# The Absolute Return Letter
# December 2007

## The Future Looks Bright(er)

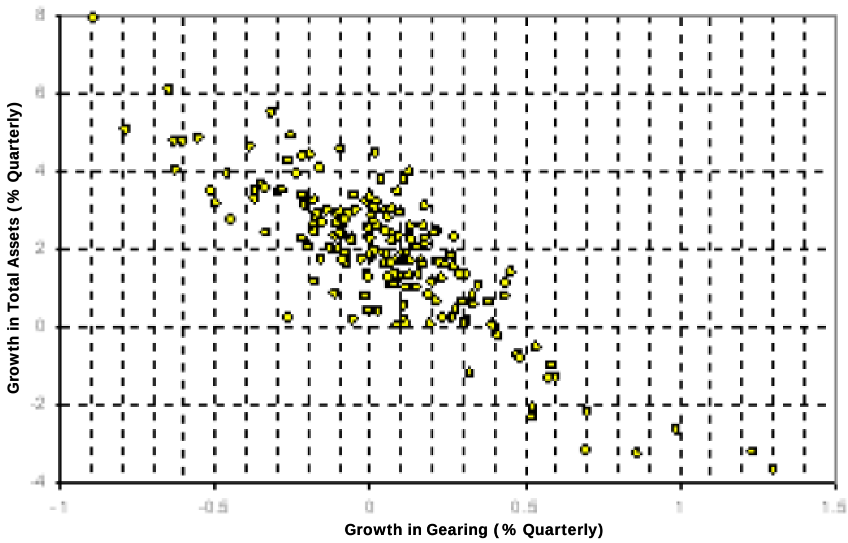
*November was ugly*

November was an ugly month. As bad as they get. In this month's letter we try to explain why that was. In particular we focus on the role of capital ratios and the effect gearing[1] has on the financial system. It is perhaps a little bit more technical than usual (and for that we apologise) but it is nevertheless very important in order to understand why markets behave the way they do at the moment.

*Defining 'capital ratio'*

Let's begin by defining the term 'capital ratio'. For the purpose of this discussion we shall define it as the value of total assets divided by total equity capital. For example, a person owning a £500,000 house with a £450,000 mortgage against it (assuming no other assets or liabilities), will have equity of £50,000 and a capital ratio of 10 (£500,000 divided by £50,000). If the value of the house rises 20% to £600,000, his capital ratio drops to 4 (£600,000 divided by £150,000). Now look at the following chart:

**Chart 1: Total assets and gearing of U.S. households**




*Source: "Liquidity and Leverage", September 2007[2]. 1963-2006.*

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1 For the benefit of our American readers, gearing is another (and very British) word for leverage.
2 "Liquidity and Leverage" is a recently published research paper, authored by Tobias Adrian, Federal Reserve Bank of New York, in conjunction with Hyon Song Shin, Princeton University.

