The Absolute Return Letter
September 2007

Another Black Swan?

What happens when a central bank keeps interest rates (too) low for too long? Everything, everywhere, goes up in price. At the same time, though, the seeds are sown for future problems, as humans tend to do stupid things with money when it comes easy. Shrewd investor Doug Casey puts it in context in the following way:

Bernanke v. Schumacher

"The long boom we've had since the bottom of the last cycle in 1982 – a time that was characterized by high unemployment, lots of bankruptcies, high interest rates, and a low stock market – has lasted 25 years. It could have ended badly a number of times along the way, such as 1987, 1993, or 2000. Each time the government propped the house of cards up higher by injecting more currency into the system. It's analogous to someone driving a high-performance car on a mountain road with a stuck throttle. The driver can mash on the brakes, slowing it from 50 to 30. The car charges to 80, but this time the fading brakes can only bring it down to 60. After a couple of cycles, it's going 140. And Ben Bernanke is no Michael Schumacher. Perhaps he can navigate the road. But the chances are better, at this point, that the economy will go off a cliff."

Deep scars in the landscape

This letter is not about pointing fingers, though. Enough has been written already on the subject of sub-prime and why it happened[1]. Instead we will focus our energy on the implications of the credit crunch which has unfolded in front of our eyes over the past 6 weeks or so. So profound has the summer crisis been that it has left deep scars in the investment landscape and the repercussions will be felt for a long time to come.

The Black Swan

I have spent several hours of my summer holiday reading Nassim Taleb's latest book *The Black Swan*. Taleb shot to fame years ago with his classic publication *Fooled by Randomness* – one of the best investment books ever written. His new book is about extreme events and how investors should deal with them. According to Taleb, a Black Swan is an event characterised by the following three attributes:

[1] *One of the better accounts of the recent malaise in financial markets has been written by Barry Ritholtz. You can find his comments on www.arpllp.com under Commentaries.*

1. It lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility.
2. It carries an extreme impact.
3. In spite of its outlier status, human nature makes us concoct explanations for its occurrence *after the fact*, making it explainable and predictable.

Is this crisis a Black Swan?

9/11 was clearly a Black Swan and so too was the Indian Ocean tsunami in December 2004. But Black Swans can also be positive events. The internet is just one example. Is the credit crisis unfolding in front of our eyes a Black Swan? Let's borrow a sentence or two from Woody Brock's latest research piece[2]:

*"To begin, note that today's crisis is **not** the result of a big shock, such as war or oil shock. Nor is it due to "the Fed this" or "the Fed that". […] In the present case, the only initial trigger event was a higher than expected rate of default on sub-prime mortgages – an event that even your dog could have predicted."*

So, seen through the eyes of Woody Brock, the current crisis is not a Black Swan. Why then is it having such a dramatic impact? Probably because pretty much everyone underestimated the effect gearing would have on the bottom line but, again, that is not what this letter is about. Let's instead turn our attention to the implications of this mess. What does it all mean?

The use of leverage will change

In the aftermath of the LTCM crisis in 1998 investors reduced their use of borrowed capital. The same is likely to happen again. The hedge fund industry is often accused of using too much gearing. The fact of the matter is that, according to data from the prime broking industry, hedge funds use less leverage today than they did pre-LTCM. The problem is that a limited number of funds (mostly credit and global macro funds) have used excessive amounts of gearing in order to generate attractive returns in a low yield environment. This is likely to change, partly because banks' lending procedures will tighten. Providing the funding for hedge funds is a major source of income for investment banks with large prime broking departments. The earnings power of these companies will therefore be curtailed.

Private equity activity to slow down

Likewise, private equity funds will be forced to use less gearing when putting their deals together. This will make many deals unworkable and therefore reduce the overall activity level in the industry. It is premature to write the obituary for the private equity industry; however, going forward, it should be expected that private equity will provide

[2] *Woody Brock is an adviser to Absolute Return Partners. Visit www.sedinc.com to learn more about his work.*

less support to equity prices. Our overall return expectations for equities have therefore been reduced as a result of this.

The tarnished reputation of the CDO market will not help the private equity cause either. The development of CDOs (Collateralised Debt Obligations) has played an important role in the growth of the private equity industry. Now, with its newfound reputation as the bad boy in class, many investors will think twice before buying another CDO. If there is no appetite for CDOs, private equity funds will have lost an important distribution channel for the products they create.

