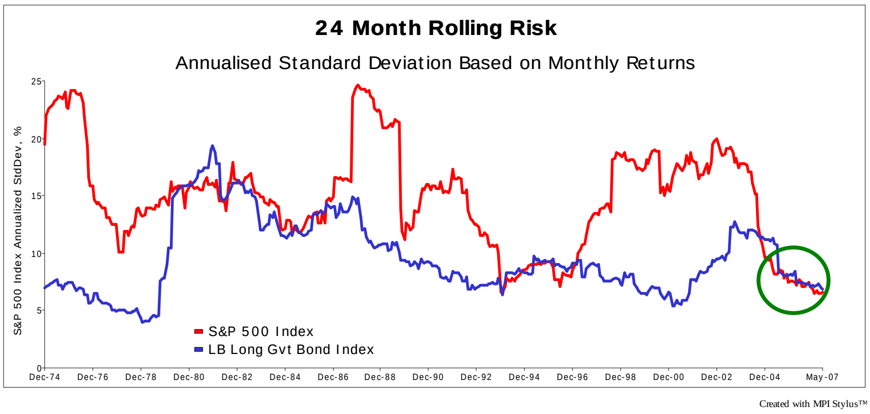
The Absolute Return Letter
July 2007

The beginning of the End?

Convergence of volatility

One of the more bizarre facts of recent years is the convergence of stock and bond market risk. However, as you can see from looking at chart 1 below, it is not that bond market risk is out of whack, but rather a function of equity volatility being at historically low levels[1].

Chart 1: Stock Market Risk v. Bond Market Risk



Source: Standard & Poors, Lehman Brothers and own research.

The appetite for risk is high

This month's letter is not so much about why that is the case, but more about risk and how we (i.e. investors in general) have become rather complacent about risk in recent years. We know all the counter arguments ("the economy is less cyclical", "companies are better than they used to be at managing their balance sheets", etc. etc.); however, even a casual look at other asset classes suggests that this goes far beyond the narrow scope of equity market risk. The difference in attitude is evident across all asset classes and has little or nothing to do with the fact that today's economy is less cyclical than it used to be.

Let's begin by looking at another chart – this time the correlation between stock market returns and bond market returns. As chart 2 reveals, the two have been positively correlated most of the time in the past 35 years, but with some noticeable exceptions.

We make three observations:

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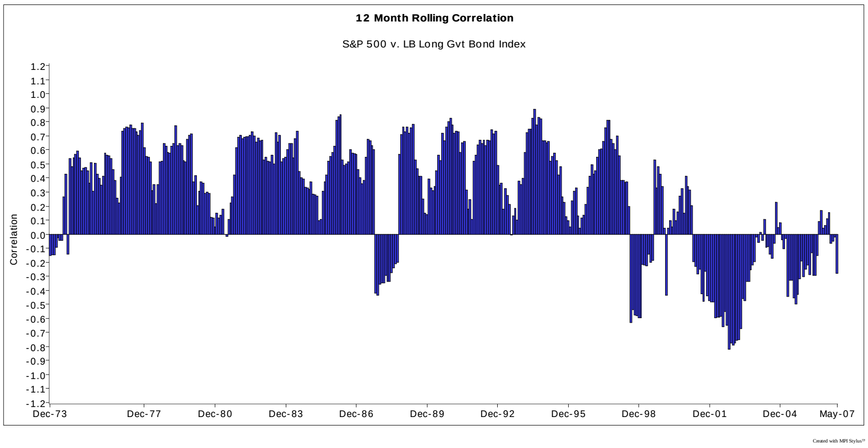
1 *Please note that chart 1, which is based on monthly data, has not picked up the recent rise in volatility.*

1) Until relatively recently, the correlation has been mostly positive. Between 1974 and 1998, there has only been one period during which the correlation turned negative and that was in connection with the stock market crash of October 1987 where equity investors used bonds as a safe haven. The rest of the time during this period the correlation was positive.

2) Since the summer of 1998, a somewhat different picture emerges. Whereas the correlation between stock and bond market returns for the entire 1974-98 period was +0.23, the corresponding number is -0.28 since August 1998.

3) Almost every time the correlation has turned negative, it has been associated with an event of some sort. First came the October 1987 crash. Then came the LTCM crisis (or Russian debt crisis if you prefer), then the great bear market of 2000-02. Only the negative correlation in 2005-06 is difficult to explain as an event related phenomenon.

