Absolute Return Partners LLP

The Absolute Return Letter
July 2008

Shadow Banking, Private Credit or…?

Empty promises

Last summer we were all assured by highly ranked politicians and senior economists such as Hank Paulson and Ben Bernanke that the sub-prime crisis was contained to a small and very specific part of the US economy, that it would not be expected to have a significant impact on the general well-being of the US economy and that the effect on the global economy would be minor at worst. Today it is not difficult to connect the dots. Economic activity is slowing across the world. At the same time, accelerating inflation has effectively tied the hands of central bankers and made any quick fix virtually impossible.

On the other hand, had we told you a year ago that credit markets would face extraordinary challenges, that Bear Stearns and Northern Rock would both collapse, that US house prices would fall at the steepest and fastest rate ever, that US home equity borrowings would fall by 85%, that UBS would write off years of profits, that oil prices would be approaching $150 and that there would be riots across the world over escalating food prices, then, quite frankly, you would be forgiven for thinking that the world would be in a much bigger mess today than is actually the case.

Macro Stability Hypothesis

This is down to what our economic adviser, Dr. Woody Brock, calls the *Macro Stability Hypothesis*. According to Woody Brock, a steady decline in economic volatility over the past century has led to the global economy becoming 80% less risky, as measured by decade-by-decade standard deviation in GDP growth, household income growth and consumption growth. The reduced volatility has (amongst other things) resulted in much lower interest rates which has greatly benefited the global economy, but it has also encouraged consumers, companies and investors to take more risk. To a large degree this explains the high level of leverage which is to be found at most levels of the global economy today.

In the last twelve months this has come back to bite risk takers. Banks all over the world, which until recently would lend money to pretty much everybody, often against questionable or no collateral, are now scrambling to sort out the mess they find themselves in. Even highly creditworthy bank customers find that the credit door has been slammed in their faces and this is not likely to change any time soon. To make matters worse, the trust between banks has deteriorated to the point where inter-bank lending has been severely curtailed, doing further damage to global credit markets. Unfortunately, we do not yet have numbers for the second quarter of this year but, as you can see from exhibit 1, consumer loans in the US not only slowed down in Q1 - they actually fell. We predict that the same will happen to commercial loans pretty soon.

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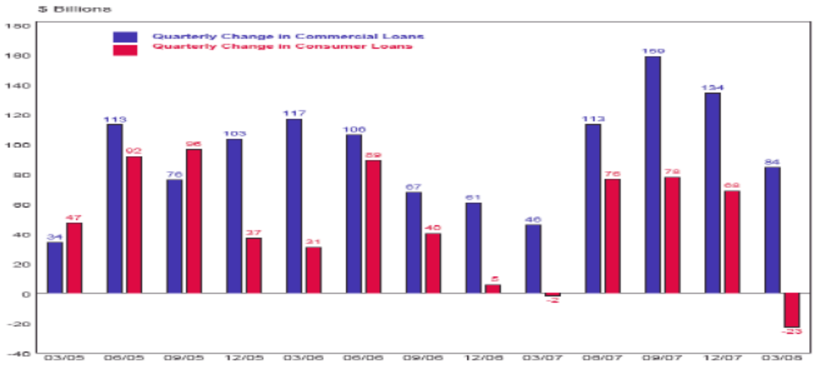
Exhibit 1: Quarterly Change in US Loans (2005-08)

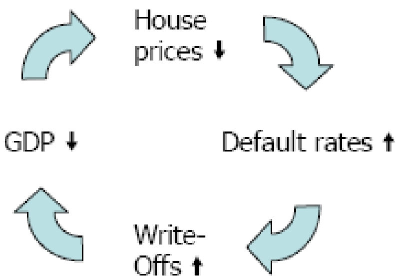


Source: Weldon's Money Monitor

Woody's worries

Loyal readers of this letter will know how much we admire the work of Woody Brock. In a recent essay, he gave his account of current credit events and what is likely to happen next. In short, Woody's thoughts can be illustrated as follows:

Exhibit 2: Anatomy of the US Slowdown



Source: SED Profile, May 2008

As Woody puts it:

> *"This is truly uncharted territory, and our single biggest concern at this writing is that house prices in general are continuing to fall – further and faster then expected – thus eroding home equity at a disturbing rate."*[1]

However, Woody's main concern is the feedback process between credit markets and the "real" economy. The obvious implication is that we have entered a vicious circle from which there is no easy way out, and the story gets worse. There are good reasons to believe that, because of the high levels of leverage and a rapidly changing attitude towards defaulting on debt (the stigma associated with bankruptcy is no longer as prevalent), default rates will most likely be much higher in this cycle than those we have experienced in the past.

And it doesn't stop there. Because of the highly complex financial system which has been erected over the past couple of decades, it is virtually impossible to predict the ultimate damage to the banking system. We can confidently say, though, that banks will be forced to write off more than they have already done.

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[1] *SED Profile, May 2008.*

John Paulson's prediction

John Paulson, the well-known hedge fund manager who predicted the credit crunch and made a killing on it last year, said to us at the GAIM conference in Monaco a couple of weeks ago that write-offs will eventually reach $1.3 trillion. The number currently stands at about $300 billion in the banking sector and an amount broadly similar to that in other parts of the financial services industry.

All this can only lead to one conclusion. Unless banks can raise hundreds of billions of dollars more in fresh equity capital - and we seriously question their ability to do so – they will be forced to pull back further. International banking standards are very clear on this point and, if capital adequacy ratios are insufficient, the loan book must be reduced. According to some estimates we have seen, around $800 billion of new capital is required for the banks to fully repair the damage to their balance sheets. Even the Sovereign Wealth Funds may cough at this number!

The birth of a new asset class

So, even if demand for credit might have slowed to some extent, the point is that the supply side has shrunk much more, leading to a liquidity squeeze for borrowers. Now, the financial services industry has never been short on creativity and the fact that the banking industry is on its knees has created opportunities for others. Borrowing a phrase from our good friend and business partner, it is *The Birth of a New Asset Class*.

Peter Bernstein alluded to it in his classic piece "The Shape of the Future". John Mauldin has referred to it as Private Credit. Bill Gross, the venerable fixed income manager at PIMCO, has called it the Shadow Banking System:

> *"[...] because of the retreat of securitization, risk spreads – from corporate bonds to equities, to commercial and residential real estate – will settle at permanently higher levels. The U.S. asset-based economy will morph into a more expensive hybrid that will reign supreme for years to come."*[2]

Asset based lending

We mere mortals call it *Asset Based Lending* (ABL). Few outside the alternative investment industry have heard of ABL, whereas most of us are familiar with GE Finance which is the hugely successful and profitable division of General Electric. GE is one of the world's largest asset based lenders. Last year GE's commercial finance division generated $34 billion of revenues. Much of these revenues were tied to ABL.

At the other end of the spectrum, numerous smaller companies are tapping into this very lucrative market. Some call them hedge funds because of the fee structure which is indistinguishable from a typical hedge fund. We prefer to think of them as alternative investment funds.

Frankly, it is not a new industry, but it is gaining momentum now for all the reasons described above. According to Hedgefund.net, which has been compiling data on the ABL industry since 1989, assets under management in this bank-like industry have grown from under $1 billion three years ago to over $12 billion today.

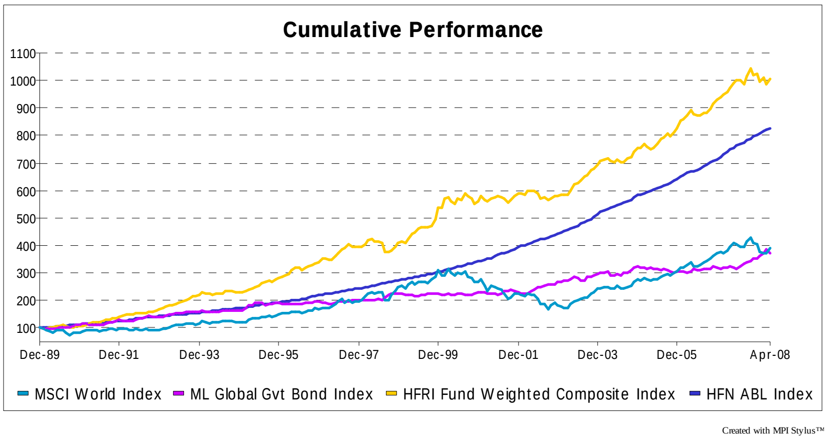
Historically, net returns to investors in ABL funds have been in the range of 10% to 14% per annum which many saw as boring because of the attractive returns on offer in equities, bonds and commodities in

[2] *Bill Gross, PIMCO Investment Outlook, April 2008*

recent years. In today's environment those returns, combined with very low volatility, have suddenly become an attractive proposition.

Hedgefund.net has been running an ABL index since 1989 which has generated a compound annual return of 12.3%. In exhibit 3 below we have compared the performance of the ABL index to that of global bonds (Merrill Lynch Global Bond Index), hedge funds (HFRI Fund Weighted Composite Index) and global equities (MSCI World Index) since January 1990. As you can see from exhibit 3, not only has the ABL Index beaten both bonds and equities, but it has done so with a fraction of the volatility you experience when investing in those asset classes.

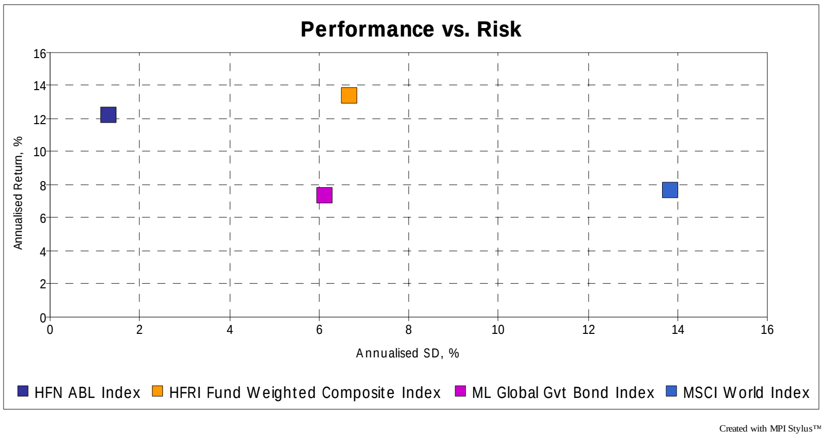
Exhibit 3: Performance of ABL vs. Other Asset Classes



Only one down month since '89

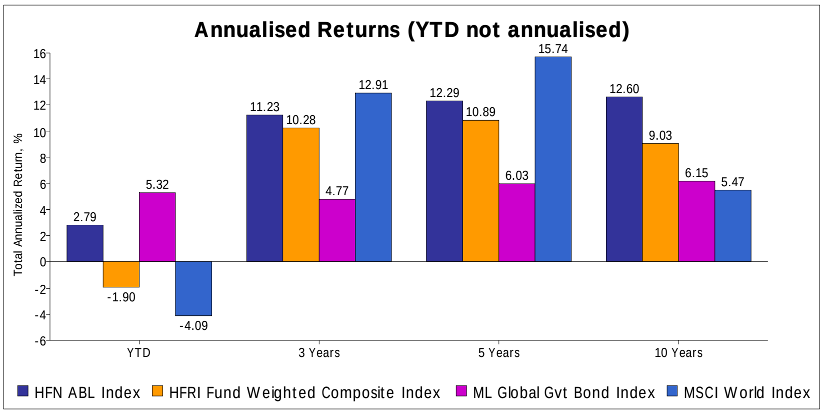
Interestingly the ABL Index has experienced only one down month since HFN began tracking the industry back in 1989. This happened in May 2006 which we all remember as a rather chaotic month for financial markets. Due to the stable return pattern, volatility is extremely low. The standard deviation for the ABL Index over the entire period is 1.31%. This compares favourably with that of hedge funds in general (6.67%), bonds (6.12%) and equities (13.82%).

Exhibit 4: Risk-Adjusted Returns



On a risk-adjusted basis, because of the very low volatility, the ABL Index outperforms all of its peers. We have illustrated this in exhibit 4 above. It is also worth noticing that, although hedge funds in general have fared better than ABL funds over the entire 1990-2008 period, in more recent years, ABL funds have actually performed better than hedge funds (see exhibit 5). This implies that ABL funds have not experienced the same pressure on returns as hedge funds have in general. We believe that the high barriers to entry in the ABL industry explain this divergence in performance.

Exhibit 5: Annualised Returns



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Another interesting feature specific to the ABL industry is that it is almost counter-cyclical. When money is plentiful and banks are keen to lend, returns for asset based lenders come under pressure. On the other hand, when money is scarce and banks are nowhere to be seen, pricing power returns and the overall performance of ABL funds improves.

Exhibit 6: Correlations

	ABL	HFRI	ML GVT	MSCI
HFN ABL Index	1.00	0.09	0.09	0.12
HFRI Fund Index	0.09	1.00	-0.05	0.69
ML Global Gvt Index	0.09	-0.05	1.00	0.15
MSCI World Index	0.12	0.69	0.15	1.00

Attractive portfolio features

The final point we wish to bring to your attention is the attractive portfolio features of ABL funds. Whereas hedge fund returns in general have experienced a steadily rising correlation with equity returns, ABL returns continue to be virtually uncorrelated to equity returns, making the industry an extremely attractive diversifier. As you can see from exhibit 6, ABL returns are virtually uncorrelated to both equity, bond and hedge fund returns, whereas the correlation between equity returns and hedge fund returns is higher than most investors realise (0.69).

How to define ABL

So, how do you define ABL? Asset based lending can be defined as private loans originated to individuals or companies secured by a specific asset or a pool of assets.

