The Absolute Return Letter
March 2007

The Volatility Puzzle

What a bugger!

What do you do when you have just finished writing an article about the continuous downtrend in stock market volatility only for it to explode before you have published your work?

Do you pretend nothing has happened? Do you bin the article? Or do you, as we have chosen to do, conclude that the spike in volatility is temporary and that we will soon revert to the norm of recent months and years?

As we interpret events, nothing fundamentally has changed in the last week. In other words, the so-called drama around the world is more likely a long overdue reaction to months of relentless appreciation in global stock markets.

Admittedly, this view is predicated on the presumption that the global economy will not slide into recession later this year. Many people believe it will. We do not. Time will tell who is right, and who is wrong.

Why is volatility so low?

Good. That was that. We can now return to the topic of this month, namely volatility. We are often asked why stock market volatility (ignoring the odd blip) continues to trend lower and we are the first to admit that we usually struggle to provide a simple answer. However, the facts speak for themselves. Until this week, the U.S. stock market has not experienced a down 2% (or more) day since the 19th May, 2003 which is unheard of. The same picture emerges pretty much wherever you look – unless you include some extreme situations such as Thailand which recently suffered an unpleasant takeover from the boys in uniforms.

The Economist ran an article a couple of weeks ago under the header *'Before the Fall'* where they compared global equity markets with the often used scene in American western movies where someone, whilst riding through enemy territory, notices: "I don't like it. It's too quiet". The next moment he is dead, shot through the heart. Did anyone die this week? Not to the best of our knowledge.

Now, The Economist is not exactly known as the most prolific forecaster of financial markets. Nevertheless, they do have a point. Or do they? That's what we will look more closely at in the following.

Is the world in great danger?

Let's begin by summarising some of the frequently used arguments why the world is in great danger. You should be familiar with most, if not all, of them:

The U.S. cannot continue to run twin deficits of this magnitude!

Credit spreads are unsustainably low and can only rise from here!

Corporate earnings cannot grow at this rate forever!

Americans cannot continue with a negative savings ratio!

The housing market will be the straw that breaks the camel's back. The U.S. economy is definitely heading for recession!

When the U.S. economy goes down the drain, the wheels will come off in other parts of the world too!

We cannot possibly discuss each of these points in detail. It would require more time and space than we allow ourselves for this publication. Yet we hope to enlighten you with some observations, many of which are inspired by our ever present economic adviser, Dr. Woody Brock[1].

Volatility is driven by surprises

Volatility is basically a function of surprises. If we knew everything which was going to happen every day going forward (obviously a ridiculous presumption), all future events would already be discounted into today's prices and "news" wouldn't really be news and would therefore have no effect on equity prices. Now, with stock market volatility lower than for many, many years, does that mean that there have been fewer incidents to surprise us in recent times? Yes and no. Let's explain.

Monetary policy is better managed

At one level, there has indeed been a drop in the number of surprises thrown at us. These days, central bankers understand much better the value of advertising future policy moves well in advance although, as one of our smarter clients pointed out to us, monetary policy is only as stable and predictable as economic circumstances allow it to be. Put differently – what appears to be better monetary policy may in fact be the result of a more stable economic environment.

These days it is indeed rare for central banks (other than the Central Bank of Zimbabwe, I guess) to take markets by surprise. Recently we experienced one of these rare events with the Bank of England increasing the Bank Rate to 5.25% against all odds. And markets reacted in kind - for a day or two. However, that is the exception which confirms the rule.

Other things are not!

At another level, the world hasn't exactly been short of surprises. Numerous geopolitical incidents in recent years, terror actions, corporate blow-ups, etc., should, in theory at

[1] *Visit www.sedinc.com for more details on his work.*

least, have kept volatility alive and kicking. But the opposite has happened. Why is that?

Table 1a:
Correlation Coefficients for Pair-Wise Real GDP Growth, 1995-2005

	U.S.	Japan	Europe	China	India	Russia
U.S.	1.00					
Japan	0.24	1.00				
Europe	0.54	-0.08	1.00			
China	0.01	0.59	-0.40	1.00		
India	0.06	0.28	-0.36	0.50	1.00	
Russia	0.01	0.22	-0.03	-0.22	-0.21	1.00

Notes:
The average pair-wise correlation coefficient for the countries listed is 0.08.
Europe consists of UK, Spain, Italy, Ireland, Germany, France and Denmark.
Source: Strategic Economic Decisions, Inc.

Globalisation is adding to stability

Increased economic stability, both locally and internationally, continues to play an important role. This is perhaps not very well understood, but globalisation has greatly improved economic stability as the world has moved from being largely a one engine economy (USA) to a network of regional economic centres. As you can see from Chart 1a above, economic growth in one part of the world has been surprisingly lowly correlated with growth in other parts of the world in the last ten years[2]. Interestingly, the average pair-wise correlation between all these regions is only 0.08. Would you honestly have guessed that?

