Absolute Return Partners LLP

The Absolute Return Letter
December 2010

The Dirty Dozen

"Risk concerns the deviation of one or more results of one or more future events from their expected value. Technically, the value of those results may be positive or negative."

Wikipedia

$$R(\theta, \delta(x)) = \int L(\theta, \delta(x)) f(x|\theta)\, dx$$

The definition of risk

No, I am not going bonkers. Some egghead came up with this formula as a way to define risk, but we can do better than that. In the world of finance, risk is essentially the probability of an investment's actual return being different from the expected return. As most of us are not overly concerned about actual returns being higher than expected, it is fair to say that in practical terms, risk is a measure of the probability of losing some or all of your investment.

Now, risk cannot always be quantified, and there is indeed a term for immeasurable risk. It is called *uncertainty*[1]. Good investment management is founded on robust risk management or, as we ought to label it, the ability to manage uncertainty well. Many moons ago, a good friend with more grey hair than myself gave me the advice to focus on the management of uncertainty. His philosophy was that if you manage that well, over time, performance will take care of itself.

Now, I must confess that over time I have made my fair share of mistakes. Managing risk/uncertainty is a heck of a lot more difficult in practice than the mathematicians want us to believe. I am only human. I get carried away from time to time like most other investors. Unless you were born with the DNA of Warren Buffett, keeping emotions at bay when making investment decisions is far from easy.

Herding like sheep

However, getting carried away seems to be the norm rather than the exception these days. Maybe it is just me getting older and more cynical, but all around me I see investors chasing the same ideas with little (apparent) consideration given to the elements of risk involved. Find me an investor who is not in love with emerging markets or, for that matter, commodities. I see this sheep-like mentality wherever I turn.

That observation gave me the inspiration to this letter. Please note that I do not provide an enormous amount of detail in this letter (who wants to read a 50 page newsletter?). Rest assured, though, that most if not all of the risk factors mentioned below will be discussed in the months to come.

Before going any further, though, I need to get one more thing off my chest. I get a lot of positive feedback on these letters but also a fair amount of criticism for being too negative. I will admit that the Absolute Return Letter

[1] *To the best of my knowledge, the first to distinguish between uncertainty and risk was Frank Knight in his 1921 book work "Risk, Uncertainty and Profit".*

has a ‘negative’ edge to it, but I do *not* view myself as a perma bear. In fact, right now, we are looking for opportunities to increase the equity exposure in our private client portfolios. So why the somewhat downbeat tone to the letter? Because, as I have already stated, investment management is about managing risk well; hence most of my time is spent on identifying what can go wrong.

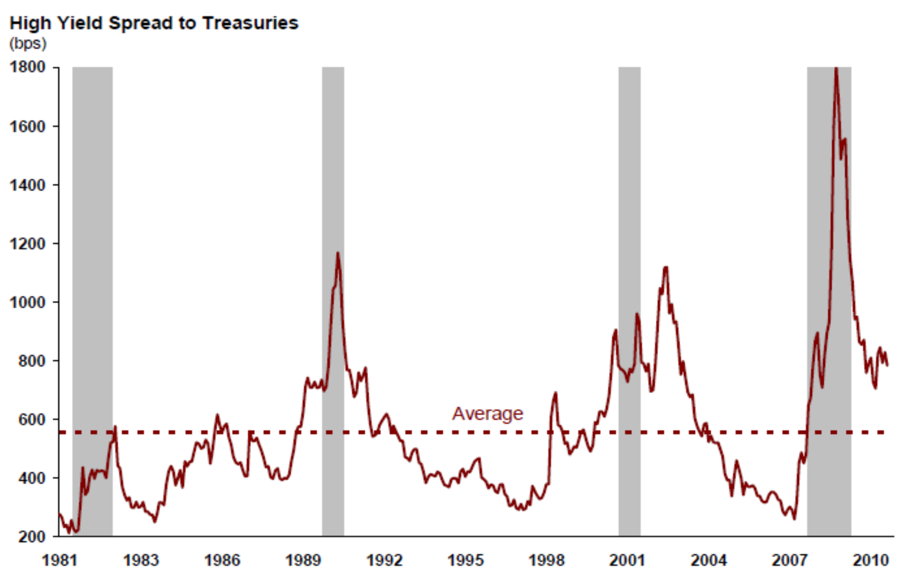
Now, let’s get started. In the following I list a number of risk factors which I believe investors should give serious consideration, but I do not for one second pretend for that list to be exhaustive. Neither should you read anything into the order of which those risk factors are listed. If you want my assessment of how to rank the various factors, you need to take a look at the risk scatter chart at the end of the letter.

