
# The Absolute Return Letter

July 2006


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## *Summary*


*Stocks and commodities have been highly correlated recently – even to the point where some market observers have been suggesting that this may represent a paradigm shift and that investors need to revise the way commodities are used to diversify their portfolios.*

*We disagree. The performance of stocks and commodities is likely to de-couple sooner or later and the key to performance will once again be to correctly assess where we are in the economic cycle. This is the focus of our first essay.*

*In our second essay this month, we take a closer look at a recent UBS study which confirmed our long-held view that certain types of hedge funds have been designed more for the benefit of the manager than investors. If you pay the high fees that hedge fund managers demand, you would at least expect to get something that you cannot easily create yourself. Many emerging market hedge funds do not pass this simple test.*

*Enjoy the summer. We will be back with the first letter of the autumn on or around the 1st September.*


## *So Much Nonsense*

So much nonsense has been written recently, following the dramatic sell-off in equities that we thought we would take a quick look in the rear mirror and see what history may be able to teach us in terms of what to expect of both stock, bond and commodity prices over the next year or so.

Let's begin by putting a marker down. We are great believers in the value of past experience. So often we hear the dreaded words - *this time things are different* – and every time those words make us cringe. As students of economic history we believe we can learn a great deal from the past. In the world we observe, things are rarely that different.

Back in 2004, Gary Gorton and K. Geert Rouwenhorst wrote a paper called *Facts and Fantasies about Commodity Futures*[1]. The paper has been updated recently and offers some revealing insight into the interaction between stocks, bonds and commodities.

Let's begin with a table which may surprise you a bit. It certainly surprised us. The National Bureau of Economic Research in the United States (NBER) divides every business cycle into periods of economic expansion and recession respectively. Since they started doing so in 1959, the U.S. economy has undergone seven full business cycles, each consisting of one expansion and one recession.

As you can see from table 1 below, it is very tempting to conclude that there is no real reason to add commodities to your portfolio, as the returns you have achieved during both expansions and recessions are broadly similar to those of the equity market. During periods of economic expansion, equities modestly outperform commodities whereas, during recessions, commodities do marginally better than equities. However, the difference in performance does not really get the adrenalin going.

**Table 1:**
**Average Returns during Expansions and Recessions**

| | Stocks | Bonds | Commodities |
|---|---|---|---|
| **Expansion** | +13.29% | +6.74% | +11.84% |
| **Recession** | +0.51% | +12.59% | +1.05% |

*Source: NBER, Working Paper 10595*

Also, bear in mind that the returns in table 1 are *not* annual returns. They are returns from economic cycle peak to trough (or trough to peak). Since the periods of economic expansion tend to run considerably longer than the

[1] *Working Paper 10595, National Bureau of Economic Research*

recessionary periods, average bond returns are not quite as attractive as they appear in table 1.

However, what Gorton and Rouwenhorst did next, changed everything. Following NBER's methodology, they divided each period of economic expansion into *early stage expansions* and *late stage expansions.* The results are summarised in chart 1 on page 3 and are really fascinating. We make the following observations:

1. As we already pointed out, over an entire economic cycle, stocks and commodities behave quite similarly, at least as far as the total return pattern is concerned.
2. Stocks (and bonds) do much better than commodities in late recessions and early expansions. Late recessions are, in fact, the worst environment for commodities where the average return has been negative.
3. The best environment for commodities is late expansions where the average return both in absolute and relative terms is very attractive.
4. In early recessions, where stock and bond returns really suffer, commodity returns are still quite attractive, at least in relative terms.

All this leads to the $1 million question: Where in the cycle is the global economy today? Knowing the answer to that may explain the difference between poor and good performance in your portfolio over the next 12-18 months. Before we go there, an important disclaimer:

*Absolutely no assurances can be made that history will repeat itself. Furthermore, the performance numbers in chart 1 are average performance numbers over seven economic cycles. The performance from cycle to cycle may in fact vary considerably.*

Having said all of that, chart 1 contains important information *unless* you believe that globalisation and cheap money has changed the way stocks and commodities correlate with each other. This argument was put forward by Merrill Lynch in a report earlier this year[2] and reiterated in a Wall Street Journal article only a few weeks ago.

