The Absolute Return Letter — October 2006

Summary

Every now and then we come across charts that say much more than words can. The first essay this month is light on words but, hopefully, rich on inspiration. We revisit the inflation story which we covered in more detail in last month's letter and we take a quick look at the U.S. current account deficit which may be about to improve, if history offers any guidance.

In our second essay we offer some thoughts on hedge fund investing. We are as frustrated as everyone with the performance of many hedge funds, particularly equity long/short funds. Many long/short funds are not doing their job, which is to diversify equity risk whilst generating attractive risk-adjusted returns.

Enjoy the read.

The Chart Room[1]

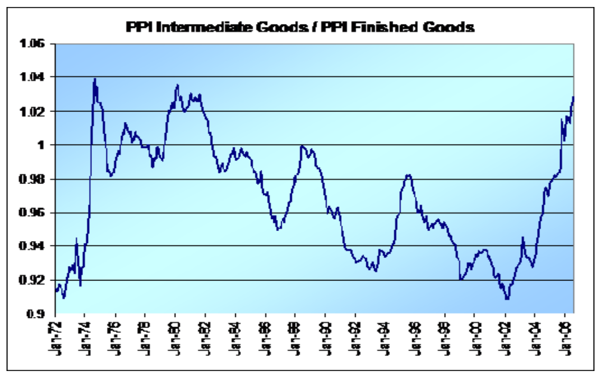
Every now and then we come across charts that say much more than words can. Shortly after we published our last newsletter - in which we expressed some concerns about the inflation outlook - we came across this chart[2] which measures the ratio between producer price inflation ("PPI") for intermediate goods and PPI for finished goods.

When we wrote last month's letter, we felt that we belonged to a minute, almost extinct, species. The behaviour of oil prices and bond yields in the month that has since passed has not diminished that feeling!

Before we cave in and succumb to the same view as pretty much everyone else – i.e. that inflation will soon turn south again - we feel urged to share this chart with you. As you may be aware, PPI for finished goods leads consumer price inflation ("CPI") by anywhere from 6 to 12 months. PPI for intermediate goods again leads PPI for finished goods by another 6-9 months.

Since PPI for finished goods and CPI are both running at about 4% at the moment (in the U.S. that is), investors have been assuming that there is no additional inflationary pressure to speak of in the pipeline. However, as chart 1 below indicates, *this is not the case!*

Chart 1: U.S. Inflation Update



PPI for intermediate goods has been running at an annual rate of almost 9% recently which provides an altogether less benign inflation outlook than the bulls want you to believe. Now, rising producer price inflation does not always result in increased pressure on consumer prices. Subject to the strength of the economy, companies may attempt to pass on price increases to consumers, or they may be inclined to take it on the chin – with lower margins to follow.

The problem is either outcome is poison for the stock market.

The second set of charts we wish to share with you come from our long standing friends at GaveKal Research in Hong Kong. They have identified a remarkable correlation between the value of U.S. housing starts and the U.S. current account deficit, with housing starts leading the current account deficit by about 6 months.

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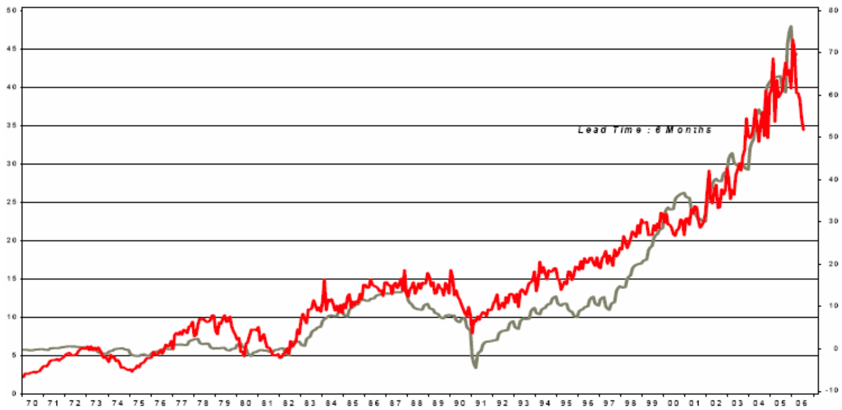
[1] *Many of our South African readers will already be familiar with this story as we traveled around your beautiful country only 3 weeks ago. We hope you will forgive us for not adding much new in this month's letter.*