We begin our journey in the high yield space, which is another asset class currently prone to herding; however, I need not look any further than my own parents to understand the urge to invest in high yield bonds. Now in their mid 70s, they are desperate for a bit of income, and corporate high yield provides that better than most other asset classes. Multiply their situation with over 100 million retired – or nearly retired – people in Europe and North America, and you will understand why high yield spreads keep going down.

 # 1: High yield spreads

We have done some research on high yield spreads in recent weeks, as we were becoming increasingly uncomfortable with the tightening spreads. We began to wonder (risk factor # 1) if ***high yield spreads are priced for perfection?*** Are spreads getting so tight that one could even talk of a bubble, and could that bubble burst, should the US (and/or European) economy fall back into recession? There is no question that corporate high yield bonds are now priced for fair weather but, we believe, not yet for perfection (see chart 1). Keep a finger near the trigger but not yet on it.

Chart 1: Spreads between US Corporate High Yield and Treasuries



Source: Kingdon Capital Management

 # 2: Double dipping

Obviously, the fate of corporate bonds is closely linked to the well-being of the corporate sector. As we see things, ***the risk of double dipping*** (# 2) is currently more prevalent in the US than it is in Europe, so let’s focus on the US for now. The other day I came across some interesting stats on the US economy (all representing year-on-year changes), which may surprise one or two people:

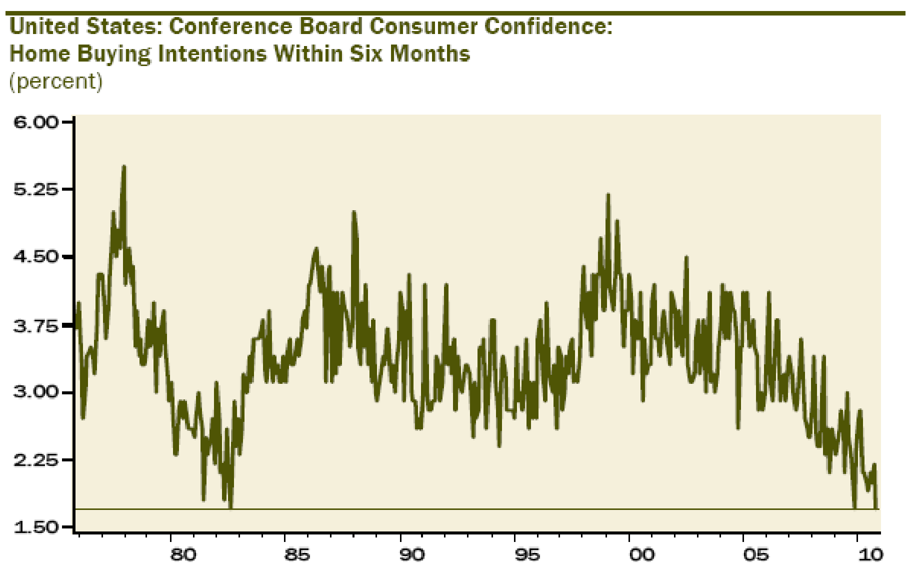
- GDP growth rate +56%
- Personal Income +4.35%
- Savings Rate +23.91%
- Fixed Investment +5.37%
- Steel Output +10.32%
- Business Sales +8.86%
- Durable Goods Sales +12.2%
- Factory Shipments +7.21%
- Retail Store Sales +7.31%
- Factory Orders +17.18%
- Exports +12.58%

Source: Contrarian Musings

I find these numbers revealing, considering how much bad press the US economy actually gets at the moment. Yes, I know that recent comparisons have been easy vis-à-vis a very weak 2009 and, yes, I am aware that this is to a large degree rear mirror analysis. But the reality is that the US economy continues to confound. The weak spot continues to be the housing sector and, unfortunately for the economy as a whole, that is a very important sector.

David Rosenberg of Gluskin Sheff produced a very interesting chart the other day, showing the recent trend in US home buying intentions (see chart 2). On the basis of that chart I can only conclude that US house prices are still too high and need to come down further. This will continue to put a significant damper on US economic activity well into 2011 and possibly beyond despite many other industries doing rather well. On that basis I would suggest that US economic growth will be subdued in 2011, but I would put the probability of a double dip at less than 20%.

Chart 2: US Home Buying Intentions Back to Record Lows

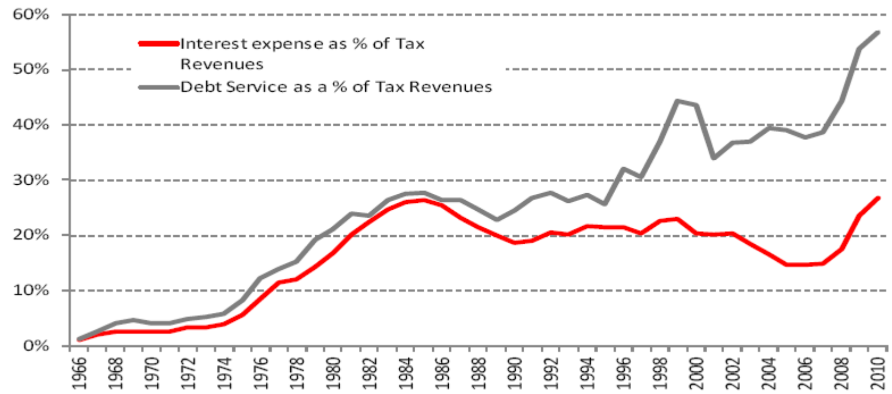


Source: Gluskin Sheff

 # 3: Japan's debt mountain

Next on my risk radar for 2011 (# 3) is what I call ***the sinking ship of Japan*** (I know – that header is not going to make me many friends in Japan). The question here is not so much the ultimate outcome, but rather the timing of their demise, and I could be wrong by several years! The essence of the Japanese problem is an ever growing pile of debt (see chart 3), which needs to be supported by a rapidly aging population. See our November 2010 letter here for further details.

Chart 3: Debt Service in Japan



Source: SocGen Cross Asset Research, Japan's MoF

 # 4: Beggar thy neighbour

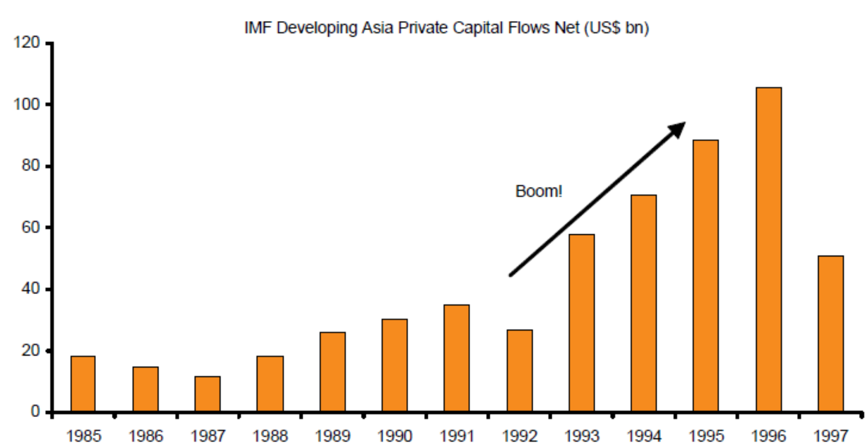
Japan desperately needs for the yen to depreciate in order to regain some of the lost competitiveness vis-à-vis other Asian countries in particular but also against countries such as Germany. But so do many other countries. I am sure Portugal, Spain, Greece and Italy all would give their proverbial right arm for a 30% drop in the value of the euro (which wouldn't actually fix their problems, but that is another story altogether). The urge to drive exchange rates lower is fast becoming a global disease and has created a ***beggar-thy-neighbour mentality*** which is # 4 on our list for 2011. For more details, see the September 2010 Absolute Return Letter here.

 # 5: Too hot to handle

Next on our list is what I have called ***capital flows too hot to handle*** (# 5). Asia is at the receiving end of enormous amounts of capital these days, not dissimilar to the experience of the early to mid 1990s (see chart 4). This has two implications, both of which may dent investor appetite for Asia longer term. First of all, one key lesson learned from the 1990s experience is that with strong capital flows come the risk of inflation (see chart 5).

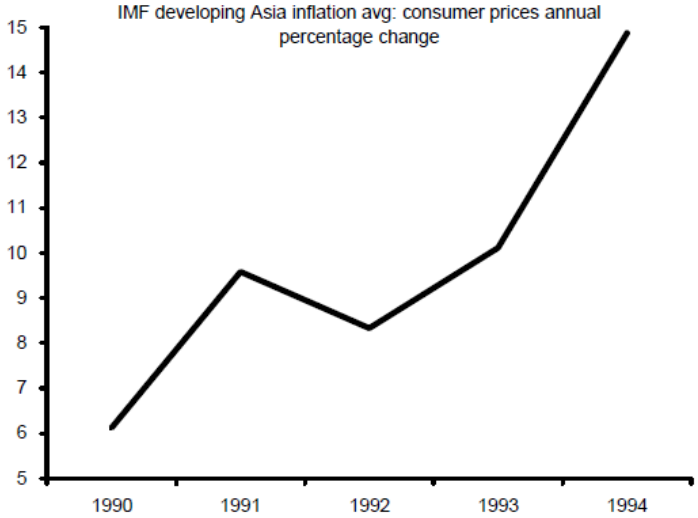
Secondly, should capital continue to flow into emerging economies in general and to Asia in particular, stricter capital controls may be the only option left for governments worried about skyrocketing exchange rates. Whilst bad news for risk assets the alternative is almost certainly worse – overheating economies where the cost of capital is far too cheap relative to the underlying growth rate of those economies. This is the true price of a miscalculated currency policy where governments of the fast growing economies of Asia thought the link to the US dollar would offer stability. In reality, precisely the opposite is now happening.

Chart 4: Capital flowed into Asia between 1992 and 1996



Source: Royal Bank of Scotland, IMF.

Chart 5: The Result? Rising Inflation



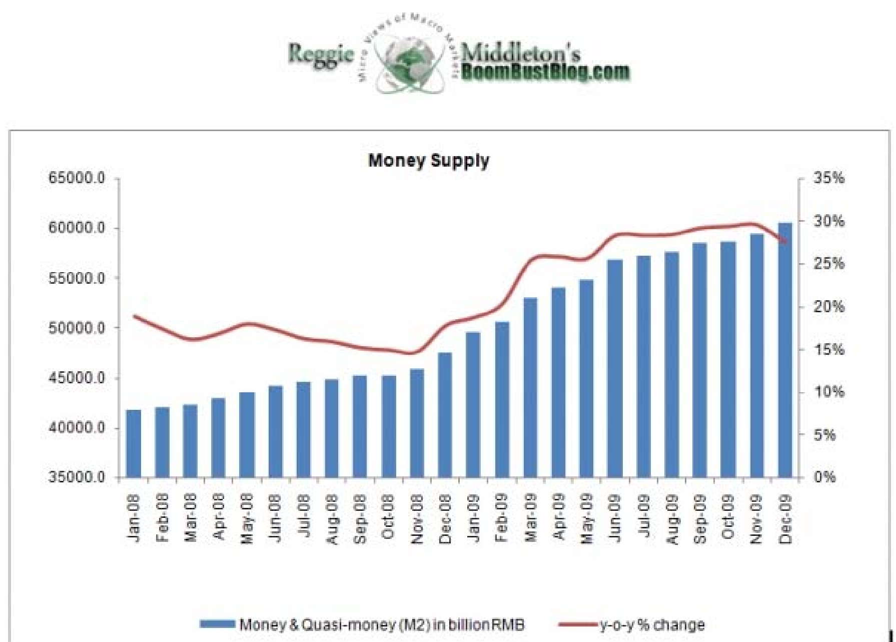
Source: Royal Bank of Scotland, IMF.

 # 6: Chinese inflation

No country has attracted more capital from abroad than China. But China's problems run deeper than that, hence risk factor # 6: ***Chinese inflation out of control?*** As recently as 6-8 weeks ago, this issue was on virtually nobody's radar but, more recently, it has attracted a lot of attention. Based on official Chinese data, inflation is rising but still very much under control. CPI was last reported to have risen 4.4% year-on-year. However, good friend Simon Hunt, who has spent the last few weeks travelling through China, paints a very different picture.