Chart 2: Correlation between Stocks and Bonds



Source: Standard & Poors, Lehman Brothers and own research

With respect to the third point made above, it is certainly worth noticing that the relationship has turned negative yet again. Unless you have spent the last few months on another planet you would have noticed that bond yields have jumped whilst stock prices have continued to push higher, hence the negative correlation.

Is another "event" unfolding?

Now, could this be the early signs of another "event"? Certainly, the subprime crisis still unfolding is a prime candidate as to why the correlation turned negative for only the fifth time since 1974. A lot of people have written about the subprime crisis in recent weeks – nobody more eloquently than Bill Gross of PIMCO[2]:

"Those that point to a crisis averted and a return to normalcy are really looking for contagion in all the wrong places. Because the problem lies not in a Bear Stearns hedge fund that can be papered over with 100 cents on the dollar marks. [...] The flaw, dear readers, lies in the homes that were financed with cheap

[2] *PIMCO Investment Outlook, July 2007.*

and in some cases gratuitous money in 2004, 2005 and 2006. Because while the Bear hedge funds are now primarily history, those millions and millions of homes are not."

Bill Gross continues by observing that many of these homes have been financed with adjustable rate mortgages (ARMs). Unfortunately, as interest rates go up, so do payments on those mortgages. Bank of America reckons that $500 billion of ARMs are due to be reset in 2007 and almost $700 billion in 2008. Upwards of 75% of those loans are subprimes.

Not just a US problem

From our somewhat more humble offices in London we note that ARMs are not only a US phenomenon. With the Bank of England having raised rates earlier today to 5.75%, almost a million UK mortgage holders with ARMs face a similar destiny and the same goes for the rest of Europe where ARMs have also grown in popularity in recent years. We have limited knowledge of mortgage markets across Europe but, at least in the UK, the concept of subprime loans has indeed caught on. Only yesterday, the Financial Services Authority issued a damning report on the UK subprime industry.

So, if you are tempted to lean back and breathe a sigh of relief that the worst of the subprime fallout is now behind us, we would instead suggest that you fasten the seatbelt for a rough ride in the months to come. The subprime fiasco is a real stinker and it could get (a lot) worse before it gets better. It also has the potential to do significant damage to both the real economy and to financial markets – and a fallout in one could certainly lead to problems in the other. Yet we suspect that this is more a financial markets issue than an economic problem big enough to tear the US economy completely apart.

Not fully priced into asset prices

Jumping back to our risk theme, over the past few weeks, financial market participants have been reminded the lesson learned (but obviously forgotten) from the LTCM crisis in 1998 that risk of this nature cannot be captured by even the best risk management models. And because such risk cannot easily be assessed, *it cannot be properly priced into asset prices*[3]. This last observation is still lost on many investors and partly explains why equity investors have not reacted more negatively to the problems in the subprime market.

This can lead to one of two outcomes, or quite possibly a combination of both:

1) Investors reduce their risk (either voluntarily or involuntarily) by lowering the leverage in their portfolios; or

2) Regulators step in and do the job by regulating the leverage used in many of the new instruments invented in recent years.

Have central banks lost control?

For this reason, the subprime debacle which led to the huge losses in the Bear Stearns hedge funds (and a few other funds as well), may have widespread repercussions. It is no secret that

[3] *Woody Brock (www.sedinc.com) was kind enough to remind us of this!*

central bankers in both Europe and the US are very concerned, not only about the leverage in the system, but also about their almost complete loss of control over it. In the good old days, central banks could fairly easily control the amount of leverage with good old fashioned monetary policy tools. Those days are long gone.

The bond market is doing the job

It all depends on how ugly the current situation becomes but we would not be surprised if one of the outcomes is increased regulation with respect to the use of leverage through various derivative instruments. In the meantime, the bond market is doing the job by raising the cost of capital. The recent rise in interest rates, which we discussed in great detail in last month's letter, was a 3 standard deviation event[4] - quite rare although not as rare as the money merchants would like you to believe.

Longer term, yields on long bonds are destined to go higher. The global economy is quite robust, with or without the subprime crisis rumbling in the background. Central bankers (outside Asia) are on the war path, and history suggests the pain isn't over yet. Did you know for example that, within a given cycle, the peak in 10-year bond yields has always been higher than the peak in the lending rate set by the central bank[5]?