The *cheap money* argument may carry some validity in the sense that low interest rates globally have contributed to the rolling asset inflation phenomenon, which started with the equity boom in the late 1990s only to move on to property markets and recently also to commodities. However, cheap money is becoming more expensive by the day, so that explanation may not hold water for much longer.

The globalisation argument simply does not stand up to closer scrutiny. It implies that *either* globalisation has changed the way we cover our commodity needs *or* that globalisation has fundamentally changed the nature of economic cycles or possibly even both. Neither, in our opinion, is true.

So, back to the $1 million question: Where in the cycle are we? Well, the world's largest economies are not synchronised at the moment, so the philosophical answer to the question is that it depends. The Anglo-Saxon economies are clearly at a more mature stage in the cycle than most continental European economies and certainly more advanced in the cycle than Japan.

So, in order not to confuse matters, let's keep our eyes on the U.S. economy which, whether we like it or not, drives everything else anyway.

The yield curve tells you that the U.S. economy is past the peak and is rapidly approaching the next recession. On chart 1, this point is represented by the red dot. If this is the point where the U.S. economy finds itself at the moment, the May/June stock market correction is probably only the beginning of something worse to come. However, in such a scenario, history suggests that commodities may do relatively well for a fair bit longer.

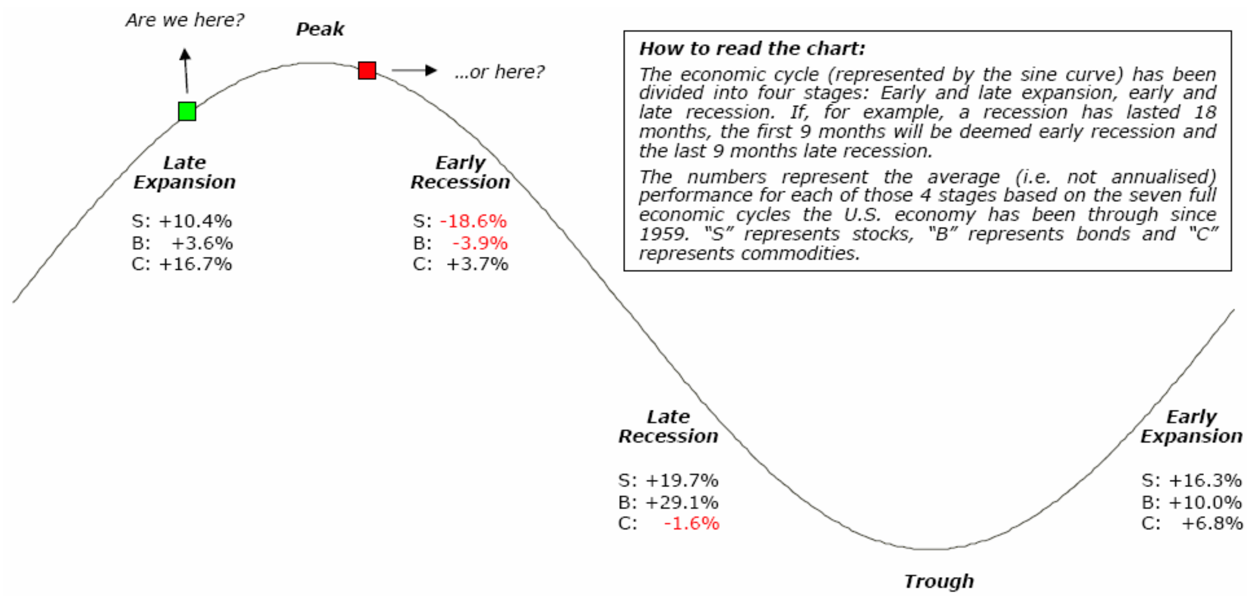
The problem with the yield curve approach, as we pointed out in our March 2005 Absolute Return Letter, is that the yield curve may not be as good at predicting recessions as it once was. Structural changes in the bond market have changed the shape of the yield curve. We concluded back then (and we stand by that conclusion) that a mildly inverted yield curve should be interpreted with care. A strongly inverted curve, on the other hand, is probably still a pretty good indication of recession knocking on the door. As these lines are written, the yield curve is only marginally inverted.