Based on anecdotal evidence, the daily cost of living in Beijing is now running 20% higher than at this time last year, and for Shanghai it is even higher - about 25-30%. Electricity prices have risen by over 300% and gas prices by some 600% over the last two years in the Shanghai area, and local manufacturers complained to Simon that operating costs are now on par with those in Singapore.

Chart 6: Chinese Money Supply on the Run



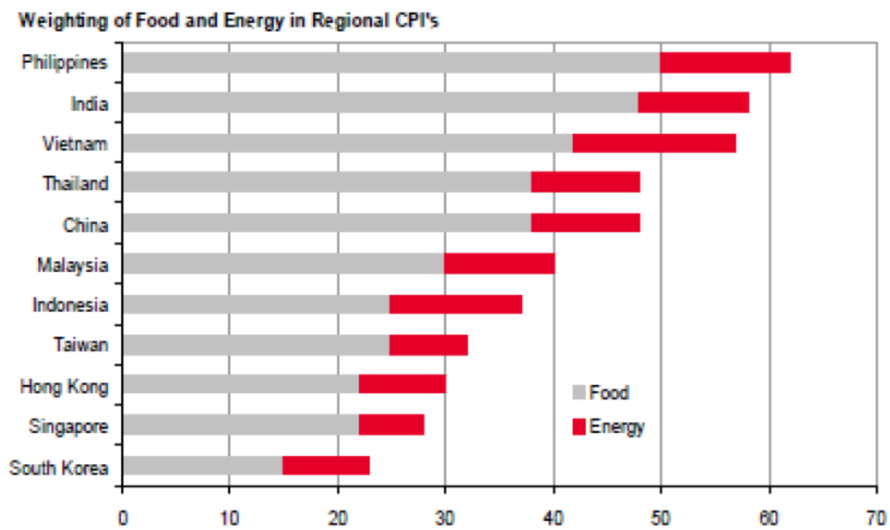
Source: www.boombustblog.com

The political leadership in China seems to be focused on food inflation and have recently threatened to instigate price controls on everyday goods; however, I suspect that the source of inflation is to be found in the extremely lax monetary policy of recent years (see chart 6). According to one source, Chinese money supply (as measured by M2) has expanded by a whopping 54% over the past 2 years alone[2]. It now stands at $10.1 trillion against $8.6 trillion in the US. Meanwhile, China's monetary base stands at $2.36 trillion versus $1.96 trillion in the US[3]. Given the fact that the Chinese economy is still only about one-third the size of the US economy, one wonders whether the Chinese leaders took their eyes off the ball and now face an almighty battle to get inflation under control again.

 # 7: Civil unrest

Rising food prices are not only a Chinese problem, though. Across Asia (as well as in Africa and Latin America) food accounts for a much bigger share of disposable income than what we are accustomed to in Europe and North America (see chart 7); hence the effect on overall consumer price inflation in emerging economies from rising food prices can be massive. We witnessed widespread riots in Asia in the summer of 2008 as a result of rising food prices. Should food prices continue to rise from current levels, ***civil unrest*** will almost certainly ensue to the detriment of the local economy and stock markets. That is our risk factor # 7.

Chart 7: Food Weightings in Asian CPIs



Source: SocGen Cross Asset Research

 # 8: Is India in trouble?

As one of the countries most prone to political unrest, India faces the added challenge of an escalating current account deficit. Hence we ask ourselves: ***Is India an accident waiting to happen?*** (risk factor # 8). At the moment, with strong capital flows into virtually all corners of emerging markets, India is finding it relatively easy to finance its external deficits but, as we have learned from experience, international capital flows are fickle at the best of times. Should investor appetite for emerging markets wane – and it will at some point – India could suddenly find itself in a situation not dissimilar to what Thailand, Indonesia, Korea and the Philippines all faced in the late 1990s (see chart 8).

