The Absolute Return Letter
April 2010

When the Facts Change

"When the facts change, I change my mind."
John Maynard Keynes

In last month's letter I looked at the challenges confronting the world's baby boomers based on the assumption that we are in a structural equity bear market, which implies below average returns for equity investors for several more years to come. Central to this forecast is my expectation that household de-leveraging, which is now underway on both sides of the Atlantic, has much further to run. In other words, we are in a balance sheet recession. When that happens, debt reduction becomes the priority. Savings rise and consumption falls at the expense of economic growth.

Please note that this forecast is predicated on a 5-10 year time horizon. Within a structural bear market – which is characterised by falling P/E ratios – it is certainly possible to have cyclical bull markets, so it is by no means one-way traffic. As you can see from chart 1, since the 1982-2000 structural bull market came to and end, we have enjoyed two powerful cyclical bull markets; however, global equity prices remain at 2000-levels.

Chart 1: Return on global equities since January 1970

Source: MSCI

That pretty much sums up the key findings in last month's letter (which you can find here in case you didn't read it). This month I will look at an appropriate investment strategy for such an environment, so let's get started. I will make five specific recommendations. Here is the first one:

#1: Beware of echo bubbles

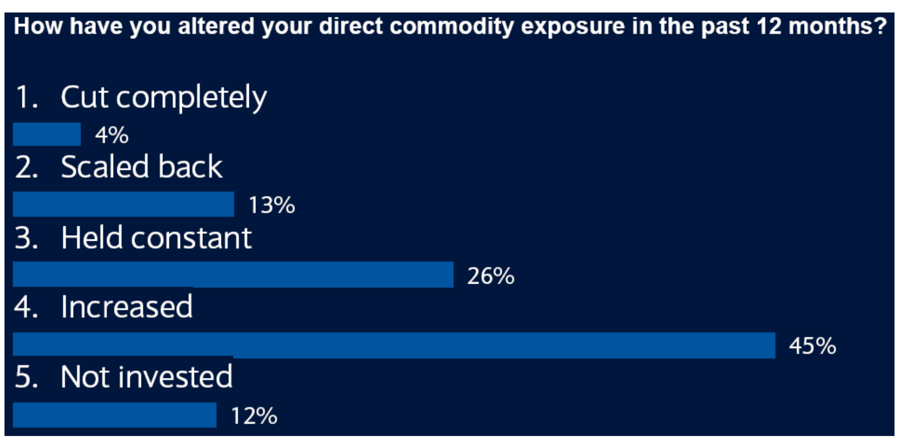
We are currently in what I like to call *echo bubble territory*. I assume that most of our readers are familiar with the DNA of an asset bubble (even if Greenspan isn't). Echo bubbles are children of primary asset bubbles and are usually conceived when monetary authorities respond to the bursting of an asset bubble by dramatically reducing policy rates.

In the current situation, banks have suffered the worst; low policy rates help banks rebuild their damaged balance sheets as they benefit from the steep yield curve. The dilemma now facing policy makers is that the extraordinarily low interest rates we currently enjoy are encouraging another bout of excessive risk taking before bank balance sheets have been restored and the economy is back on its feet again. If monetary authorities were to raise rates now in order to avoid the formation of echo bubbles, it would almost certainly kill the fledgling recovery. The pressure is therefore on them to keep rates low and for that very reason asset bubbles are often followed by echo bubbles.

So how do you spot a bubble? Edward Chancellor of GMO has recently published a paper which I recommend you read from A to Z (you can find it here). It is a brilliant account of all the features which characterise asset bubbles. The scariest part of Chancellor's story is that China ticks virtually all the boxes. I would actually go one step further and urge you to beware of emerging markets in general. They have shot up over the past year as a result of massive inflows from European and US equity investors. We are not yet at ridiculous valuation levels, so the bull market probably has further to run; however, investors seem to be forgetting why emerging market equities usually sell at a discount to US and European equities despite their superior earnings growth. There are risks associated with investing in emerging markets which are quite conveniently being ignored at the moment. Sooner or later, something will happen which will remind investors that those risks still exist.