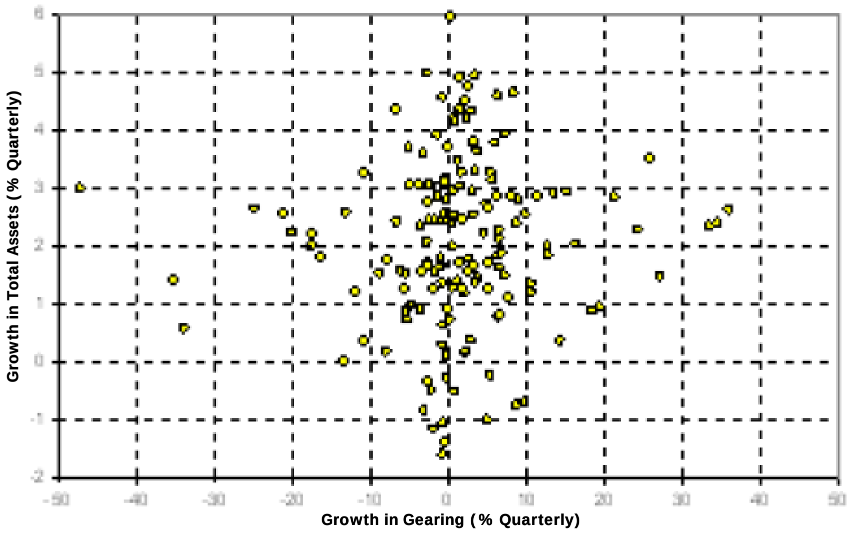
*Households*

As you can see, there is a strong inverse relationship between the value of assets and the gearing amongst private households. This study was done in the US; however, there is no reason to believe that households in other parts of the world behave differently. As the value of your house goes up, your net worth increases and consequently your gearing goes down. Many households withdraw some of the incremental value for general consumption but few spend it all. No surprises here.

*Commercial banks*

Moving our attention swiftly to the financial sector, you will note a very different pattern. Chart 2 below illustrates how commercial banks manage their balance sheets. You will note a large number of observations through the vertical 'zero' line, indicating that commercial banks target a fixed capital ratio. For many banks that number happens to be around 10. The implication of this is not to be ignored. If a bank manages it business with the objective of maintaining a steady capital ratio, a write-off in the order of $10 billion would force the bank to reduce its assets by $100 billion. This is most easily done by reducing its loan book which again explains why many banks are suddenly reluctant to lend and why LIBOR rates have sky-rocketed.

**Chart 2: Total assets and gearing of U.S. commercial banks**

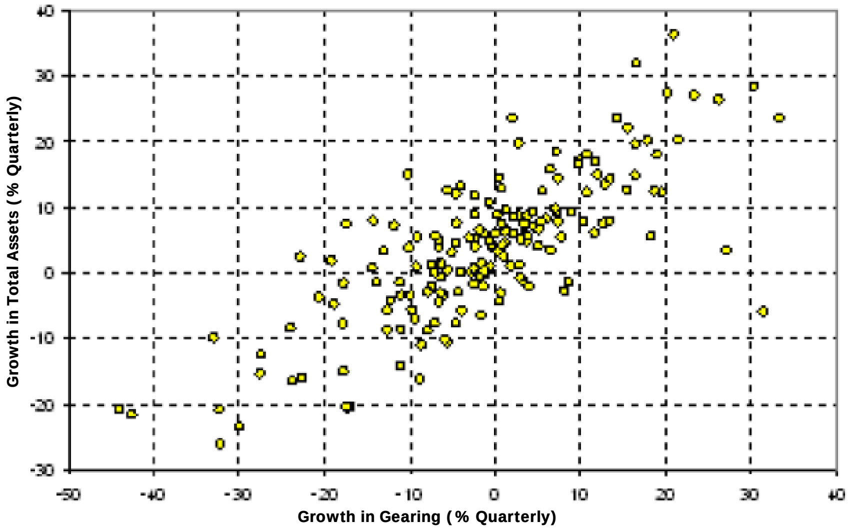



*Source: "Liquidity and Leverage", September 2007. 1963-2006.*

*Investment banks*

If we go one step further and instead look at the behaviour of investment banks, an even more remarkable picture emerges. Now the correlation is clearly positive as depicted in chart 3 below. A rise in asset prices will lead to higher gearing amongst investment banks whereas a fall in asset prices will cause these banks to reduce their gearing. If you add to this that the capital ratio for most investment banks is significantly higher than 10, it is easy to understand how falling asset prices can potentially cause a rather nasty spiral where lower prices lead to sell-offs which again lead to further weakness, etc. etc.

**Chart 3: Total assets and gearing of U.S. investment banks**




*Source: "Liquidity and Leverage", September 2007. 1963-2006.*

*Do not trust Bernanke*

Now let's move to the current situation. Following a rather dark period since the credit crunch began in earnest in July, banks around the world have written off approximately $50 billion of toxic mortgage debt. Based on sources which we consider reliable, we believe total mortgage related losses over the same period amount to somewhere around $400 billion. Don't trust Ben Bernanke for one second when he estimates total losses to be around $150 billion. The real numbers are much, much higher. If our estimate is correct, that leaves about $350 billion unaccounted for. However, before you jump out of the window, consider the following.