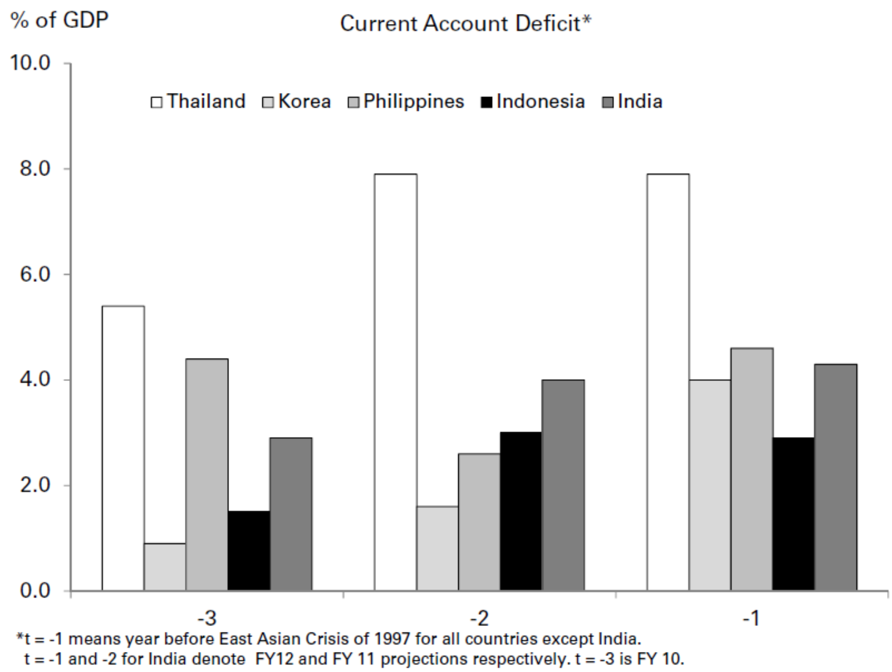
 # 9: European sovereign risk

Moving our attention swiftly to risk factor # 9 – ***European contagion and solvency risk*** – I do worry if the extent of the current crisis has fully dawned on our political leaders, who continue to act as if they are dealing with a liquidity crisis – not a solvency crisis. In my opinion, we passed the

[2] *Source: www.boombustblog.com*
[3] *Source: Simon Hunt Strategic Services*

point a long time ago where the crisis could be solved by writing a €85 billion cheque.

Chart 8: India's Current Account Deficit



Source: Goldman Sachs, CEIC

I have written extensively about this particular issue in the past, and shall therefore resist the temptation to repeat myself. Suffice to say that the only way Ireland and Greece (and soon to come Portugal) can ever hope to pay back the bailout loans granted to them is through strong economic growth, but that is a pie in the sky as long as the underlying problems are not addressed. They will eventually have to bite the bullet; it is just a shame that so much wealth has to be destroyed before they get it right.

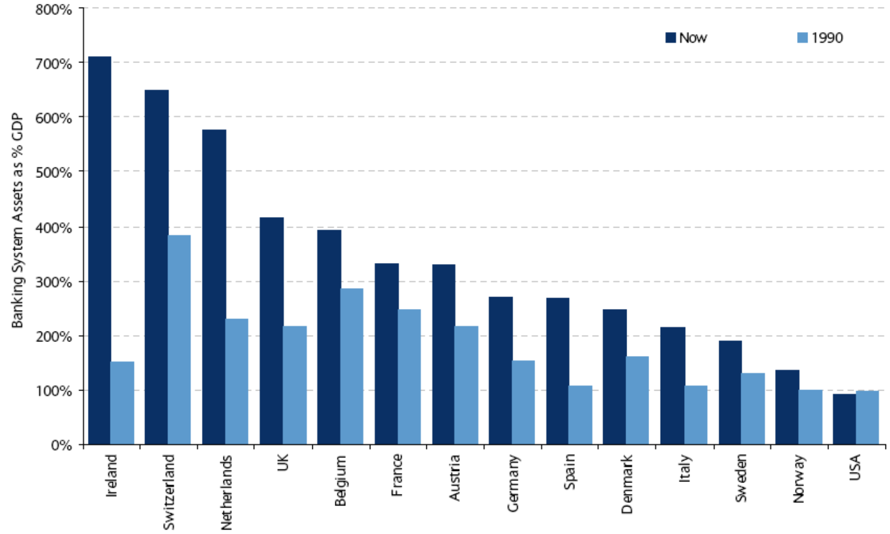
Maybe our leaders should look north towards Reykjavik. It is remarkable how the Icelandic economy has recovered following its demise in 2008-09. Iceland did what no other European country has been prepared to do – they let the banking sector go bust. I know Iceland is a small country and hence the contagion risk is less of an issue, but perhaps we should learn from that.