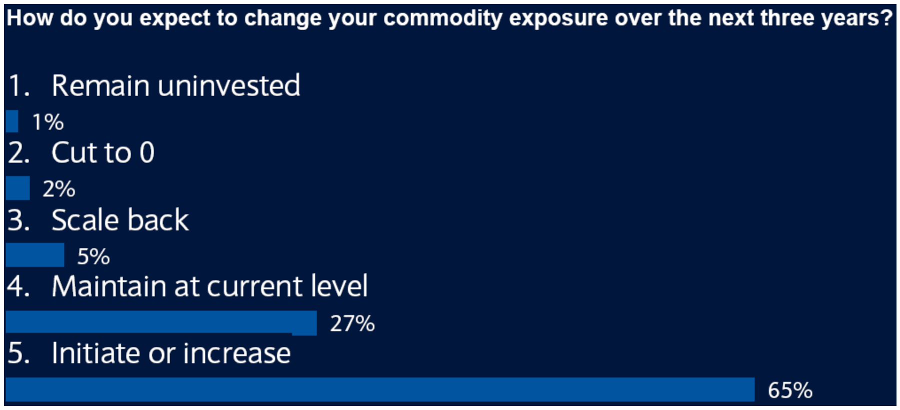
In the short term, though, I actually worry more about commodities. Barclays Capital held an institutional investor conference on commodities in Barcelona last month, during which they polled the audience. Although one has to bear in mind that investors attending a commodities conference probably are positively disposed towards commodities, the results are still powerful (see charts 2a and 2b). As we all know, investor appetite for commodities has been growing rapidly in recent years - just look at the growth of commodity linked ETFs. However, I suspect that many of those investors do not fully understand the complexity of the products they invest in (see here for a brilliant analysis of this problem), and they don't realise how small many commodity markets actually are. I fear that many investors are setting themselves up for serious problems as ETFs account for a bigger and bigger share of the total commodity pool.

Chart 2a: Change in commodity exposure – Last 12 months



Source: Barclays Capital

Chart 2b: Change in commodity exposure – Next 3 years



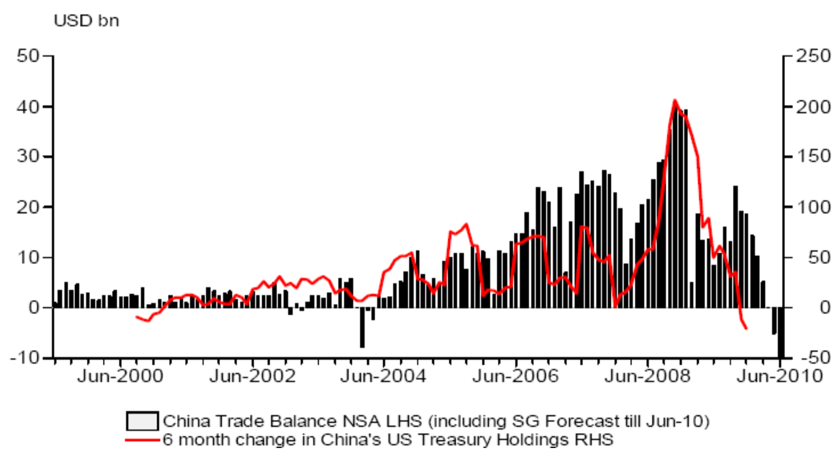
Source: Barclays Capital

One of my favourite reads is Albert Edwards of Societe Generale. Last November he warned anyone who cared to listen that China would soon post their first monthly trade deficit since April 2004 and that it wouldn't be an isolated incident. The problem was that nobody believed him. Now, China has officially recognised that the March number will indeed be negative and investors across the world are wondering what on earth is going on.

There is no question that the Chinese have been very active buyers of commodities, and it is also a fact that much of the buying has been stockpiling for the future. One can only speculate about the motive(s) for doing that. Perhaps they are worried about future supply channels. Perhaps they are playing games with the Americans who have been arguing that the Chinese must allow the renminbi to appreciate in order to bring down the Chinese trade surplus with the United States. That argument suddenly looks very hollow, should the Chinese trade deficit prove to be more persistent.

It will also be interesting to see how the renminbi reacts, should the Chinese give in to American demands and let it float. Pretty much everyone has assumed that a non-dollar pegged renminbi would mean a higher renminbi which, all other things being equal, should reduce the Chinese trade surplus with the US (which is what the Americans want). On the other hand, if China is entering a period of more consistent trade deficits, do not be surprised if the renminbi actually falls, once they give up the dollar peg. What a spectacular own goal that would be for the Americans.