Higher yields will do damage

Higher interest rates will do damage to equity prices for at least four different reasons:

a) The value equilibrium changes in favour of bonds;

b) Higher rates is a tax on consumers through higher mortgage payments;

c) Corporate earnings suffer as a result of higher interest costs;

d) Sooner or later the private equity cycle will slow down as a result of the higher cost of capital, removing much of the demand for equities.

Higher rates, in particular when combined with the recent damage done to investor confidence and the risk appetite amongst banks[6], could therefore be lethal. As you are probably aware, the ample liquidity in recent years is largely behind the bull market we have enjoyed in most asset classes.

The liquidity is again a function of banks falling over each other to lend money to eager investors looking for surreal returns. Much of the bull market of 2003-07 has been driven by this factor, and it is our prediction that the very same bull market will disappear, should the liquidity tap be tightened[7].

Covenant-Lite the next problem?

As if the subprime crisis wasn't bad enough, there are other signs of investors' risk tolerance having become seriously distorted. Take the corporate loan market for instance. When you lend

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4 For non-geeks, this means an event occurring every 200 years or so.

5 Whilst true for the US market, we have not been able to verify whether this is the case in Europe as well.

6 No bank is particularly keen to be labeled the next Bear Stearns.

7 It is critical to understand that in today's financial system it is the commercial banks and other credit providers holding the key to the liquidity situation. Central banks have lost much of their power.

money to corporate borrowers, normally such loans would be associated with certain covenants[8]. Now, with the flood of capital hitting financial markets in recent years, and with investors hungrier than ever for a bit of extra yield, the flood gates have opened for so-called covenant-lite loans.

A covenant-lite loan is, as the name suggests, a loan which is light on covenants. All other things being equal, such a loan is of less quality, and should therefore trade at a higher yield than loans protected by standard covenants.

Lo and behold, the spread has not only disappeared; it is actually negative. According to a recent article in Euromoney[9], the unthinkable has happened. The market is now prepared to buy covenant-lite leveraged loans at a lower yield than corresponding "covenant-heavy" loans. What on earth is going on?

Well, we believe that the astounding success of covenant-lite loans is feeding on itself. As recently as two years ago, covenant-lite loans accounted for low single digit figures of the total loan market. Now, the market share in the US has grown to almost 40% and Europe is catching up quickly.

Because of the enormous investor appetite for corporate loans, and because there has been virtually no push back by investors, you cannot really blame the issuers for going down this path. If you can get away with it, why wouldn't you?

Tears will almost certainly flow

The problem facing investors is that covenant-lite is another accident waiting to happen. The subprime crisis is essentially the result of loans backed by low or no security and poor documentation. Covenant-lite? Different asset class. Same story. Tears to follow.

All this would not be a problem if investors (and lenders) were a bit more diligent and asked the right questions. Call us old-fashioned, but in the *long term* asset prices cannot outgrow the pace of the overall economy. Including dividends, this means that you should expect annual equity returns of about 8-10% over the long run.

Since the early 1980s, global stock markets have generated returns much higher than that – even if you include the occasional set-backs, such as the bear market of 2000-02. Due to the magnitude and duration of this bull market, we have an entire generation of investors who have grown accustomed to exorbitant levels of returns, and *that is precisely where the problem lies*.

The end of easy money?

8-10% is no longer good enough and leverage is happily applied to further enhance the bottom line. Greed and fear have always been the primary factors determining asset prices and always will be. We are clearly in the greed phase at present but, eventually,

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[8] *Covenants are conditions attached to a loan (or bond). Those conditions are typically promises made by the borrower/issuer (e.g. max. debt/equity ratio, minimum working capital, etc.) and are designed to protect the interest of the lender (or buyer of the bond).*

[9] *Volume 38, No. 458, June 2007.*

fear will take over. What has happened to subprime, and what will happen to covenant-lite eventually, is not necessarily the beginning of the end. But it could very well be the end of easy money.

Niels C. Jensen

Absolute Return Partners

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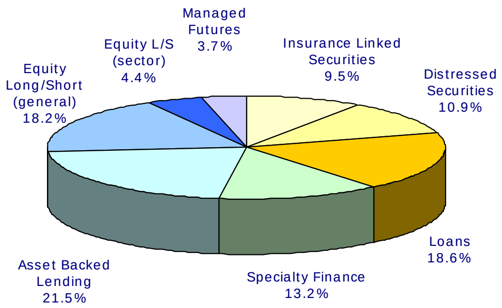
The **Multi-Strategy Portfolio**
as at 31st May, 2007:



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