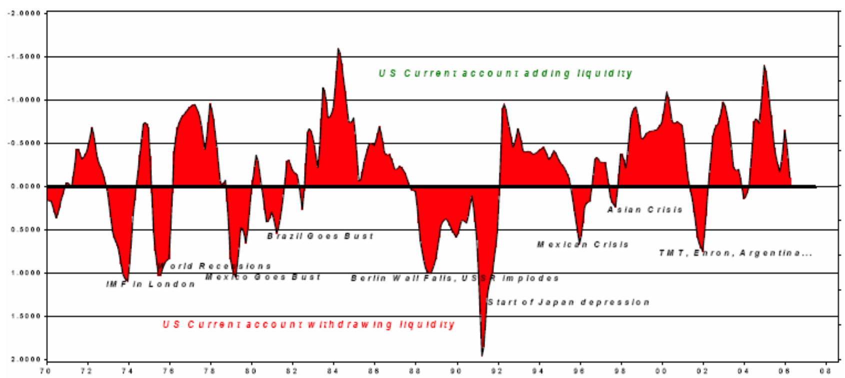
[2] *Source: Hussman Funds, Inc.*

Chart 2a: U.S. Current Account Deficit v. Value of U.S. Housing Starts



— *U.S. Housing Starts * Average Price of U.S. Homes (in $bn - left scale)*
— *US Current Account Deficit (in $bn - right scale)*

Chart 2b: U.S. Current Account Deficits & Financial Crises



— *Changes in the current account deficit as a % of GDP*

Now, with the recent collapse in U.S. housing starts, one might reasonably expect a significant improvement in the U.S. current account deficit late this year or early next year. Well, that can't be bad news you may think. After all, isn't it what the entire world has been screaming for in recent years? The U.S. must sort its own house out! It will end in tears if they continue to run a deficit of this magnitude! Or so the argument goes.

Before you nod your head in silent agreement, take a look at chart 2b. In the past 35 years, every significant improvement in the U.S. current account deficit has resulted in a financial accident or crisis somewhere on planet Earth. No exceptions!

Think about it the following way. The U.S. currently runs an $8-900 billion annual current account deficit, which is approximately 7% of GDP. A 1% improvement (as a percentage of GDP) is equivalent to removing $120 billion worth of liquidity from the rest of the world.

To some countries, that is a lot of money, which is why GaveKal states that "a reduction in the U.S. current account deficit is equivalent to a liquidity squeeze".

If you look more closely at chart 2b, you can see that 5 situations have occurred since 1970 where the current account deficit has improved by more than 1% of GDP and another 3 where the improvement has been between ½% and 1% of GDP. All 8 situations resulted in some sort of crisis somewhere.

All we can say is - be careful what you wish for.

Nick Rees & Niels C. Jensen

Absolute Returns Revisited

Investors buy hedge funds for two reasons - performance and diversification from traditional asset classes. Usually, you can achieve the desired performance through more traditional asset classes as well, but if you share our view that we are currently in a p/e bear market[3], you would probably also have to agree that one may have to look towards alternative asset classes in order to generate satisfactory long term returns.

A p/e bear market does not imply continuously falling equity prices. In prior p/e bear markets, which have lasted 13-14 years on average (se table 1a below), stock prices have enjoyed good years in between the not so pleasant ones. However, in the last 200 years, we have experienced 7 periods of 8 years or longer, where p/e values have declined significantly, resulting in average stock market returns during those periods which have only just exceeded the level of inflation.

Table 1a: P/E Bear Markets in Last 200 years:

Period	Number of Years	Real Return per Annum
1802-1815	13	2.80%
1835-1843	8	-1.10%
1853-1861	8	-2.80%
1881-1896	15	3.70%
1906-1921	15	-1.90%
1929-1949	20	1.20%
1966-1982	16	-1.50%
Overall	**95**	**0.30%**

Table 1b: P/E Bull Markets in Last 200 years:

Period	Number of Years	Real Return per Annum
1815-1835	20	9.60%
1843-1853	10	12.50%
1861-1881	20	11.50%
1896-1906	10	11.50%
1921-1929	8	24.80%
1949-1966	17	14.10%
1982-2000	18	14.80%
Overall	**103**	**13.20%**

[3] *A p/e (price/earnings) bear market is a market of declining stock market valuation.*

We originally highlighted this to our readers back in June 2004[4]. It is our contention that the spring of 2000 marked the start of a new p/e bear market. In such a market environment, investors cannot rely on the stock market to generate the returns they require. They must seek alternatives.

It is partly the search for higher returns which has caused the explosion in the growth of hedge funds in recent years. However, investors have been disappointed by the performance so far. Many hedge funds have not delivered the *absolute returns*[5] investors were told they were capable of, a point which leads to our first observation:

Not all hedge funds offer absolute returns, in the same way as not all absolute return funds are actually hedge funds.

Let's illustrate this by looking at a few charts. However, before we do that, let's point out that the analysis in the following focuses exclusively on equity long/short funds[6]. There are two reasons for this. Firstly, it is by far the single largest segment within the hedge fund universe - about 50% of all hedge fund assets are directly or indirectly invested in long/short strategies. Secondly, equity long/short is often the choice of default for first time buyers of hedge funds.

Chart 3 (see next page) compares long-only global equities (represented by the MSCI World Index - the red dot in the chart) to equity long short funds (the green dot) over the past 2 years. The small grey dots represent all the individual equity long/short funds which make up the equity long/short index.

It wouldn't be unreasonable to expect equity long/short funds to have underperformed global equities over the past 2 years but, at the same time, you would expect them to be less volatile as well.

As you can see from chart 3, equity long/short funds have indeed underperformed long-only equities but, to add insult to injury, they have also been more volatile!

[4] *Based on work conducted by Michael Alexander: "Stock Cycles: Why stocks won't beat the money markets over the next twenty years". Source: S&P500.*

[5] *By 'absolute return strategies' we refer to investment strategies looking for consistent, positive returns as opposed to relative return strategies which offer the prospect of returns that vary according to market conditions.*

[6] *In the following, equity long/short funds are represented by the HFR Equity Hedge Index.*

Chart 3: Performance v. Risk (last 2 years)