Your pension funds may be at risk

Although most pension funds keep a low profile about this problem (for obvious reasons) the fact is that a significant share of all CDOs issued in the last few years have been sold to European pension funds. The problem is that these CDO programmes are not marked to market. Instead they are priced according to some mathematical model, the validity of which is now being questioned. It is therefore quite possible that pension funds are sitting on substantial unrealised losses. In the UK, the FSA is cognisant of this problem and is working on some kind of policy to confront the issue. The risk to the system is that if pension funds are forced to mark these portfolios to market, large losses in their CDO portfolios may dig an even deeper hole for many pension funds which have found themselves in a precarious situation ever since the equity bear market of 2000-02.

Distressed debt will prosper

Distressed debt managers are licking their lips with investors offloading paper at all cost, effectively pricing many bonds and loans at levels normally only seen when the economy is in recession and the default rate is high. It is still too early to say whether the current crisis will actually develop into a full blown economic crisis or not (more about this later); however, we predict a dramatic rise in activity levels amongst distressed debt managers and some very attractive returns to come from some of the shrewder operators.

Large-cap to outperform small and mid-cap

The prosperity of private equity has driven prices of small and mid-cap companies up relative to their large-cap peers, as it is predominantly in the small and mid-cap pond that private equity managers have been doing most of their fishing. If our prediction that that the private equity frenzy will acquire a more pedestrian look going forward proves correct, the pendulum may very well swing back in favour of large-cap companies. It may therefore be wise to take a close look at your equity portfolio and re-visit some of the old large-cap favourites which have lagged the market in the last year or two.

A word of warning: Unless you are forced to allocate at least some of your capital to equities (as is the case for most institutional investors), bear in mind that equities tend not to do well in the early parts of a recession. Losses of 10-20% are the norm – not the exception. So if you believe that we are starring down the barrel of a recession, now is *not* the time to add to your equity portfolio[3].

A higher risk of recession

The recent debacle has unquestionably heightened the risk of recession. Until now we have maintained our long-held view that the world will escape recession. Clearly, the odds have changed after the damage done to confidence in July and August. The problem remains the US housing market, although there is now evidence of softening property markets in many parts of Europe as well; a trend which will become more pronounced when more than a million adjustable rate mortgages reset over the next year (meaning higher costs to millions of home owners). Given the fragile nature of the market at present, we may see a violent reaction to further problems in the US housing sector, potentially causing the economy to drop the second shoe.

A changing inflation outlook

As regular readers of this letter will know, we have taken a more hawkish view on inflation than most other commentators. With the global economy softening, we may have to revise this view – at least in the short to medium term. On the other hand, when central banks were last forced to intervene they did so against a backdrop of serious deflation risk. Now the situation is dramatically different. Inflationary forces are still lurking underneath[4] and there is a real risk that any easing now will come back and bite later.

Therefore, we can only conclude that, in the short to medium term, the recent crisis has reduced whatever inflation risk was in the pipeline. Longer term, however, central banks may have opened a can of worms by abandoning their fight against inflation. We will hold our breath.

Central bank policy to change course?

Current market conditions have forced central banks around the world to abandon their inflation fighting policy for a while and instead focus on avoiding any longer-lasting damage caused by panicking investors.

The FOMC who sets Fed policy will meet again on the 18th September. The market expects a 25 basis point cut on that day. Whether the Fed will actually deliver or not depends partly on news from the economy and partly on the behaviour of the markets between now and then. On balance, recent

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[3] *See the July 2006 Absolute Return Letter for a detailed discussion of historical stock market performance in different parts of the economic cycle. You can find this letter on www.arpllp.com.*

[4] *See the June 2007 Absolute Return Letter for a more detailed discussion on inflation.*

economic data suggest a US economy coming back from the brink of recession, so one could actually argue that the Fed need not act at all. However, playing that card is poker at the highest level and could backfire spectacularly. Expect the Fed funds rate to be cut.