Chart 1b illustrates how the pair-wise correlations have changed over time. With the exception of India and possibly also Russia, both of which have opened up in the past 15 years, correlations are clearly trending down. This is good news in the sense that it makes a global recession less likely. Perhaps equity investors have already figured out what many economists are yet to discover.

Table 1b:
Change in Pair-Wise Correlation Coefficients, Real GDP Growth, 1991-2006 versus 1975-1990

	U.S.	Japan	Europe	China	India	Russia
U.S.	1.00					
Japan	-0.39	1.00				
Europe	-0.18	-0.66	1.00			
China	-0.17	0.06	-0.34	1.00		
India	0.67	0.08	0.46	-0.01	1.00	
Russia	-0.04	0.46	0.20	-1.02	0.11	1.00

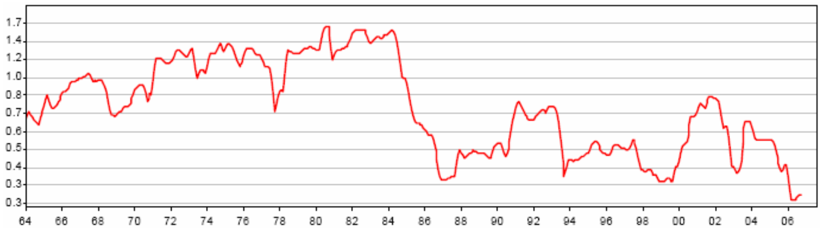
Notes:
Europe consists of UK, Spain, Italy, Ireland, Germany, France and Denmark.
Source: Strategic Economic Decisions, Inc.

[2] *For example, a correlation of 0.01 between GDP growth in China and the U.S. suggests virtually no dependency between the two variables; i.e. China should be able to withstand a U.S. recession.*

The local economy is less volatile

Even within our own national borders, the economy is less volatile today than it has ever been before. Woody Brock has calculated that the average pair-wise correlation coefficient between the principal sectors of the U.S. economy has dropped from about 0.70 to 0.12 during the past century. GaveKal Research have also studied this phenomenon and came up with the following chart (see chart 1 below) which depicts the quarterly volatility of US GDP. Again, it is clear for everyone to see that after a couple of decades of rising GDP volatility from the mid 1960s to the mid 1980s, the trend has been down since, although not in a straight line.

Chart 1:
Quarterly Volatility of U.S. GDP (Last 40 Years)



Source: GaveKal Research

Given the low correlation between the various different parts of the economy as documented above, it is probably unwise to assume that, just because the U.S. housing market appears to have hit a brick wall, this will inevitably drag the rest of the economy into recession. We note for example that U.S. home equity withdrawals have fallen from an annual rate of $750 billion to $350 billion in the last 16 months without having had any drastic effect on consumer spending[3].

The reduced correlation between the various different parts of the economy is a function of the rising dominance of service-based industries. Unfortunately, we don't have any numbers for Europe, but given the strong service orientation in many European countries (particularly in the UK), we would be surprised if the numbers look very different.

The US can handle a downturn

Talking about the risk of recession, we note that the US fiscal balance is now in much better shape than what is portrayed in the media. From a rapidly deteriorating situation in 2004/05 when the budget deficit peaked at almost 4% of GDP (and could only go one way according to the critics), the U.S. administration is now in the enviable position of being able to stimulate economic growth should the need arise. By the end of 2006, the deficit had been reduced to about 2% of GDP and it continues to fall, a fact almost universally overlooked by the bears who continue to ramble about the unsustainability of the twin deficits. Perhaps another sign that the collective wisdom of equity investors is a great deal

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[3] *Strategic Economic Decisions, February 2007 Profile.*

higher than that of market commentators most of whom seem to be of the opinion that the U.S. deficit problem is going from bad to worse.

Guaranteed products play a role

Enough said about the economy's effect on stock market volatility. Another and an altogether different factor is the proliferation of guaranteed products – sold mostly by brokerage firms and banks to private investors. Again, it is difficult to come up with numbers to back up our claim, but when we look at our clients' portfolios it is evident that large amounts of risk in private client portfolios have been transferred from equity market risk to counterparty risk. What do we mean by that?

Private investors are known to be more 'trigger happy' than institutional investors. This has sometimes worked in their favour, sometimes not. Historically, though, through their more active trading, private investors have added to overall volatility.

Now, with a significant part of their equity portfolios tied up in illiquid guaranteed products, private investors trade less and hence add less to volatility. The problem, as we indicated above, is that there is still risk involved, although a different sort of risk. Guaranteed products are usually issued by large banks but instead of carrying the risk on the banks' own balance sheets, these products typically sit in so-called Special Purpose Vehicles (SPVs), where the quality of the balance sheet is nowhere near that of the mothership.

...but they are likely to disappoint

When the horse poo eventually hits the fan (and it will – trust me), it will be interesting to see which banks will honour their implicit obligations and which ones will run for the hills. Just don't take anything for granted. In the meantime, guaranteed products are destined to disappoint.

