us into believing that they had finally figured it out, and that we could count on them to steer the global economy through thick and thin. We do not buy that argument. If the global economy is less cyclical today than it used to be, it is because of globalisation, not because we have been fortunate to select some über-humans as our central bankers who know how to take the volatility out of the global economy.

4. Each story created by the bulls is actually quite plausible. How can commodity prices go anywhere but up with ever rising demand from China? The bulls have created plenty of hype and the pigs have followed like sheep. For those of you not entirely familiar with our animal kingdom, the logic is that bulls get in early and understand the value of taking profits. The pigs get in late and never take profits until the profit has suddenly turned into a loss.
5. Recent events were actually not entirely unpredictable. On the basis of the deteriorating global liquidity situation in the second half of last year, we predicted a spike in volatility and a sell-off in some of the riskier asset classes in our September and October letters last year. The only thing which has surprised us is that it took 6 months to happen.
6. Following on from the last point, and as demonstrated in our September 2005 letter (see chart 2 below), there is a strong link between volatility and monetary policy. When central banks drain liquidity from the system, as they are now busy doing, volatility goes up and visa versa. Chart 2 measures only U.S. dollar liquidity. However, with the world increasingly becoming one big market place, not only as far as trade is concerned but also with respect to capital movements, the fact that the European Central Bank and the Bank of Japan are both in the early stages of their tightening cycle does not bode well for volatility.

**Chart 2: Global USD Liquidity v. Volatility**



Source: Merrill Lynch

So what does it actually mean for your portfolio – and wealth – if volatility is yet again on the rise? Obviously, rising volatility is often associated with falling prices, and it is indeed true that the spikes on the VIX chart (see chart 1) were all associated with quite violent downward price moves.

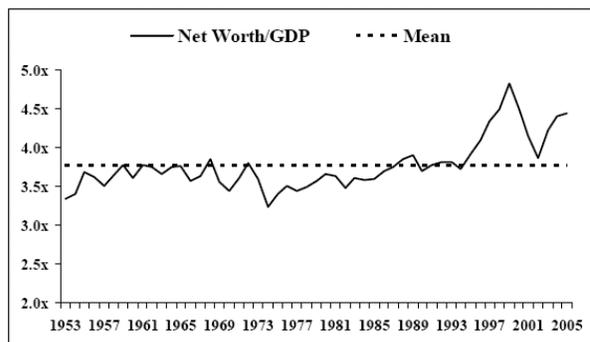
But volatility in itself is not the end of the world if you can afford to sit it out. What you should really worry about is the value of your portfolio when you actually need your savings. For most of us, that day arrives when we retire. And given the demographics of the western world, the reckoning day is actually closer than most of us like to admit.

In another essay from his latest research publication<sup>4</sup>, Woody Brock shares with his readers a revealing link between GDP growth and wealth growth. Needless to say, it shouldn't come as a great surprise that there is some link between GDP growth and wealth growth.

However, what we certainly didn't realise is that the relationship is locked in a fairly tight range and that there are reasons why the ratio cannot move out of that range on a more permanent basis. We shall not tire you with the details, but suffice to say that it has to do with the capital-output ratio. This ratio measures how much capital is required to produce a unit of output (GDP). Economic theory suggests that this ratio is a remarkably constant 3-4 times, regardless of whether you measure it in a mature slow-growing European economy or in a fast growing South-East Asian economy.

Now, and with this ratio in mind, Woody Brock demonstrates that the wealth-GDP ratio works in much the same way. As you can see from chart 3 below, which we have borrowed from his latest research piece, the long-term average for the wealth-GDP ratio is about 3.75. In fact, if it wasn't for the strong growth in wealth over the past decade, the long-term average would only be about 3.5 times.

**Chart 3: U.S. Net Worth v. U.S. GDP**



Source: Strategic Economic Decisions, Inc.

The point of all this is that *wealth has to grow slower than GDP for years to come*, because the ratio is a factual relationship that cannot be broken other than on a temporary basis. This observation is obviously based on U.S. data, and

<sup>4</sup> *The Disturbing Dynamics of U.S. Net Worth*, Strategic Economic Decisions, Inc., May 2006

you cannot automatically assume that the country you live in will be subject to the same mechanisms. However, if you look at the strong run in equity and property prices in many European markets over the past decade, we would be surprised if a fundamentally different picture emerged in Europe.

Falling asset prices at a time when millions of people in Europe and North America contemplate retirement is the true end-game. Rising volatility is really only a bi-product.

*Niels C. Jensen*

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## **Size Matters**

In hedge fund investing size matters, but big is not always beautiful. A number of surveys over the years have documented that younger funds significantly outperform their older peers. Funds younger than 2 years tend to do particularly well, even when taking into account the failure rate of start-ups.

