



The Absolute Return Letter

April 2008

The Moral Balance Sheet

“He who wishes to be rich in a day will be hanged in a year.”

Leonardo da Vinci

“Greed is good. Greed is right. Greed works. Greed cuts through, clarifies, and captures the essence of the evolutionary spirit.”

Gordon Gekko, “Wall Street”

Preface

Last night, after I finished writing this month’s Absolute Return Letter, a fascinating piece authored by Michael E. Lewitt of HCM landed on my desk. He actually does a far better job than I could ever hope to achieve in terms of laying out the moral dilemma the world is facing, as the credit crisis threatens to take down not only large financial institutions but also ordinary people like you and I. It is amazing to see how many people do not seem to grasp the seriousness of the situation. “It’s really the Americans’ problem, isn’t it?” is one of the more frequent questions I am met with. Don’t believe it for a second. This crisis is a global crisis and will affect every single one of us whether you live in Anchorage or Zagreb. I highly recommend you read Michael’s piece. It is called “How to Fix It” and can be found on our website www.arplp.com.

The dirty tricks campaign

Only a few days ago, an article appeared in a UK national newspaper¹ which made me sit up and reflect on the industry I work in. Here are a few extracts from the article:

“A hedge fund based in London set up a “dirty tricks unit” to manipulate share prices and get illicit information on companies in an attempt to make millions on the stock market [...]. Private detectives were allegedly employed to hack into executives’ emails and telephone records. Front companies were set up to allow the hedge fund traders to pose as independent researchers or journalists. Negative information on companies was then distributed to leading investment banks in the hope that rumours would spread and some share prices would fall...”

Is this really what our industry has come to? Going back to Michael Lewitt for a moment, he phrases it the following way:

¹ *‘The Dirty Tricks of Rogue Traders’, The Daily Telegraph, 22nd March, 2008.*

“At some point, society has to figure out that the way an investor earns his money is even more important than the amount of money he makes. This is why human beings were vested with moral sentiments, so they could distinguish the quality of human conduct from the quantity of its results.”

How far does our tolerance reach? The City of London has always thrived on gossip and one may argue that the self-regulatory nature of the UK market is not conducive to stamping out people who sail closer to the wind than is good. But this sort of behaviour is not only morally deploring – it is criminal.

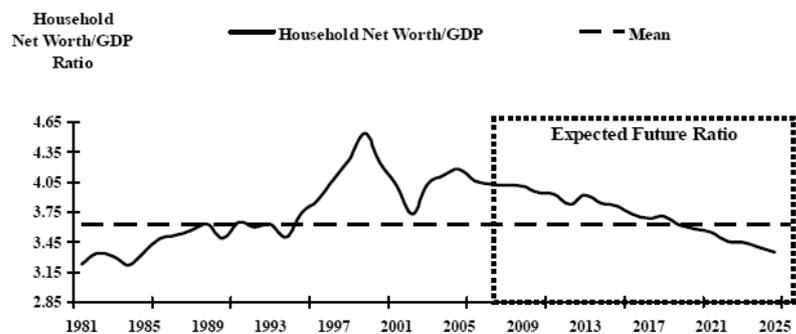
15% is not a human right

It is also symptomatic of a wider problem. For years (basically since 1982) investors have been spoiled by abnormally high returns. Yes, I do remember 2001-02, and the pain of October 1987 hasn't been lost on me either but, by and large, the last 25 years have been extraordinarily good to equity investors – in fact so good that some investors have lost all perspective on risk. We often come across people who believe it is a human right to earn mid-teens returns every year. As we shall see later, reality is very different.

The mean reversion of wealth

With 25 years of benign markets behind us, wealth has grown correspondingly. However, as our economic adviser Woody Brock keeps reminding us, in the long run, wealth *cannot* grow any faster than income². After years of rising asset prices, net worth at the aggregate level is well ahead of economic fundamentals and it appears that the long anticipated mean reversion of wealth is now in full swing. Woody has illustrated this in chart 1 below (I know we have shown this chart before, but it is important). Obviously, mean reversion may happen suddenly and rather dramatically or it may be a slow and grinding process whereby asset prices rise less than the underlying economy for a sustained period of time. Unfortunately, there is no way to tell whether it will be one or the other.

Chart 1: Mean-Reverting Dynamics of Net Worth



Source: Strategic Economic Decisions, Inc.

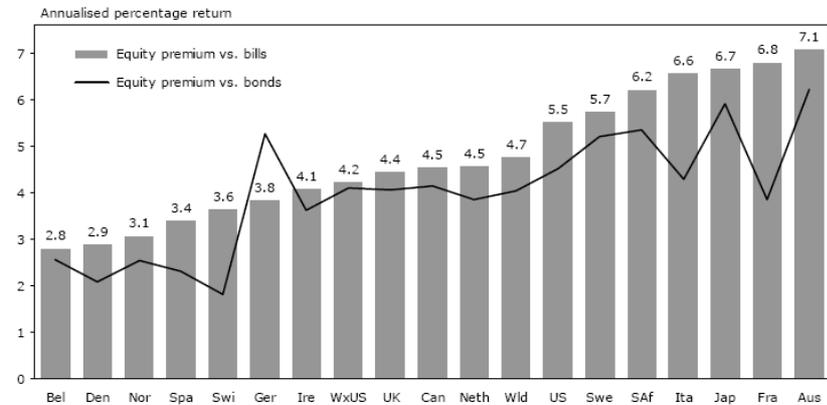
So what are the returns you should realistically expect from your equity portfolio going forward? In order to answer that question, we dug out a two year old study from London Business School³. The authors have completed one of the most comprehensive studies on long term equity returns. The bars in chart 2 represent the average annual return over

² This is not necessarily the case at the household level but is always the case at the aggregate level.

³ The Worldwide Equity Premium: A Smaller Puzzle, April 2006. You can access the full study on www.arplp.com.

and above the risk free rate of return during the period 1900-2005. The solid line represents the average excess return over the long term bond yield.

Chart 2: Annualised Equity Premiums, 1900-2005



Source: Dimson, Marsh and Staunton, LBS. Germany omits 1922-23.

By comparison, during the 'golden decade' of the 1990s, investors in the UK earned real returns in excess of 11% per annum and US investors earned over 14% annually⁴. Although the LBS study does not provide detailed information on the great bull market of the last 25 years, we estimate that most countries have enjoyed real equity returns in excess of 10% per year during this period. If you compare that to chart 2 below, you can see that the returns we have grown accustomed to in the last quarter century are a far cry from the long term averages and go a long way to explain why mean reversion of wealth is long overdue.

Expect lower returns

Over the long term, you cannot and should not expect much more than 4-5% over the risk free rate on your equity portfolio, which in today's world translates into 8-9% nominal returns in Euroland, a little bit more in the UK and a little bit less in the US. Obviously, this does not imply that you are entitled to 8-9% year in year out. Given the fact that asset valuations in general are rich (if you disagree with that, take another look at chart 1), and that we are heading towards economic trouble, it is in fact quite likely that returns will be much lower in the short term. On the other hand, when equity investors collectively decide that the bottom of the economic cycle is in sight, it is likely that equity prices will go through a period of sharply rising prices. In other words, the 8-9% annual return projection is for the long term.

Negative returns can be painful

Having tried to dampen investor expectations, let's kill another sacred cow. There appears to be a firmly entrenched view that, whenever the going gets rough, it won't be long before equities will get back on track. For that very reason, many investors have chosen to sit out most storms in recent years. If you subscribe to this philosophy, let me remind you that equities sometimes spend *decades* under water before they finally come back with a vengeance. This is illustrated in chart 3 below which we have taken from the same LBS study:

⁴ These numbers are from the same LBS study as referred to in footnote 3.