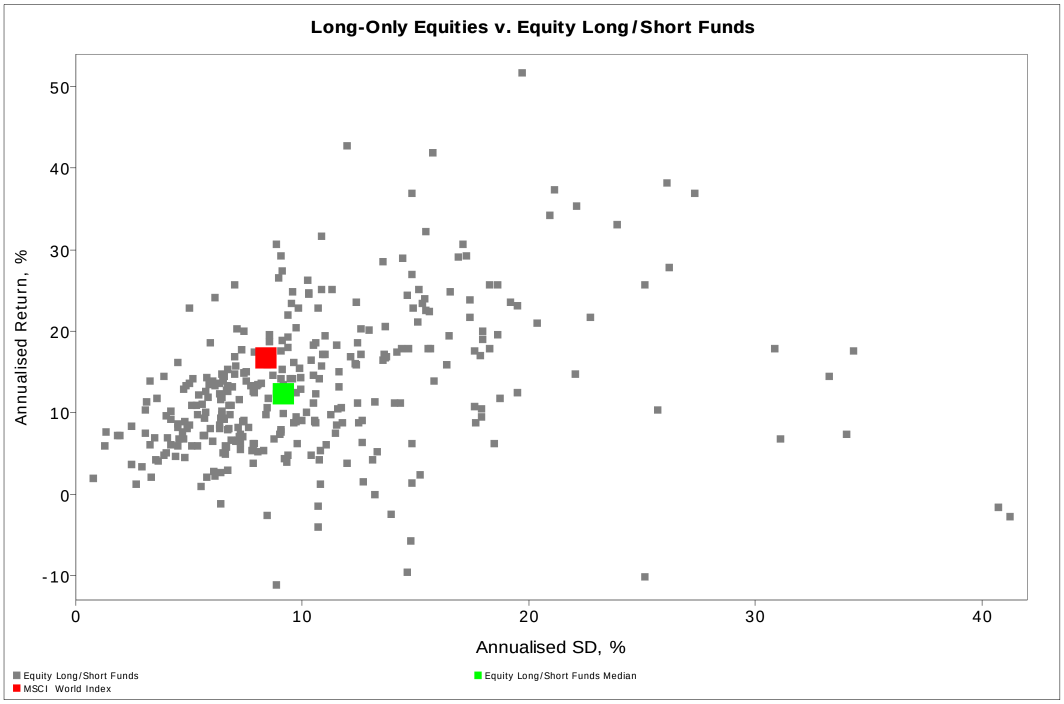


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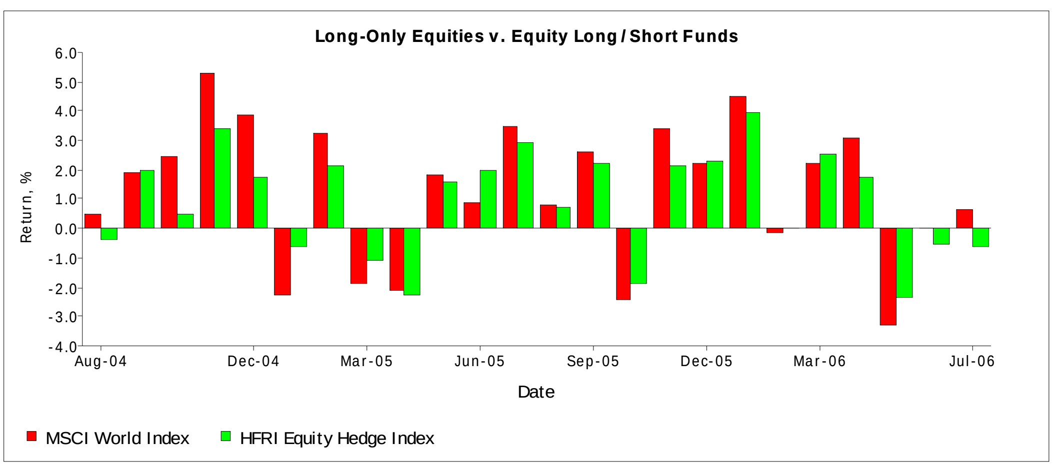
Chart 4: Monthly Performance Comparison (last 2 years)



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In other words, risk-adjusted returns for equity long/short funds have been inferior to those of long-only equities.

We mentioned earlier that there are usually two reasons why investors would buy hedge funds – performance and diversification. As illustrated in chart 3, equity long/short funds haven't really done the job in the past few years as far as performance is concerned. Let's now take a closer look at the diversification argument.

Chart 4 compares monthly performance numbers for long-only equities and equity long/short funds over the past 2 years. If equity long/short funds do their job properly, you would expect them to preserve investors' capital during difficult periods.

As you can see from chart 4, in the past 2 years, global equities have suffered 5 months of significantly negative returns – January, March, April and October 2005 and May 2006. In all of these months, equity long/short funds were down as well, raising a suspicion that perhaps equity long/short funds do not deliver the diversification benefits which are expected of them.

In order to test this thesis, we have run a 10-year chart showing the correlation between long-only equities and equity long/short funds. As you can see from chart 5, the correlation has risen significantly over the last decade. Whereas ten years ago, the correlation was hovering around 0.4-0.6, it is now in excess of 0.9!

Based on the above, we can only reach one conclusion. As far as equity long/short funds are concerned, total returns have been disappointing. Risk-adjusted returns likewise. And the diversification argument does not stand up to closer scrutiny either. In other words, on average, *equity long/short funds are not doing the job they are supposed to be doing.*

In our last chart, we have analysed how risk-adjusted returns have drifted for equity long/short funds over the past five years (in chart 6 below, the smaller dots represent more distant data points whereas the larger dots represent more recent performance). It is clear even to the casual observer that equity long-short funds have experienced a rather dramatic deterioration in absolute performance. At the same time, volatility has dropped substantially.