Chart 3: China's trade surplus is turning into a deficit



Source: Societe Generale

My immediate concern, though, is not why the Chinese are suddenly running a deficit (see chart 3) but rather what effect on commodity prices the aggressive Chinese buying has had. My advice? *Stay clear of commodities until the dust has settled.*

#2: Do not benchmark

An entire generation of investors (including myself) have been trained to believe in the importance of benchmarking. Nobody tells you (I found out the hard way) that benchmarking is appropriate only in structural bull markets, where active managers usually struggle to keep up with the ever rising markets. What your portfolio does relative to the market in an environment such as the one we are currently in becomes irrelevant, because GDP growth becomes a function of your government's willingness to run deficits. The private sector will struggle, earnings growth will be anaemic, and equity returns will be comparatively low. Therefore, if you buy the market, you buy mediocrity (over the long run).

For the same reasons, buy-and-hold is the sure way to poor performance. In a structural bull market it is the most profitable strategy unless you are a genius at trading, which most of us aren't unfortunately. However, this is *not* the same as saying that it will always be a losing proposition to invest in equities. Equities can, in fact, do quite well for long periods of time despite the negative undercurrent. This is what the perma-bears do not understand. They assume that structural bear markets equal negative returns and that is not necessarily the case.

Instead be active with your asset allocation. Trade more but apply a strict discipline. Look for value rather than growth; define your entry and exit points and stick to them! One of the most overlooked truths of financial markets is the almost dead certainty of mean reversion. Few things in life actually mean revert with as much predictability as securities prices. Take advantage of this fact when something becomes significantly under- or overvalued.

#3: Include uncorrelated assets

You should also include a healthy portion of 'uncorrelated' asset classes in your portfolio[1]. In my humble opinion, the average investor is over-exposed to equities right now. I would consider myself extremely lucky if my equity portfolio were to deliver more than a 5% annualised return over the next 5-10 years. You need exposure to other asset classes – and in particular to absolute return strategies – to ensure a reasonable return over that period of time. The laws of this country prevent me from being too specific about the opportunities in the absolute return space, as many absolute return funds are unregulated and hence cannot be marketed to the public.

Having said that, we launched a wealth management business last year (see Quartet Capital Partners for details) which has a strong focus on absolute returns; however, the investment strategy has been designed to comply with the strict UK rules that apply to private investors' hedge fund activities. In other words, absolute return investing is about a lot more than just hedge funds, and it is indeed possible to structure a portfolio which has a focus on absolute return investing without loading up on hedge funds.

Ideally, in the current environment, I would allocate 30-40% to uncorrelated asset classes. This is a *much* higher allocation than most investors give to this space at the moment. Many became disillusioned with absolute return investing, following the horrible experience of 2008-09 where many absolute return vehicles did as poorly as, and in some cases worse than, more directional investment vehicles. Ever since, it has been difficult to attract investors back to absolute return products.

[1] *I have chosen to put uncorrelated in inverted commas as nothing is truly uncorrelated at all times, but you probably get the point. Also, when I refer to something being uncorrelated, it is measured relative to equities.*

What is not so well understood is *why* so many absolute return vehicles failed to deliver what it says on the tin. As a whole, absolute return strategies actually did much better than more directional strategies, but returns were widely dispersed. And those products/strategies which performed poorly mostly did so, because they underestimated the liquidity mismatch between the asset and the liability side of the balance sheet.

#4: Do not use leverage

Which brings me to the next point. If we are, as I suspect, in echo bubble territory, there will be at least on more down leg before we can finally declare this crisis to be over. One does not want to be leveraged when that happens - not so much because leverage *per se* is bad. In fact, I am a believer that leverage, applied intelligently, can significantly enhance returns. However, our banking industry has not yet recovered from the near disaster of 2008-09 and, even worse, *is not* likely to have fully recovered by the time the next downturn kicks in. This will leave the banking industry on either side of the Atlantic extremely vulnerable and, as we can testify to at Absolute Return Partners, a bank which is under severe stress can virtually obliterate your business if you have leveraged your investments.