Meanwhile, the ECB has all but announced one further rate hike, expected to become official at the next ECB meeting on the 6th September. Unless market conditions deteriorate further, it will be difficult for the ECB to turn back on its "promise" without sending a signal to the rest of the world that it has been held hostage by the markets. The more interesting question to ask is actually whether another rate hike is really necessary. Signs are growing that after several quarters of robust growth, the European economy has slowed down recently. Raising rates on the 6th September could turn out to be a massive policy mistake - not the first time central bankers get it wrong!

In the UK, the situation is even more precarious. No G7 economy is more dependent on the financial sector than the British. The recent chaos in financial markets certainly has the potential to do serious damage to the UK economy and, although the Bank of England is still officially in hawkish mode, the next move could very well be a rate cut.

On balance we believe that the summer credit crunch has fundamentally changed the outlook as far as short term interest rates are concerned and now expect rates to be lower everywhere by next spring. We took a somewhat different view only a couple of months ago before the near meltdown of financial markets.

The likely path of gold prices

Gold prices will probably broadly follow the path of inflation. In the short to medium term, the outlook has therefore deteriorated with the bleaker economic outlook. In the long run, though, we suspect that central banks could quite well have scored a massive own goal by changing course midstream (in fairness to central bankers around the world, only the Fed has so far officially declared a change in bias). If our concerns about inflation longer term are not misplaced, there could be substantial upside for the yellow metal in the long run. You just have to be a little patient.

Property prices to sink

A near inevitable consequence of the recent debacle is an abrupt stop to the multi-year bull market in property prices. So much of the property bull in recent years has been driven by second mortgages (in the UK, often third, fourth or even fifth mortgages) as well as no or low document mortgages. Much more stringent mortgage application procedures will be one of the many fall-outs of this crisis. Prices will stall at best, fall 25-35% at worst. Brace yourself for something in between.

A rethink on hedge funds?

One of nasty surprises of the current crisis has been how some - but by no means all – hedge funds have been caught up in the crunch. Risk management models which have been considered solid can now be thrown out of the window. Hedge fund managers and prime brokers both use an approach called VaR (Value at Risk). The entire risk management process is built on this one number and the crisis has brutally exposed the shortcomings of this approach.

The crisis has also revealed how supposedly uncorrelated asset classes are in fact highly correlated. We have been writing on this subject for a while, but this crisis has reminded us yet again that when things go well and truly haywire, there is nowhere to hide.

Finally, whether they like it or not, hedge fund managers will also have to get used to facing a more difficult credit environment. Many banks have learned a bitter lesson in recent weeks and, going forward, much more difficult questions will be asked before any credit line is provided. This will hit new hedge funds particularly hard and may slow down the growth rate of the industry at least for a couple of years.

The death of hedge fund replication?

Huge losses amongst quant hedge funds in July and August have raised more than a few eyebrows. Well, as we have seen before, when the proverbial s*** hits the fan, most models stop working and that is precisely what happened earlier this summer. Quant funds are 100% model-driven and the geeks behind the models either couldn't or didn't want to intervene until the damage was done.

Now, let's look at the latest market gimmick, also known as hedge fund replication. In some way, these funds are to hedge funds what index funds are to the mutual fund industry. Many market observers consider these funds the next big thing and fully expect replication funds to become a multi-billion dollar industry. At least that was the view until recently. The problem is that many replication funds are built on models similar to those used by quant funds. We predict that the appetite for those types of products will be lukewarm at best for a long time to come, given the damage caused over the past few weeks.

Long Live Cash

As always, cash is king when panic strikes. However, we urge you not to rush into anything. The current crisis reminds me so much of the LTCM crisis in 1998 which took several months to clear. We would be very surprised if there is not at least one more twist to the current credit crisis, so save a bit of ammunition as more buying opportunities will present themselves over the next several weeks.

Niels C. Jensen

Absolute Return Partners

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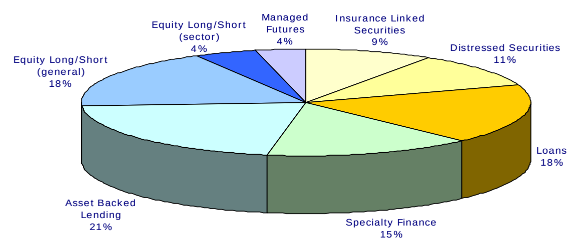
The **Multi-Strategy Portfolio**
as at 31st August, 2007:



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