Partly responsible for the reduction in volatility is unquestionably the fact that global equity markets are less volatile today than they were five years ago. However, we strongly suspect that equity long/short managers are also more risk-averse today than they were half a decade ago. Why is that?

Two reasons: Hedge fund managers are increasingly inclined to protect their business franchise at all cost. More and more managers can now live very comfortably on management fees alone which may impair their appetite for risk.

Secondly, institutional money accounts for a larger and larger share of hedge fund assets under management and, as we all know, institutional investors have a different agenda from the original buyers of hedge fund products (i.e. high net worth individuals). To the CIO of a pension fund, low volatility is often prioritised higher than superior returns so, in some way, hedge fund managers are only responding to what their largest customers expect them to do.

Should we then conclude that one should no longer invest in hedge funds? Absolutely not. However, it is becoming increasingly important to distinguish between directional and non-directional hedge fund strategies. As we have illustrated above, a large number of equity long/short funds are directional. And why pay someone a 20% performance fee if you can create the same risk/return profile by combining a really good long-only manager with an investment in money market funds?

So, yet again, the answer is to think outside the box. Hedge funds are not one but 20+ different asset classes. Some of these are truly non-directional, and we believe it is in those corners of the hedge fund universe that investors should look for both returns and diversification.

More about this next month.

Niels C. Jensen

Chart 5: Correlation (rolling 2 years):