But let's not kid ourselves. When many European countries make handsome contributions to the Greek and Irish bailout packages, it is not because we are concerned about not being able to visit the beaches of Greece next summer or that the famous Guinness beer will suddenly run dry. No, over the years, we have allowed our banking system in Europe to inflate their balance sheets to a point where contagion risk became a clear and present danger. Take a look at chart 9 and in particular at the size of the US banking system compared to that of most European countries.

 # 10: Refinancing needs

However, from a risk point of view, Spain is the main worry – at least for now. According to the IMF, Spain's gross financing needs for 2011 approach €200 billion – about 18% of GDP (see chart 10). In addition to that, Spanish banks need to roll a similar amount in 2011-12. This ***massive refinancing programme*** (# 10) can only be accomplished if Spain manages to maintain its credibility in international markets because, unlike Japan, financing it domestically is not an option.

Chart 9: Banking System Assets Relative to GDP



Source: Barclays Capital

Refinancing existing debt is a mammoth task over the next 12 months, not just in Spain but across the world with approximately $10 trillion being up for rollovers globally[4]. This programme poses the biggest risk to my benign outlook for bond yields and needs to be watched carefully in terms of investor appetite.

Chart 10: 2010-11 Financing Needs

(Percent of GDP)

	2010			2011		
	Maturing Debt	Budget Deficit	Total Financing Need	Maturing Debt	Budget Deficit	Total Financing Need
Japan	43.4	9.6	53.0	48.9	8.9	57.8
United States	15.4	11.1	26.5	18.1	9.7	27.8
Italy	20.3	5.1	25.4	18.2	4.3	22.5
Ireland[2]	6.5	31.9	38.4	6.1	11.8	17.9
Belgium	17.8	4.8	22.6	18.4	5.1	23.4
France	14.3	8.0	22.3	16.0	6.0	22.0
Spain	10.8	9.3	20.1	11.0	6.9	17.9
Portugal	11.6	7.3	18.9	15.5	5.2	20.7
Greece	10.3	7.9	18.2	16.5	7.3	23.8
Canada	13.1	4.9	18.0	13.3	2.9	16.2
United Kingdom	5.3	10.2	15.5	7.5	8.1	15.6
Germany	8.5	4.5	13.0	9.1	3.7	12.8
Finland	9.1	3.4	12.5	9.3	1.8	11.1
Sweden	4.1	2.2	6.3	4.5	1.4	5.9
Australia	1.5	4.6	6.1	2.0	2.5	4.5
Weighted Average	17.0	9.1	26.1	19.3	7.6	26.9

Source: IMF

#11: Monetary tightening

Risk factor # 11 on my list represents another potential fallout from the credit crisis – I call it ***premature withdrawal of monetary support***. Over the last few weeks we have witnessed the effects of approximately SEK 300 billion of crisis loans being withdrawn in the Swedish market. Short term interest rates and mortgage rates shot up instantly as a result. Sweden is amongst the healthier nations in Europe. Imagine what will happen in

[4] *Source: Daily Telegraph*

countries such as Ireland, Portugal, Spain and Greece, should liquidity facilities be pulled prematurely.

To give you an idea of their predicament, borrowers from Greece, Portugal and Ireland (their combined GDP account for just over half that of Spain's) took 61% of all loans provided by the ECB last month, up from 51% the previous month. A premature withdrawal of liquidity could have catastrophic consequences for those countries. Over the past few days the crisis appears to have eased off just a little bit - at least enough for the extreme scenarios laid out by some commentators suddenly to look less likely in the short term; however, the crisis is clearly not over yet. The risk is that the ECB, encouraged by the somewhat better tone, begins to drain larger amounts of liquidity from the markets.

#12: Israel vs. Iran

Finally, # 12 is a bit of a wild card. So wild, in fact, that some of my colleagues have ridiculed me for including it on this list (not for the first time, by the way). Israel is clearly not happy with developments in Iran, and it is not entirely inconceivable that they decide to launch a **pre-emptive strike on Iran's emerging nuclear facilities**. Only a few days ago a leading Iranian nuclear scientist was assassinated in Tehran. I have no idea who did it, but it is clearly not in the interest of Iran to kill its own nuclear talent, so some foreign power must have been involved.