Having said that, we are starting to see leverage creeping up again across the hedge fund industry. Take Convertible Arbitrage. As you can see from chart 4, it was the best performing alternative asset class in 2009 with a total return of 47.4%. Remarkably, this was achieved with a historically low 1-2 times leverage. Now, as returns are coming down, Convertible Arbitrage managers are applying more leverage in an attempt to protect their returns.

In a recent hedge fund industry report published by Citibank, it is suggested that Convertible Arbitrage managers now use 4 times leverage on average (see chart 5). Other strategies show a similar pattern. Fixed Income Arbitrage, Equity Market Neutral, Event Driven, Global Macro and Multi-Strategy all use considerably more leverage than at this time last year. Most of them are also struggling to deliver returns anywhere near the levels of 2009. The implication is obvious. When managers resort to increased use of leverage it is an implicit admission that underlying returns are not high to generate attractive returns. It is a danger signal that one should not ignore.

#5: Prepare for yields to fall

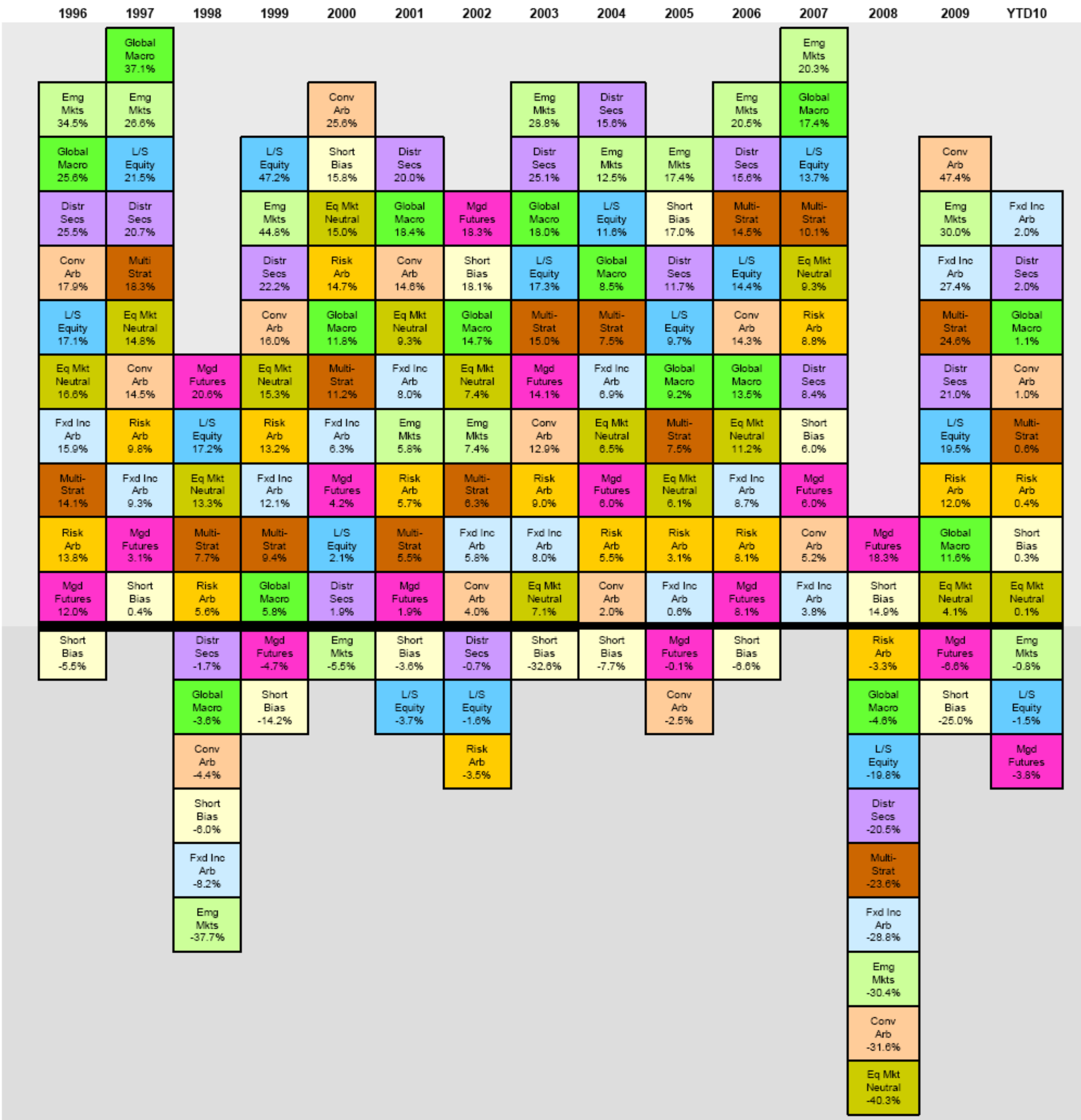
Now, I am really going to stick out my neck. Bond yields could very well fall over the next few years. This is unquestionably my most controversial prediction, and it is admittedly a risky forecast. I have been arguing for a while (see here) that for years to come we will face a tug-of-war between deflationary and inflationary forces, and I continue to stick to my projection that deflationary forces will ultimately prevail. Classic monetary thinking would suggest otherwise. The rapid growth in the monetary base over the past 18 months is hugely inflationary, or so the monetarists amongst us argue. In a cash based economy I would agree, but we are dealing with the biggest credit bubble of all times which must now be shrunk. That is extremely deflationary. Just look at the wider measures of monetary growth. There is none.