How are the loans structured? The loans are typically issued with a very conservative loan-to-value (LTV) ratio, meaning that the market value of the collateral will cover both loan and accrued interest. The collateral or secured asset can be tangible or intangible and will have an identifiable market value. In most cases the collateral is locked up and bankruptcy protected through a trust or special purpose vehicle which insulates it against corporate events. Often the lender requires personal guarantees on top of the collateral.

How are they priced? The loans are often more expensive than traditional bank loans and, in some cases, the ABL manager obtains some type of equity participation through warrants, etc. In return, the borrower avoids all the red tape associated with the banking industry and the terms are normally much more flexible than those offered by banks.

What are the risks? As with all asset classes there are risks. Default risk is actually not as big a risk as generally perceived. This is due to the very conservative LTV approach taken by most lenders in the ABL industry. We believe manager risk and fraud are the two single biggest risk factors. Investors in ABL funds should always perform comprehensive due diligence before handing out monies to fund managers. Researching the manager's handling of documentation and collateralisation is a critical part of the due diligence process.

Do all ABL managers follow the same strategy? No, there is a variety of sub-strategies. Some of the larger ones are:

Accounts Receivable Financing. The borrower will pledge a portfolio of accounts receivable as collateral. When a company has delivered the product and invoiced the customer, the ABL fund will offer to finance the gap until the customer has to pay and at the same time assume the credit risk. The LTV or advance on this type of credit facility is typically 50-80%.

Trade Finance. Some also refer to this as credit arbitrage, as the lender transfers the credit risk from lower credit rated suppliers to higher credit rated customers. The collateral is typically the shipment which is being financed. As the goods are shipped and stored in warehouses, it is of utmost importance for the lender to secure control over the goods through shipping contracts, warehousing documents etc. Likewise the lender will ensure money flows are under his control.

Real Estate Finance. Typically this comprises bridge loans that facilitate the early stages of a real estate project, residential or commercial, before the long term finance has been established. LTVs are normally in the 50-90% range but, given the current market conditions, LTVs are at the low end of this range.

Corporate Lending. There are many ways of structuring and securing loans to corporations. One route which has been very popular in the US is PIPE (private investments in public equity) lending. Here, small and mid-cap listed companies issue convertible bonds to the lender in exchange for the borrowings. It is a fairly controversial form of lending as many of the lenders request an option to reset the strike price if the stock price of the borrowing company drops below the conversion price. Other lenders structure the loans as first or second lien secured against equipment, inventory, plant or other assets.

Premium Finance. In certain states in the US it has become very popular to issue loans to private individuals with the purpose of financing their life insurance premiums. The lenders are typically wealthy individuals in their late 70s where life expectancy is well documented. The loans are for two years and only cover the premium of the policy. After two years the policy holder can either sell the policy in the open market or keep it and continue to pay the premium. The two year threshold is driven by the fact that US insurance companies cannot contest the cause of death thereafter, making it a high quality and liquid collateral.

We have only listed a few examples of the many sub-strategies available in asset based lending. Other lending strategies would include entertainment finance, legal claim finance, commodity finance, aircraft financing, auto loans and consumer finance.

No free lunch

Obviously there is no such thing as a free lunch and there are many risk factors to be considered. For that reason, investing in ABL funds is not for everyone. We have already discussed fraud risk which we consider one of the major risk factors. Every sub-strategy should be individually researched for strategy-specific risks.

A few years ago premium finance was associated with high regulatory risk as the SEC investigated the business practices of premium finance funds. This issue has since faded; however, other risks might emerge at some point in the future. In today's economic environment we would assign a high risk to ABL funds with exposure to consumer finance and real estate finance. However, those particular areas might represent an opportunity in a few years time. For all of these reasons we advocate that ABL investors have a broadly diversified portfolio, avoiding areas which are likely to suffer from macroeconomic or regulatory stress factors.

Conclusion

The world of investing is clearly in a very different place today than it was a year ago and there are good reasons to believe that it will take some time, perhaps a long time, to recover completely from the mess we are in. For example, only recently have global equity markets begun to discount the possibility of the current problems spreading from the financial and housing sectors to the rest of the economy. The optimists argue that equity valuations are now low. Well, only if you believe in what increasingly look like hopelessly optimistic forecasts for 2008 and 2009.

Also, as mentioned in the beginning of this letter, there is little the world's central bankers can do to ease our pain, as commodity induced inflation has seriously curtailed their manoeuvrability. For all these reasons investors may have to look elsewhere for attractive returns. This is where the ABL industry comes in. The banking industry's desire to reduce its loan books is music to the ears of the ABL industry, and ABL funds have demonstrated that they can deliver attractive returns even in tough times. The industry has been through two recessions already and has delivered resilient returns throughout.

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Absolute Return Partners

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