The Financial Times ran a most interesting article the other day, quoting a recent study from ABN Amro Bank[4]. According to this study, the expected performance from guaranteed products is absolutely dismal (see table 2), a conclusion investors will eventually reach themselves.

Table 2:
Long-Term Performance of Equity Portfolios With Protection of Downside Risk

(UK)	-100%	-20%	-15%	-10%	-5%	-2%	-1%
Return	13.80%	12.37%	12.28%	11.10%	8.58%	3.99%	1.95%
Sharpe	0.34	0.32	0.33	0.28	0.19	-0.14	-0.47

Source: ABN Amro Bank and FT fm.

As you can see from table 2, the long-term performance of UK equities (unprotected) has been 13.80% per annum. The

[4] *FT fm," 'No free lunch' in downside protection", 19th February, 2007.*

more protection you buy, the worse the expected return is, but it is not a linear function. If you can live with 'just' 10% annual downside risk, you only give up 2.7% of the upside. If you wish to be virtually fully protected, the expected return is only marginally better than breakeven.

Why do investors then buy guaranteed products? Because a lot of them look good on paper and because the issuers are very good at hiding how much you really pay. Given the substantial fees involved, there is typically only one party making money on these products, and it is not the investor.

Perhaps, that is why the industry is now busy inventing the next 'big thing', aka hedge fund replication products. Don't be surprised if these prove to be as disappointing as structured products have been. At least we won't.

Other factors influencing volatility

Other factors have played a role in reducing stock market volatility, hedge funds probably being the most controversial one. If you read the financial press regularly, you will have noted an overwhelmingly negative bias against hedge funds. Truth of the matter is, relatively speaking, there are as many bad hedge funds as there are bad long-only managers.

However, when observed from 30,000 feet, a market where investors sell short in addition to just buying and selling will experience reduced volatility because, at any given point in time, there will be more investors cancelling each others actions out. Most people assume hedge funds add to volatility. Once you start thinking about it, you realise the opposite is actually the case.

Without going into any amount of detail, we should also mention factors such as *low bond yields* (making investors less inclined to switch from equities to bonds during hard times), *enhanced collateralisability of illiquid assets* (making it easier for investors to raise cash from other sources) and *investor optimism* (a typical phenomenon after years of rising equity prices).

Another word for *optimism* is *complacency.* In a rising market investors worry less about volatility than they do in a flat to down market. After years of rising stock markets, investors gradually become convinced that stock prices will never fall again. Famous last words.

The million dollar question

The million dollar question is – will volatility gradually make its way back to historical levels or is it in fact possible that it is driven by structural forces and may therefore stay low for a sustained period of time? Again, it is not an easy question to answer and really depends on the sustainability of the forces described above.

Is recession a foregone conclusion?

It seems to be a foregone conclusion amongst many market observers that the U.S. economy is heading for recession later this year. Whilst not impossible, we would not recommend you bet your house on this outcome. Likewise, even if the U.S. economy were to fall into recession, do not necessarily expect a global fallout, just because that is what used to happen. The world is a very different place today, as we have attempted to illustrate above.

Where will the shock come from?

As we see it, the shock - if there is to be one - is more likely to come from a different place altogether (for the record - in our books, the action of the last few days does not count as a shock). We are not entirely comfortable with some of the practices going on in the investment community today. We have already mentioned guaranteed products sold to retail investors. We could also have mentioned Collateralised Debt Obligations (CDOs) or credit default swaps both of which are owned mostly by institutional investors. We also have our concerns about private equity (see the December 2006 Absolute Return Letter). So much debt is now being used that you wonder if investors will ever make any money on these investments.

The last time the world faced difficult times (2000-02), the wheels came off many a private equity deal. For a period of time, nobody wanted to touch this asset class with a barge pole. Now, only 5 years later, no one seems to remember.

Most of the newer financial instruments are yet to be seriously tested and we suspect that at least some of them will not stand the test of time. Of one thing we are convinced - the financial world has not experienced its last crisis and the next one will probably pop up when least expected by the public. And when that happens, you want to be long volatility, not short.

Niels C. Jensen

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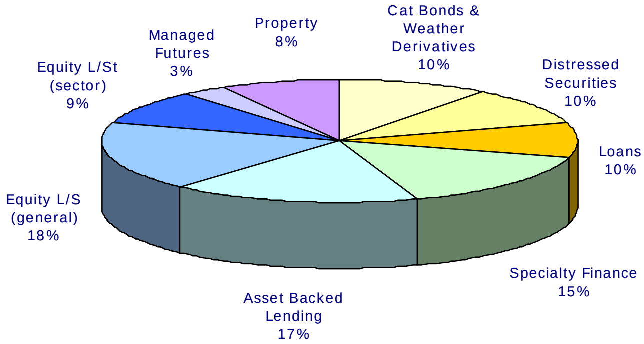
The **Multi-Strategy Portfolio** as at 31st January, 2007:



The **Millennium Wave Portfolio** as at 31st January, 2007: