The Absolute Return Letter November 2006

Summary

There a recessions and there are soft landings. And once in a blue moon, you may even come across a perfect landing. So perfect, in fact, that it justifies the exuberant behaviour arguably displayed by most asset classes today. This month we do our best to try to explain this. The only problem is, we don't believe in Nirvana.

In the second essay we follow up from a previous story as more evidence supports our long-held view that many hedge funds do not offer the qualities they claim to deliver.

Enjoy the read.

Priced for Perfection

I am starting to question the market's wisdom. Back in the mid 1980s, when I arrived in London still wet behind the ears, my then mentor taught me never to ignore the signs the market is throwing at you. The market is *always* right, he reminded me more frequently than I care to remember. *Always!*

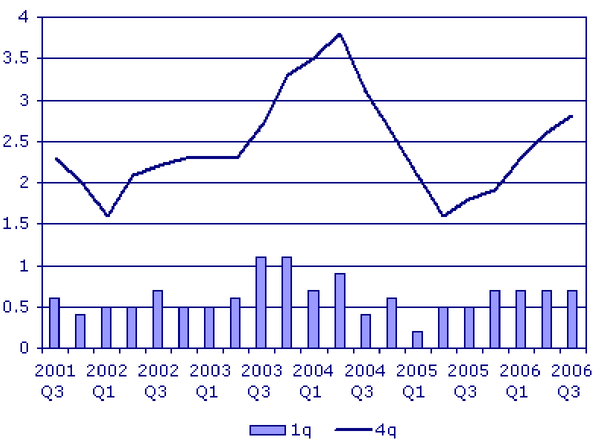
I never forgot those words, and they have quite frankly served me well over the years. How can you ignore the collective wisdom of thousands of investors? How can you possibly think you know better than everyone else? Or so I thought until recently. But I am starting to doubt. Here is what is causing me some serious headaches.

When it comes to gathering intelligence on the market, I am probably no different from anyone else. There are indicators which can do nothing wrong in my little invisible book and there are indicators which I couldn't care less about. The problem arises when the indicators you trust, and which have served you well for years, start to deliver conflicting signals.

Let's start with the yield curve. An inverted yield curve (i.e. short term interest rates being higher than long term rates) has long been a pretty foolproof indicator of recession, at least in the Anglo-Saxon world. It is considered gospel in some circles and I have to admit to paying close attention to the shape of it. Right now, the U.S. yield curve is modestly inverted from 3 months to 10 years, following the path of the U.K. curve which has been flattish for years.

Now, if you go back to the Absolute Return Letter from March of this year, you will find an essay named "The Forecasting Powers of the Yield Curve". In there, we argued that the yield curve has been "tinkered with" by structural factors, thereby reshaping the curve and reducing its predictive powers in the process. Whether this is true or not, the fact of the matter is that the U.K. yield curve has done a poor job in terms of predicting the behaviour of the U.K. economy over the past couple of years.

Chart 1: U.K. GDP Growth.



Source: *www.statistics.gov.uk*

As you can see from chart 1 above, the U.K. economy lost considerable momentum in 2004 and early 2005, without actually tumbling into recession, only to recover nicely in late 2005. A classic case of a soft landing. Today, with the growth rate enjoying unprecedented stability, nobody talks about recession on the horizon for the U.K. economy despite the ongoing inversion of the U.K. yield curve. So it is possible for the yield curve to invert without the economy automatically falling through the cracks.

Across the pond, it is not only the yield curve predicting problems on the horizon. In Duke University's latest CFO survey, a full one-third of Chief Financial Officers of the largest U.S. companies predict a recession to begin during the next 12 months. That is the highest level of pessimism since the last recession to hit the U.S. economy 5-6 years ago.

Interestingly, only 20% of the CFOs asked are more optimistic about the overall economy than they were 3 months ago, whereas 46% are more optimistic about their own company's prospects. This is a strong indication that much of the bad news having hit the U.S. economy in recent times has not filtered through to the companies yet. In other words – expect more earnings disappointments in the next few quarters.

Let's move on to another topic close to my heart. Unit labour costs. I always believed unit labour costs told an important story. I was brought up to believe in that. During my years at Goldman Sachs, it almost became religion. *Keep unit labour costs under control and you keep inflation in check,* so we were told.

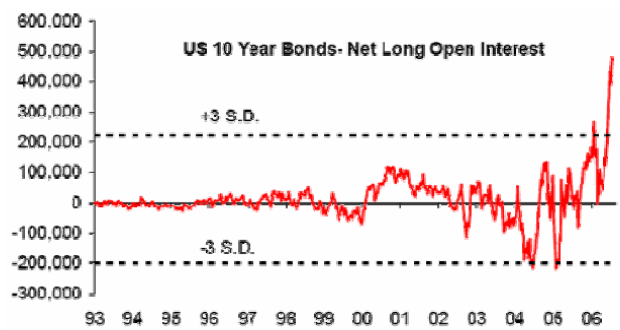
Now, with labour costs rising more rapidly again in many countries, and productivity enhancement not being nearly powerful enough to offset the increase, unit labour costs are starting to form some serious clouds on the investment horizon. In the U.K. private sector, average pay rises of 4-5% now appear to be the norm. The U.S. is not far behind; neither is continental Europe.

What bothers me is that many of these people who told us, year in year out, that all we had to worry about was unit labour costs (I am exaggerating only a tiny bit for effect), now argue that unit labour cost is a flawed concept. They say that it is a low quality measure and cannot be relied upon. Instead they all clap their greasy hands in excitement over falling oil prices and say that the worst of the inflation problem is now behind us with crude trading $20 below its peak earlier this year.

Technically, I guess they are correct. Headline inflation is indeed falling like a stone out of the sky. But that is not the point. The more interesting point is what will happen to inflation once the temporary effect of falling crude prices is washed out. Will rising unit labour costs drive core inflation higher? Will the Fed start to focus on headline inflation now that it is opportune to do so? Will the ECB abstain from further rate hikes now that the headline number they always chose to focus on is better behaved?

Furthermore, we find the contradicting behaviour of many asset classes even more disturbing. To begin with, look at the record high level of interest for U.S. bonds as portrayed in chart 2 below. Demand for bonds is usually strong when investors expect soft economic conditions, perhaps even recession. Given the recent spike in demand, one would expect the general consensus to favour a very soft economy. Otherwise chart 2 does not make much sense.

Chart 2: Record Interest in U.S. Bonds

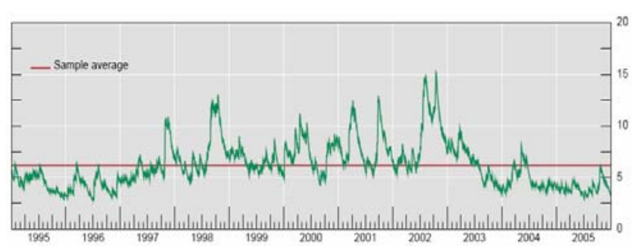


Source: CFTC, Morgan Stanley.

At the same time, though, riskier asset classes such as emerging market equities, high yielding currencies and commodities (other than energy products) have also performed very well recently. All these asset classes are usually "products of good times". In other words, they require strong economic conditions to outperform. So where is the logic? How can defensive and aggressive asset classes perform well simultaneously?

One possible explanation of this odd behaviour may be found in chart 3 below. The chart shows what most of us know already, namely that volatility in financial markets has dropped precipitously in recent years. However, the implications of this drop may not be quite so clear to everyone.

Chart 3: Global Volatility Indices[1]



Source: Bank for International Settlements

As Bill Gross points out in his November Investment Outlook (see www.pimco.com), lower volatility leads to overconfidence amongst

[1] Annualised daily volatility of an equally weighted bond-equity international portfolio including the FTSE global stock index and the EFFAS global bond index; in per cent.

investors which results in lower and lower risk spreads and more and more financial leverage. Ultimately, and contrary to common belief, low volatility can therefore lead to financial and economic instability.