*It is not only the banks*

It is estimated that 'only' one third of all bad mortgage related debt is on the balance sheets of the world's banks. Total losses for the banking industry as a whole are therefore estimated to be about $130-140 billion. Another third belongs to insurance companies and the last third is to be found mostly amongst other institutional investors such as pension funds, hedge funds, etc.

*The effect on markets*

Let's try to put these numbers into context. $400 billion is approximately 1% of global GDP – nasty but by no means the end of the world. $400 billion is also equivalent to a really bad day for the U.S. stock market – a drop of 2.5% or thereabouts. The stock market has experienced falls of this magnitude many, many times without falling into a coma. However, going back to my earlier point about capital ratios, if banks stand to lose $130-140 billion, in order to maintain a constant capital ratio of about 10 and unless they can raise substantially new equity capital, they would have to reduce their balance sheets by $1.3-1.4 trillion, and *that* is a big number. That translates into about 4-5% of all debt owed by the non-financial sector to the banking industry which is enough to ignite a recession.

*The worst is probably over*

The sell-off in November should also be seen in this context. Most investment banks closed the books for the year on the 30th November and, over the past few weeks, they have been busy reducing the size of their balance sheets. Afraid of being left behind, commercial banks participated in the sell-off despite their fiscal year running for another month. With much of the year-end selling now behind us, we expect an improvement in overall market sentiment going forward. Also, the two thirds of total mortgage debt related losses which belong to financial institutions other than banks are not subject to the capital ratio 'rule'. Hence we do not expect the same dramatic effect on the markets when these losses are announced in connection with the publication of the annual accounts sometime in the first quarter of next year.

*Reducing our expectations*

For all of these reasons we have modified our economic outlook for 2008. Up until this point we have assigned no more than a 50% probability of recession in the U.S. in 2008 and only a modest risk of recession in Europe. Now, with banks caught in this vicious cycle, the recession risk has risen significantly and we have raised the probability of recession (which we define as two consecutive quarters with negative GDP growth) to 65% in the US, 75% in the UK and 40% in Europe. The financial sector's huge importance for the British economy is behind our rather more pessimistic outlook for the British economy. Adding insult to injury, Gordon Brown has painted himself into a corner with his reckless fiscal policy of recent years. Whereas both the US and the Euro-zone can currently afford fiscal expansion to kick-start the economy, should it become necessary, Brown's heavy spending whilst in no. 11 has left a large budget deficit, defying all logic following years of solid economic growth.

*Several rate cuts to come*

The situation has in fact become so serious that those interest rates controlled by central banks could fall dramatically in months to come. Since Greenspan took control of the US Fed, this has been the tool favoured by most central bankers. Earlier today the Bank of England cut the rate by 25 basis points to 5.50% (the first UK rate cut since August 2005) and the Fed governors are due to meet again next Tuesday (December 11). Expect a cut of at least 25 basis points, possibly 50, with more to come over the next 12 months. Even the ECB, despite all its macho talk about inflationary pressures, may have no choice but to reduce rates. Since we take a fundamentally different view than most other commentators on the long-term outlook for inflation (we are more bearish than most), we are not convinced that reducing rates dramatically is the right thing to do, but the economic reality may force the hands of King, Bernanke and Trichet. Any such action may end up causing even more pain further down the road, but that is an altogether different story which we shall revert to in a future letter.

*Merry Christmas*

With these words we would like to extend our most sincere wishes for a happy and prosperous 2008 to all our readers and their families. We shall take a break from our writing as we always do at this time of year but plan to return with more thoughts on the world around us when we publish again around the 1st February. Merry Christmas!

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***Niels C. Jensen***


## Clones or Concept Exploitation?

*Hedge fund cloning*

In previous editions of the *Absolute Return Letter* we have voiced our concerns over hedge fund replication strategies. Armed with new evidence and anecdotal support, we revisit the concept of cloning and offer our opinion on the first attempts to create hedge fund clones.