A recent survey from Hedge Fund Research (HFR) reveals that, over the past 5 years (through 2005), funds less than 2 years of age have returned 11.13% per annum to their investors compared with an overall hedge fund return of 5.17% per annum. Over the past 10 years, the young funds are up 16.91% per annum, outperforming the overall hedge fund universe by 6.38% per annum.

HFR also found that those who started a hedge fund in 2003 with \$30-250 million under management, returned 11.39% in 2004, compared with an overall hedge fund return of 6.55% in 2004, according to the MSCI Hedge Fund Index. In 2005, the young funds were up 9.55% against 8.20% for all hedge funds, again according to MSCI.

Back in 2001, The Cross-Border study (using the TASS hedge fund database from 1994 to 2000) found that the youngest 10% of all hedge funds beat the oldest 10% by a whopping 9.70% per annum. The study further concluded that investors should focus on funds up to 3 years of age. This study also took failures into consideration.

Lazards have also conducted a study supporting these findings. In addition to the above, they found that risk-adjusted returns for young hedge funds are superior to those of older funds. They were also able to show a declining Sharpe ratio as a function of age.

Given the compelling statistical evidence, it is appropriate to ask why the rising stars do so much better than their older peers.

Number one on our list is *sweat and hard work*. In the early stages of the hedge fund's life, the managers are hungry for success. The people behind are *strongly motivated* to survive and be successful. As the fund grows in size, not only may some complacency find its way into the heads of these managers but, more importantly, the appetite for risk changes. Now the funds' key investors are most likely to be institutional investors, and they steer, deliberately or not, the managers towards taking less risk. With that, returns start to suffer.

Another argument in favour of younger funds is what we would call *anomalies in new markets*. Managers sometimes spot investment opportunities which have not yet been fully exploited. In the early days of the fund's life, it will most likely benefit from these anomalies. However, the better the fund performs, the more competition it will naturally attract within that space.

*Size* is a third reason behind the outperformance of young funds. Young hedge funds with modest amounts of money under management can find sufficient liquidity in small markets where returns are often superior. Multi-billion dollar funds, on the other hand, often suffer from liquidity constraints. The choice for the large fund is simple – either to accept some additional liquidity risk or not to invest at all. This raises an important issue for the mature fund. How much capital should be accepted before the fund closes its doors to new investors? In our opinion, too often the manager accepts too much money which, in turn, is likely to ruin his performance.

If you decide to buy into the argumentation laid out in this article, the question then becomes how to assess the risk of investing in a new fund. In our opinion qualitative risk assessment becomes much more important when investing in younger funds. Our preferred approach is to look at, and analyse, a young manager the same way we would analyse a company. It is not enough to be satisfied with the investment approach and returns. We need to have a thorough understanding of the set-up, logistics and risk management procedures in place. The younger the fund is, the more important it is to verify the investment team's pedigree. It is all part of good due diligence procedures to ensure a satisfactory understanding of the investments and the people behind the fund.

Another major challenge we as investors are faced with is an understanding of how long the young manager can reasonably be expected to remain his "sweet spot". The simple approach is to look for the performance numbers to change pattern. However that, by definition, is retrospective. We therefore also closely monitor

other factors such as flows into the fund and changes in personnel.

In conclusion, there is no doubt in our minds that young and rising stars have helped our performance. Having said that, we will continue to invest with more mature hedge funds as long as they act like the young ones. In particular, we like to invest with older funds that demonstrate an entrepreneurial attitude and that constantly seek to renew their business model in order to take advantage of the same market anomalies as their younger competitors. As with everything in life, getting the balance right is the key to success and happiness.

*Jan Vilhelmsen*

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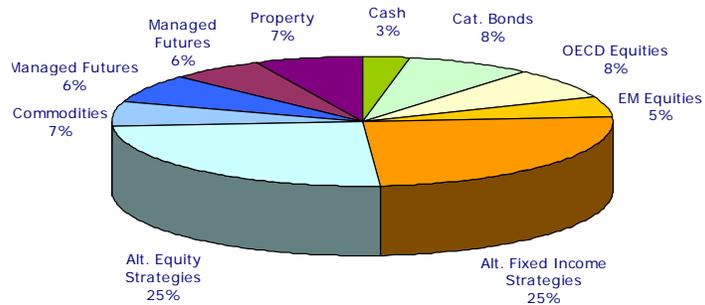
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The Absolute Return  
**Multi-Strategy Portfolio**  
1<sup>st</sup> June, 2006



The Absolute Return  
**Alternative Portfolio**  
1<sup>st</sup> June, 2006