This line of thinking goes hand in hand with the irrational (exuberant?) behaviour of many asset classes recently. Unless you believe in perfect landings (not just the 'soft' variety), it is inconceivable that all asset classes can continue their first class journey to financial Nirvana. To us it is more La-La Land than Nirvana anyway.

Niels C. Jensen

Show Me the Hedge (Again)

It is no secret that we invest in hedge funds. At the same time it should be apparent to both readers of the Absolute Return Letter and clients of Absolute Return Partners that we are indeed among the most critical of the hedge fund industry. The point we make consistently is that investors should stay away from highly directional and leveraged equity funds dressed up as hedge funds.

In the July issue of this letter we wrote about the reasons why we find it difficult to get excited about emerging market hedge funds. We concluded that these types of hedge funds tend to outperform broad equity indices when markets are rising, and they underperform when markets are falling.

Last month we demonstrated that the correlation between the stock market and long/short equity hedge funds has risen to almost 0.9 from levels around 0.4-0.5 a decade ago.

Recently we came across an interesting article from Bridgewater Associates named "Hedge Funds Selling Beta as Alpha". The author argues that many hedge funds package up beta and sell it as alpha, thereby implying that the funds in question charge high fees without delivering any form of hedge.

In very simple terms beta is the return that can be explained by market movements and alpha is the return over and above the market return which the manager is capable of generating. If the market is up 7% (beta = 7%) and the manager generates a return of 10%, we say that he generated alpha of 3%. In the hedge fund industry managers are paid to produce alpha.

Bridgewater Associates constructed a number of "naive" (long only) funds, replicating to the best of their ability the return pattern of the corresponding hedge fund indices over the past 10 years. As you can see from table 1 below, it makes for some interesting reading.

Table 1:

Correlation of Hedge Fund Strategies

Convertible Arbitrage	50 % (70% last 3 years)
Fixed Income Arbitrage	78%
Emerging Markets	80%
Distressed Securities	78%
Risk Arbitrage	52%
Managed Futures	70%

Source: Bridgewater Associates

The inevitable conclusion is that hedge fund investors buy a significant amount of beta when indiscriminately investing in hedge funds. Some of the numbers above are surprisingly, and frankly disappointingly, high. Investors are entitled to expect more from the industry. Certainly we do.

Increasingly the hedge fund industry subjects itself to very risky and speculative strategies wrapped as hedge funds. Ideally an equity long/short fund or an arbitrage fund should take two speculative tools, short sales and leverage, and apply them in a conservative manner, as Alfred Winslow Jones did when he established the first hedge fund back in 1949. His goal was to lift the burden of performance from market timing to stock picking. It was simple and it worked, which is more than a lot of today's hedge funds manager can say about their models.

Of course, we recognise that we are making broad generalisations here, but our point is that investors should look very carefully at the strategies they invest in. We spend a huge amount of time on this process because we believe it is an essential ingredient in generating absolute returns.

Jan Vilhelmsen

Absolute Return Partners

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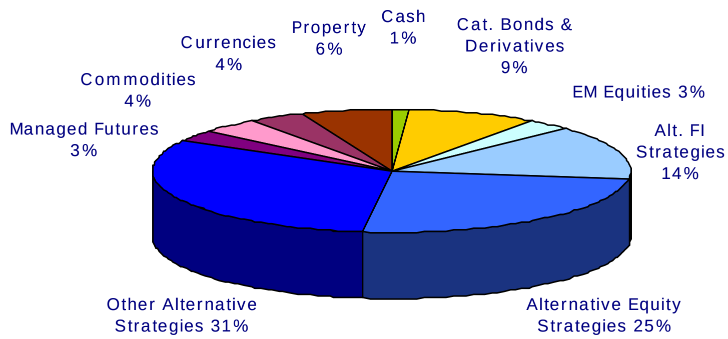
The **Multi-Strategy Portfolio** 31st October, 2006



The **Millennium Wave Portfolio** 31st October, 2006