Another argument frequently put forward by the inflationary camp is that governments will be forced to inflate their way out. They have no alternative because they cannot afford otherwise. I am not convinced it is that simple. Morgan Stanley published a very interesting research report recently in which they made the observation that nearly half of all US budget outlays are now effectively indexed to inflation[2]. The obvious implication of this simple fact is that it is no longer possible for the US government to inflate its way out of its deep deficit hole, however tempting that may be. We should also learn from the Japanese experience.

---

[2] *"Downunder Daily – Default or Inflate or ...", Morgan Stanley, 24th February, 2010*

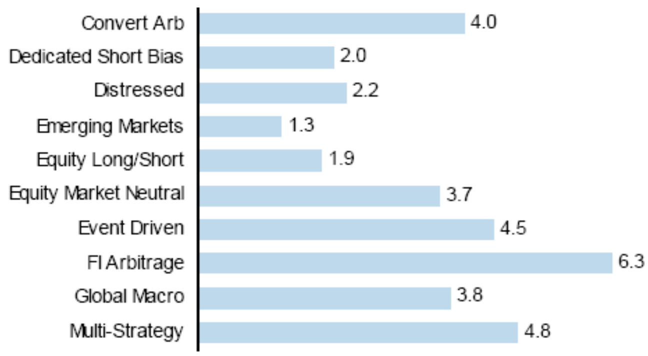
Chart 4: Periodic table of hedge fund returns



Source: Boomerang Capital. Note: Through January 2010

They have made repeated attempts to inflate their debt away in recent years but have found it much more difficult than anybody would have anticipated. The inescapable conclusion is that when you need inflation the most, it is the hardest to engineer whereas, when you don't want it, you can have it in spades.