Meanwhile, virtually all other indicators suggest that the U.S. economy has not yet peaked. It may be prudent to expect a modest slowdown from the rampant growth in the first quarter of this year but, overall, Uncle Sam is still firing on most cylinders. This scenario is represented by the green dot on chart 1. Importantly, the behaviour of both stocks, bonds and commodities over the past 12 months supports this line of thinking, i.e. that we are in the latter stages of economic expansion but that we have not yet passed the peak. We prefer to listen to the markets. They usually don't lie.

As an aside, we actually think something completely different caused the hiccup in May and June. We often disagree with Stephen Roach of Morgan Stanley but believe that he nailed the

[2] *"Asset Allocation: 'Uncorrelated' Assets Are Now Correlated." Merrill Lynch Strategy Update, March 2006.*

**Chart 1: Average Returns by Stage of the Business Cycle**




issue when suggesting that the correction was a result of the world's leading central banks once and for all closing the book on the Greenspan era of cheap money and bail outs.

The so-called *Greenspan put* (the Fed's apparent limitless willingness to flood the system with liquidity and bail out markets every time someone caught the flu) has been ruthlessly removed and the change in policy has radically altered investors' appetite for risk. Don't expect it to be reinstalled anytime soon.

If our read is proven correct, then global equity markets will enjoy a decent spell over the next several months before markets start to discount the point at which the U.S. economy finally tips over and lands in the next recession. At that point in time, you do not want equities in your portfolio.

If, on the other hand, our analysis is wrong and the U.S. economy has already passed the peak, you can draw your own conclusions from chart 1. The picture isn't pretty. And that goes for European and Asian stock markets as well. However, wherever we are in the cycle, do not expect stocks and commodities to continue to move more or less in parallel. History suggests that this is a highly unlikely outcome. The sooner you decide whether to put your chips on green or red, the better.

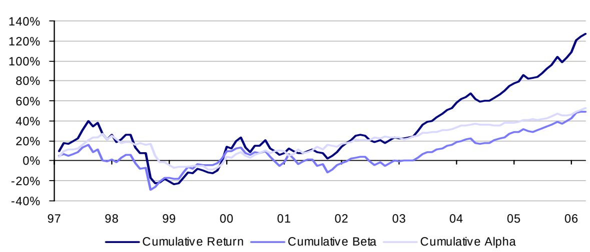
*Niels C. Jensen*

## *Show Me the Hedge*

With the strong growth in emerging market economies as well as booming equity markets (well, until about six weeks ago), we are frequently asked by our clients if we know any good hedge funds in this area. The problem is, when we invest in a hedge fund we expect to get some degree of 'hedge' on our investment. Without having any tangible statistical evidence, we long suspected that emerging market hedge funds do really well in strong markets but suffer noticeably in weak markets. As a result, with one or two exceptions, we have chosen not to invest in emerging market hedge funds, simply because we have not been able to identify any funds in this area which satisfy our strict risk/reward criteria.

To our aid came a research report from Darren Read, a strategist at UBS, tackling exactly the issue we have been struggling with. The study, which he called *The Alpha and Beta of Emerging Market Hedge Funds*[3], found that alpha[4] in emerging market hedge funds has been positive and stable for the past couple of years. Chart 2 below shows the cumulative return of emerging market hedge funds since the beginning of 1997. In addition to showing the total return, the alpha and beta[5] components have been shown separately. The findings are hardly surprising.

**Chart 2: Where Have the Returns Come From?**




*Source: UBS*

More interestingly, UBS then looked at alpha and beta in rising and falling markets, respectively. The results, seen in table 2 below, are striking. Emerging market hedge fund managers beat the market in positive markets and underperformed in negative ones - *exactly as we suspected*. In other words, they add value in good markets and destroy value in bad markets. This was the case even when the Russian crisis of 1998 was excluded from the study.