*Different replication models*

First, let us look at what is on offer. Factor replications are models which seek to replicate the returns of a given hedge fund strategy by establishing a set of long/short positions which explain historic results. Typically, the manager will rebalance the portfolio at regular intervals.

Strategy replications use a methodology very similar to that of single manager hedge funds. The manager will establish a forward looking model which he believes will replicate the hedge fund strategy. The aim is not only to get the same returns but also to capture the risk profile of the hedge fund.

Lastly, some investment banks have created investable hedge fund indexation strategies. These provide investors with some generic exposure to the hedge fund industry.

*Mercer's findings*

It is still early days and the statistical evidence is not yet great but Mercer Investment Consulting has, in a recent report, made an attempt to gauge the success of hedge fund cloning. The conclusion is hardly surprising - there is no evidence whatsoever that cloning works. In particular, results from this summer show unfortunate performance patterns, with high correlations between clones and the stock market in July followed by high correlations between clones and hedge funds in August – both negative events.

*130/30 funds*

We are often confronted with the view that replication strategies are cheap relative to the real thing. Ignoring the fact that current evidence suggests they don't work, this statement might actually be true. We have not been able to obtain reliable data on the pricing of replication strategies; however, we recently attended a launch presentation of a 130/30 fund. Such a fund structure allows 'long only' managers more latitude as they can leverage the long book by 30% and short up to 30% at the same time. The fee structure of this particular fund is 1.5% and 20% - similar to most hedge funds. However, in the marketing material for this fund it is stated that this is not an absolute return strategy so for that reason performance fees are calculated against a relative benchmark. In other words, if the benchmark is down 30% and the 130/30 fund is down 'only' 20%, it will still charge a performance fee.

*Retail investors to suffer*

We found it rather amusing that this particular fund, run by people with no short experience, is actually more expensive than an average hedge fund. Towards the end of the presentation we figured out what it was all about. The bank behind it is looking to make the fund UCITS compliant which will allow them to sell the product to retail investors. Why is it always retail investors who have to suffer when so much time and effort is dedicated by regulators to protect them? We have absolutely no problem with the concept of 130/30 funds. All we ask for is transparency. Investors should understand what they are buying and how much they actually pay.

*Our conclusions*

We think investors should think twice before investing in linear factor replication models. These funds are based on historic results and offer no flexibility and little proactive management. The quant fund 'blow-up' in August of this year springs to mind and they are even supposed to be very sophisticated models run by incredibly smart people!

Strategy replication models could potentially work and are worth following within areas such as long/short equity, convertible bond arbitrage and other strategies operating in fairly large and liquid markets.

The indexation strategies add little value in our opinion. Investors who track the returns provided by various service providers will agree that there is a significant dispersion in results, making it difficult to assess the true return on hedge funds. Certain banks seek to capture the risk/return profile of a given strategy through various index products. There are pages of problems with that approach with a big one being capacity constraints.

At the end of the day we ask ourselves – do replication strategies offer anything to investors which hedge funds don't? If the replication strategy can mimic the risk/return features at a reduced price, then the choice should be simple. Unfortunately, there is no evidence to suggest that they do.

We agree with Alexander Ineichen (of UBS Alternative Asset Management) when he talks about the asset management industry being in the middle of a paradigm shift. Many clones are simply strategies trying to close the gap between the old relative benchmark approach and the new absolute return approach. Five years from now the transition will have been completed and this discussion will become redundant. However, during the transition period it is of immense importance not to be misled by people who sell complicated products which offer no value-added to your portfolio at potentially higher costs.

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***Jan Vilhelmsen***

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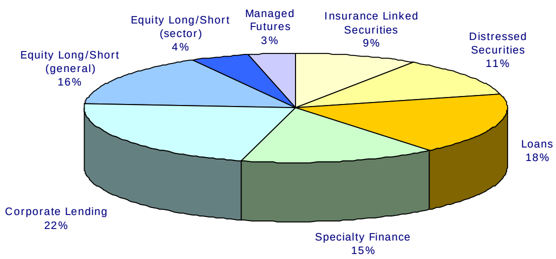
The **Multi-Strategy Portfolio** as at 31st October, 2007:

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