Chart 5: Hedge fund leverage ratios



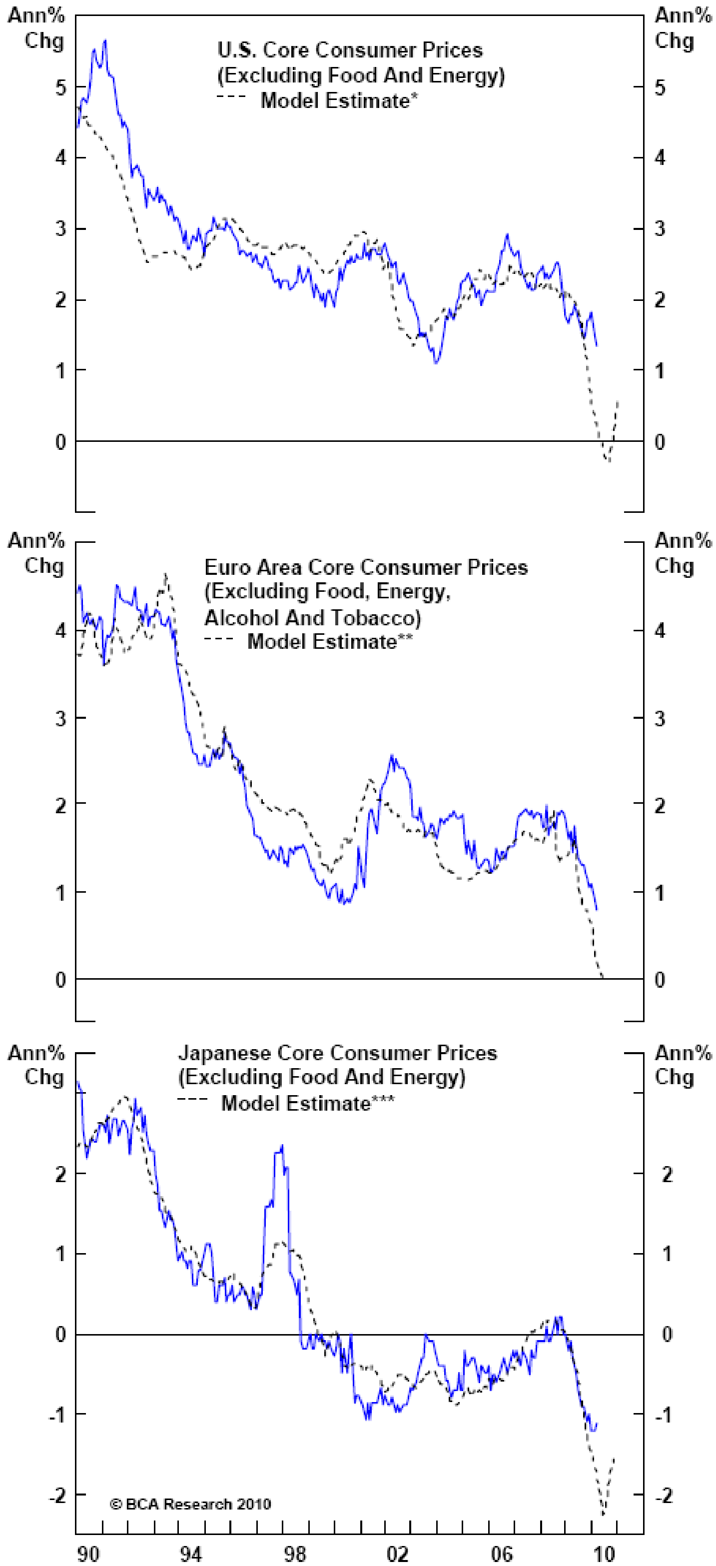
Source: Citi Prime Finance

All of which brings me to Greece. A sovereign borrower can inflate its debt away over time by generating higher nominal GDP growth than its cost of capital (i.e. the interest it pays on its borrowings). This is why Greece is in such a pickle. With bond investors now demanding 7% on 10-year Greek government bonds, the Greek economy must grow by at least 7% in nominal terms for the problem not to get worse. That is near impossible and explains why Greece will ultimately default one way or the other. Remember, a country can default overtly or covertly (the latter being through devaluing its currency). As a member of the eurozone, Greece is precluded from a unilateral devaluation of its currency, so it is down to one of two choices – leave the eurozone or face an overt default! Given Greece's predicament, the *worst* possible outcome is outright deflation. Guess what – Europe is heading towards it (see chart 6).

The main challenge facing the eurozone is not so much Greece but rather Germany. In all honesty, Germany can hardly be criticised for being better at controlling its costs than its currency partners, but the fact that its unit labour costs[3] have risen far less than those of its main EU competitors raises almost insurmountable problems for the currency union (see chart 7). Unless this problem is addressed, Greece won't be the last victim in the euro 'experiment'. It is physically impossible to have a successful currency union with one member country doing so much better than others. Over the next few years the Germans will have to make a straightforward choice. They will either have to abandon their hardcore, low-inflation economic policy, or they will have to abandon the euro, because the two are quite simply incompatible. My money is on the latter.