**Table 2: EM Hedge Fund Alphas and Betas**

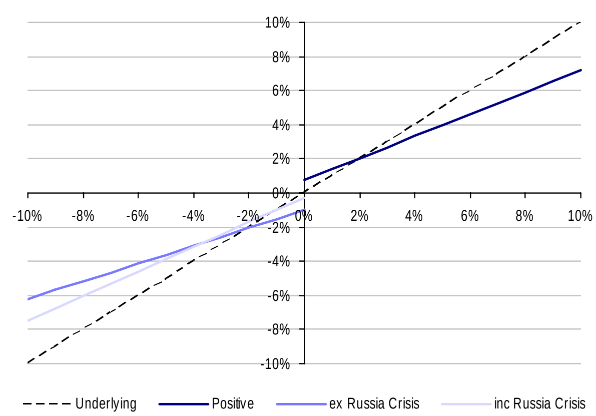
| Market Direction | Alpha | Beta |
|---|---|---|
| Positive | 9.6% | 0.64 |
| Negative | -3.0% | 0.72 |
| Negative, ex. Russia Crisis | -11.4% | 0.52 |

*Source: UBS. Benchmark is 50/50 bonds and equities.*

We would go one step further and suggest that the results would look even worse if the numbers were adjusted for leverage. In the UBS report, the (often) leveraged hedge fund results are measured against un-leveraged indices, which will tend to overstate alpha in positive markets and understate alpha in negative markets. Since there are more positive than negative months in the study, the net effect is that the alpha is inflated through leverage.

Chart 3 below shows the average return profile of emerging market hedge funds relative to the market. In the upper right quadrant (representing 'positive markets'), you will note that hedge funds (the solid line) outperform the benchmark (the dotted line). However, in the lower left quadrant (representing 'negative markets'), hedge funds underperform the benchmark.

**Chart 3:**
**Average EM Hedge Fund Returns v. Market**




*Source: UBS. Benchmark is 50/50 bonds and equities.*

The important point here is that, given the risk investors take and the fees they pay, the two light blue lines in the lower left quadrant would be expected to be on the other side of the dotted line (which is the market). Furthermore, if the hedge fund manager is true to the absolute

[3] *UBS Investment Research, May 2006.*

[4] *Alpha is a measure of excess performance, i.e. if the global emerging market index is up 10% and a global emerging market hedge fund is up 13%, we say that the hedge fund in question has generated an alpha of 3%.*

[5] *Beta measures the volatility of (for example) a hedge fund relative to the overall market. A beta above 1 suggests volatility above the market average while a beta below 1 indicates below market-average volatility.*

return philosophy, he should be able to protect investors against losses in negative months. We note that this is particularly important in emerging markets which are notoriously volatile.

The conclusion is inevitable. On average, *emerging market hedge fund managers do not deliver* on this most critical element of hedge fund investing – the ability to protect investor assets in difficult times. The problem is well documented in that it is difficult from a regulatory and liquidity point of view to go short in many emerging markets.

In short, we believe that return profiles of emerging market hedge funds look very similar to that of leveraged long-only funds. A friend of ours once defined hedge funds as 'compensation schemes' as it is about the only thing they have in common across the board. In emerging markets, that definition seems to be spot on. We have no interest in paying exorbitant fees for a leveraged long-only fund.

When it comes to investing in emerging markets, we generally prefer to put our money with a solid long-only manager where we are comfortable with the level of risk and we know we do not pay for a hedge which does not exist in the first place.

The UBS report is obviously based on historic returns. Going forward, we would expect the picture to change gradually as shorting becomes more and more accepted across emerging markets. Given this trend, we would expect more sophisticated and properly 'hedged' funds to emerge out of these markets in the not so distant future.

*Jan Vilhelmsen*

## ***Absolute Return Partners***

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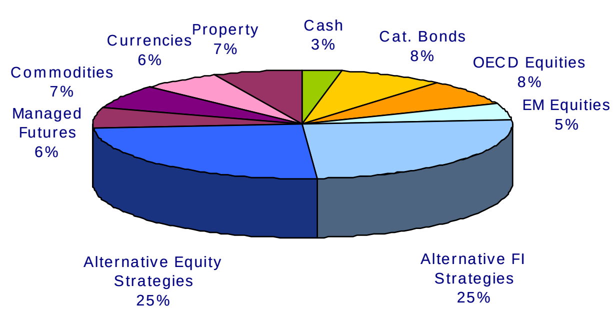
The Absolute Return
**Multi-Strategy Portfolio**
1st July, 2006

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