At the same time, in recent weeks, we have had two important revelations with respect to the dynamics between Israel, Iran and the United States. When George W. Bush published his memoirs last month, it became apparent that the US administration did not endorse the Israeli attack on Syria's nuclear facilities back in 2007, which suggests that the Israelis will not necessarily shy away from taking unilateral action if they feel sufficiently threatened.

Even more recently, WikiLeaks documents suggest that King Abdullah of Saudi Arabia has privately been pushing for an 'endlösung' in Iran. Again, the Americans did not take the bait. All this is telling me that the Americans do not rate this problem as highly as the Israelis and the Saudis do. That is potentially an explosive cocktail. How likely is a conflict? Probably less than 30%, but the implications are quite nasty, should anything happen.

Summing it all up

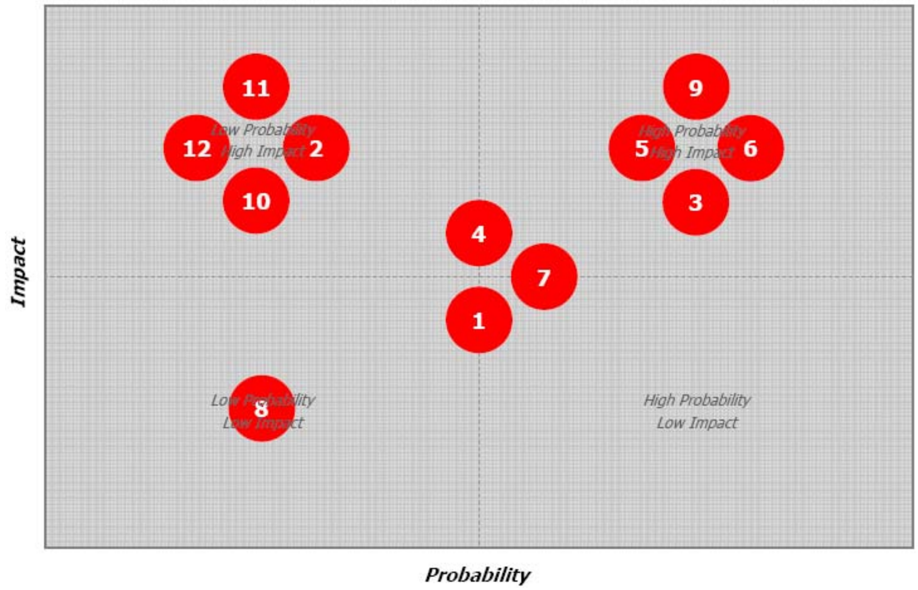
That pretty much sums up our landscape of risks and uncertainties as we prepare to enter another calendar year. You may agree or disagree. I can already see my inbox filling up with emails saying: what about inflation risk? My view on that remains unchanged. In Europe, Japan and North America, deflation risk remains a bigger concern than inflation, at least for now. Only in emerging markets do we see a significant risk of inflation for the next 12 months. Will it go on the list in the future? Possibly, but most likely not until 2012-13 at the earliest.

In order to give you a sense of how we rate each of the risk factors in terms of probability and potential impact, we have developed a new proprietary risk scatter chart (see chart 11), which we will update regularly going forward. As a reminder, the 12 factors are:

1. High yield priced for perfection?
2. The risk of double dipping
3. The sinking ship of Japan
4. Beggar thy neighbour mentality
5. Capital flows too hot to handle
6. Chinese inflation out of control?
7. Food inflation induced civil unrest
8. Is India an accident waiting to happen?
9. European contagion and solvency risk
10. Massive refinancing programme

11. Premature withdrawal of monetary support
12. Israel launching a pre-emptive strike on Iran's nuclear facilities;

Chart 11: The ARP 2011 Risk Scatter Chart



All of us at Absolute Return Partners would like to wish you a happy and prosperous 2011, both at a personal and a professional level. For those of you wondering what happened to our new equity fund, we are hopefully only days away from obtaining final regulatory approval. As soon as that has been obtained, those of you who have expressed an interest will receive all the necessary documentation.

Niels C. Jensen

Important Notice

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.

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