[3] *Unit labour costs are defined as productivity-adjusted labour costs and are one of the best measures of relative competitiveness across countries.*

Chart 6: Global inflation – Low and falling



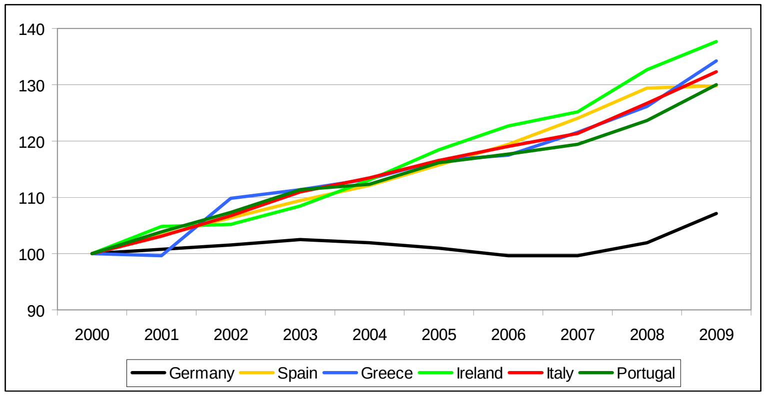
* Based on long-term interest rate, money supply, the output gap, import prices, capacity utilization, unit labor costs and commodities.

** Based on short rates, trade-weighted euro, consumer confidence and the output gap.

*** based on import prices, the output gap, labor productivity, unit labor costs, and the yen.

Source: BCA Research

Chart 7: Unit labour cost index in selected EU countries (2000=100)

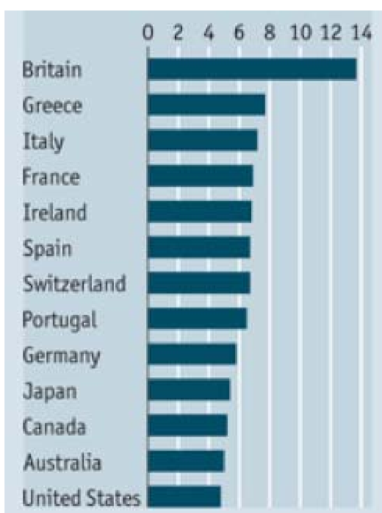


Source: Eurostat

The final point I would like to make with respect to the outlook for interest rates has to do with the sheer supply of bonds waiting around the corner. In the past, I have taken the view that interest rates would probably have to go up, even if there is little or no inflationary pressures; however, after having studied the Japanese case in more detail, my conviction level is weakening day by day.

The reason was pencilled out in last month's letter and has to do with *why* governments are running these exorbitant deficits. The deficits are to a large degree necessitated by rising savings rates which translates into lower economic activity. In other words, without the large deficits, we would be facing negative GDP growth in many countries at the order of 5-10% per annum for several more years. Not only would that be politically unacceptable, but don't forget that, contrary to common belief, much of the money to buy those bonds will be available because of the higher savings rates.

Chart 8: Sovereign debt – Years to maturity



Source: The Economist

On this note, one needs to pay attention to which government debt one buys. In the UK, for example, the average government debt maturity is about 14 years, whereas in the US it is less than 5 years (see chart 8). Whether by design or sheer luck (I suspect the latter), it does provide the UK with a significant advantage over most other countries which have significantly less room for manoeuvring. The UK pension funds play a significant role here. There has been, and continues to be, an enormous appetite for long-dated gilts from the pension sector. Although this is not well understood outside the pensions industry here in the UK, many pension schemes have automated investment programmes in place which are triggered when real interest rates hit certain pre-defined trigger points. All other things being equal, this puts a very effective lid on real rates and is one of the key reasons why I am gradually coming around to the realisation that long dated bonds could be one of great surprises of the next few years.

However, the inflation v. deflation war of words is likely to rage for several more years. This implies that none of the above will happen in a straight line so be prepared for a bumpy ride. It also means that volatility could be quite dizzying at times, so make sure you have investments in your portfolio which benefit from high volatility. Unfortunately, these types of strategies are typically unregulated which means that I am not permitted to write about them in a freely available letter like this. Call us instead if you want to learn more about being long volatility or would like some help in positioning your portfolio for what lies ahead.

Niels C. Jensen

Absolute Return Partners

Absolute Return Partners LLP is a London based private partnership. We provide independent asset management and investment advisory services globally to institutional as well as private investors, charities, foundations and trusts.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

Absolute Return Letter Contributors

Niels C. Jensen	njensen@arpllp.com	tel. +44 20 8939 2901
Nick Rees	nrees@arpllp.com	tel. +44 20 8939 2903
Tricia Ward	tward@arpllp.com	tel: +44 20 8939 2906