Chart 3: Longest Runs of Negative Real Returns, 1900-2005

	Real Return	Period	Number of Years
US	-7%	1905-20	16
UK	-4%	1900-21	22
France	-8%	1900-52	53
Germany	-8%	1900-54	55
Japan	-1%	1900-50	51
World	-9%	1901-20	20
World ex US	-11%	1928-50	23

Source: Dimson, Marsh and Staunton, London Business School.

So, with asset prices generally overvalued, with the economic outlook murky at best, and with a near meltdown in financial markets incapacitating the banks, it is no wonder that some people fall for the temptation to use extreme measures to maintain the superior performance of recent years. Deep down, is it the fear of being exposed as the emperor with no clothes on? Is it possible that the excellent performance of recent years is mostly a function of using excess leverage and that returns are, in fact, beta rather than alpha driven⁵?

Leverage in the sin bin

We believe so. In our minds, there is no question that 'liberal' use of leverage explains many an outperforming hedge fund manager. We also believe that excessive use of leverage explains much of the mess the world finds itself in at the moment. Leverage per se is not bad. Even the best run companies in the world have leveraged balance sheets. Appropriate use of leverage may in fact significantly enhance the risk/return profile of an investment. The challenge is when to say stop.

In recent years, in an environment of very low volatility, the gravy train delivered in spades, and more and more investors convinced themselves that we were in the midst of a new investment paradigm where the economy was bullet proof, financial returns would stay high for the foreseeable future and volatility would remain low, justifying an accelerated use of leverage with little or no perceived risk to investors prepared to go down this path.

Obviously, had you been the *only* investor applying such aggressive tactics, you might just have gotten away with it, but the sheer fact that everyone everywhere, from small investors to the largest banks in the world, played to the same tune, ensured that a collapse was inevitable. We wholeheartedly agree with Woody Brock when he suggests that regulators need not look any further than to the role of leverage, when they eventually do their post-mortem on today's crisis. Part of the problem is that over 70% of all loans today are facilitated outside the banking system, effectively granting the Fed control of less than 30% of all lending. Not an ideal position to be in if it is your job to control lending.

The party is over

As we do not need to remind you, all this has now come to an abrupt halt. Leverage has been flushed down the toilet faster than investors can count their losses and the financial world is starting to prepare itself for a brave new world which will look very different from the

⁵ *This is another way of saying that few investors are capable of consistently outperforming their peer group despite most fund managers claiming that they can do so.*

party atmosphere of the last 25 years. As Peter Bernstein pointed out in a recent article⁶ in which he discussed how the loss of trust between market participants has been instrumental to the unfolding of the current crisis:

“Now, it would be naïve to project this set of conditions into the indefinite future. Trust will regenerate over time, and the burdens of research will lighten. The pace of change in that direction, however, will be slow, a matter of years rather than months. An entire structure has crumbled and has to be re-built, brick by brick. Nor will that process necessarily be smooth. The impact of unforeseen but inevitable credit problems will loom large, detouring and delaying the pace and patterns of recovery on each occasion.”

We are not convinced that the economic downturn which is just around the corner will be particularly deep. There are still too many good things happening in the world for that scenario to unfold. However, for every day that passes, our conviction grows that we are in for a prolonged period of subdued growth. In his article, Peter Bernstein used the phrase “water torture” – drip by drip by drip until all the excesses of recent years have been washed out.

Banks play a critical role in society today. Without lending, no new investments. Without investments, no growth. So, with banks keen to slim down their bulky balance sheets and eager to tighten their lending standards, there can be no outcome other than reduced economic growth ahead of us.

Even more worryingly, banks do not change their lending policy light-heartedly. When they pull back, as they have done recently, it usually takes years before their appetite returns. The UK commercial property market provides a great example. Back in 1993-94, at the peak of the previous property crisis in this country, UK banks pulled back *en masse* from providing bridge financing to commercial property developers and now, 15 years later, they remain uncommitted to this particular market segment.