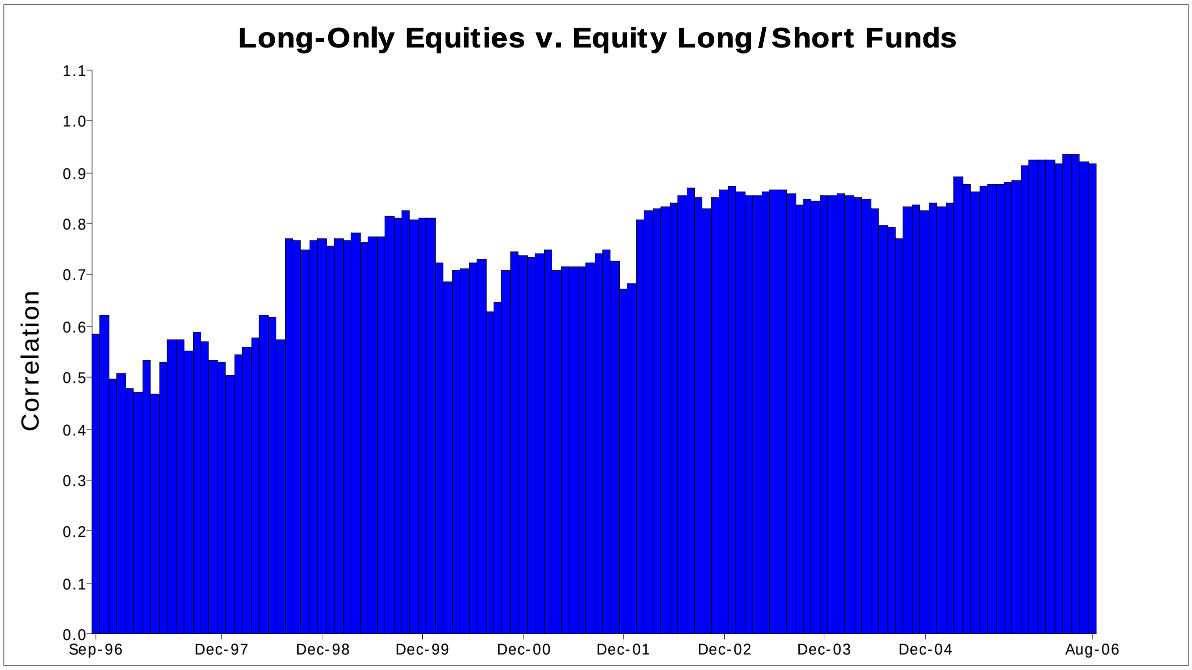

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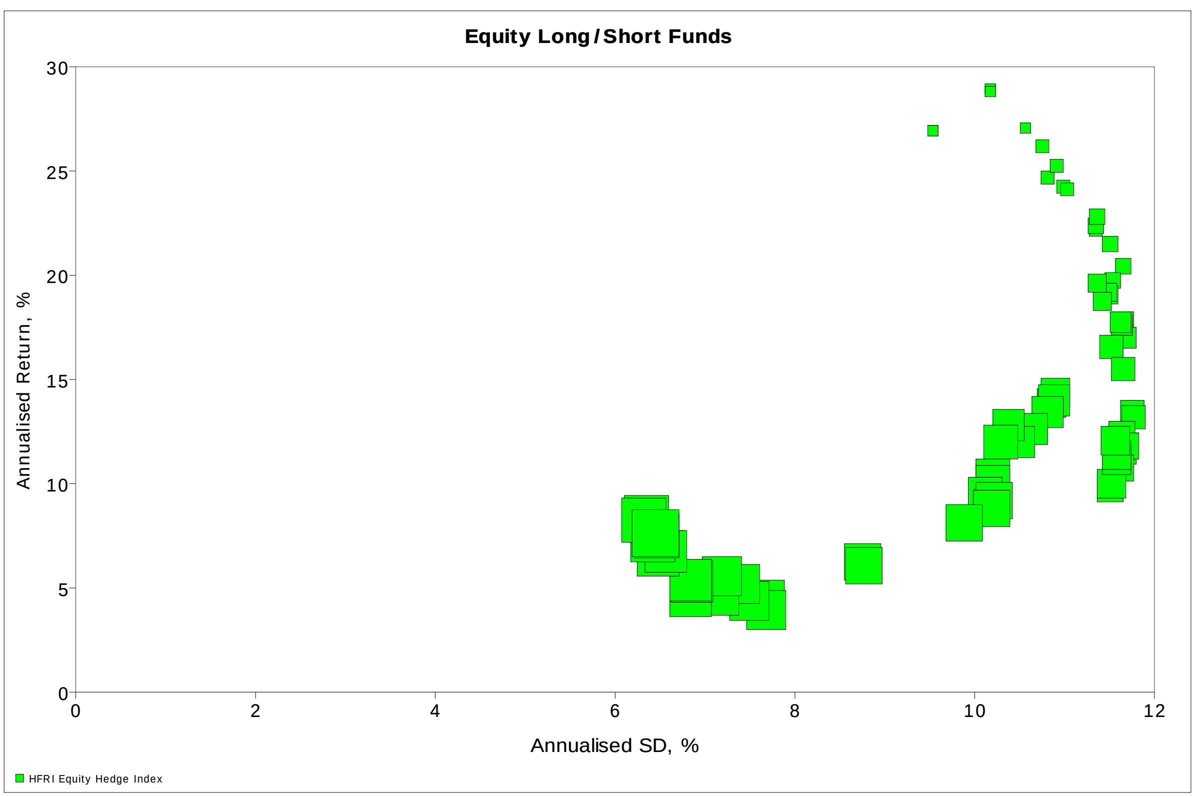
Chart 6: Performance v. Risk (last 5 years):



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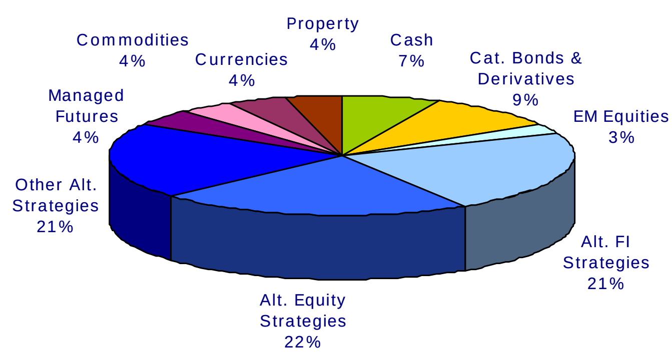
The **Multi-Strategy Portfolio** 1st October, 2006



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