Obviously, some countries will be harder hit than others – with those where access to cheap capital has been easy being hit hardest (e.g. US, UK, Ireland, parts of Scandinavia and Eastern Europe). There is no question, though, that the de-leveraging is a global phenomenon and that every single country on the planet will be affected by this.

The boomers are in trouble

The slowdown will be further exacerbated by the effect the crisis is going to have on the many millions of baby boomers who plan to retire in the next 10 years but who may now have to work longer than planned as they may not be able to afford retirement. All over the Anglo-Saxon world (and in some other countries as well), baby boomers have relied on ever rising property prices to provide for their retirement. Savings ratios have been low, very low in some cases, and actually negative in the case of the United States, but little difference has it made until now, as rising property prices have done the job. Not anymore. The emergency exit door has been closed firmly and is not likely to re-open for several years. Therefore, baby-boomers have no other option than to start saving aggressively. This will further impede growth.

⁶ *One of the leading lights of our industry, Peter is still going strong despite having passed his 87th birthday. He has recently produced an absolute must-read called “The Shape of the Future”, a copy of which you can find on www.arpllp.com.*

The silver lining

Before you despair, remember that every cloud has a silver lining. One of the more reassuring aspects of human nature is that its ability to spot opportunities in adversity is almost endless and this crisis, like other crises in the past, will generate some very attractive investment opportunities. Last month I wrote about the market for leveraged loans which has taken a big knock in recent months. Despite the month of March providing further challenges for this asset class, we continue to believe that this is one of the great opportunities of all time. Many of you contacted us following last month's letter, wanting to learn more about the loan market. In the next few days we will write to those of you who contacted us with a specific idea we have in mind.

This month I will bring your attention to another investment strategy which is likely to benefit from the current crisis and in particular from the restricted lending appetite shown by most banks. In the alternative investment space, there is a collection of funds named asset backed lending (ABL) funds. These funds are *not* hedge funds in the traditional sense of the word, as they don't invest in equities, bonds or commodities, and shorting is unknown to them. So what are they? ABL funds are almost like small banks. They provide capital to both companies and individuals. They lend against collateralised assets and the loans are typically heavily over-collateralised. Some funds provide trade finance. Other funds lend against the value of life insurance policies. Others again will provide bridge finance for various different purposes (e.g. TV production, films, property developments, etc.). There are many varieties of ABL funds.

ABL funds should benefit

ABL funds generate relatively stable returns, not the highest you have ever seen but quite consistent. The largest risk is the borrowers defaulting on the loan but that risk is mitigated through the collateralisation of assets which secure the loans. Here comes the punch line: *We believe that ABL funds will be amongst the biggest beneficiaries of the ongoing credit crisis.* As the access to capital becomes scarcer and scarcer, ABL funds will not only be able to charge higher interest rates, they will also be able to improve the quality of their loan book as they can move up the food chain and attract higher quality borrowers. Interestingly, history has proven that the worst environment for ABL funds is during times of ample liquidity when banks will chase their clients with more favourable terms. On the other hand, adverse economic conditions has historically provided for very attractive returns for these funds.

The rules prohibit us from going into detail on this investment opportunity and I shall be the first to admit that they are not appropriate vehicles for all types of investors, but feel free to contact us (see last page for details) if you wish to learn more about the ABL industry. Oh, by the way, most ABL funds use NO leverage!

Niels C. Jensen

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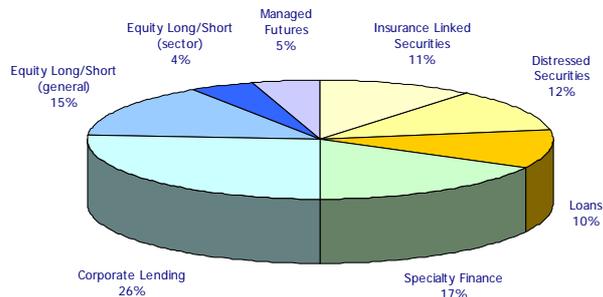
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as at 31st March, 2008:



The **Millennium Wave Portfolio**
as at 31st March, 2008:

