

December 2014 A Brave New World

“The deepest sin against the human mind is to believe things without evidence.”

Aldous Huxley

In the the last two Absolute Return Letters I have argued why one should expect global GDP growth to be below average over the next decade or so, why interest rates should, as a consequence, remain low and why equity returns should also disappoint. Not as in negative returns but below the levels we have grown accustomed to over the past 30 years. If you have read those two letters, none of this should come as a surprise.

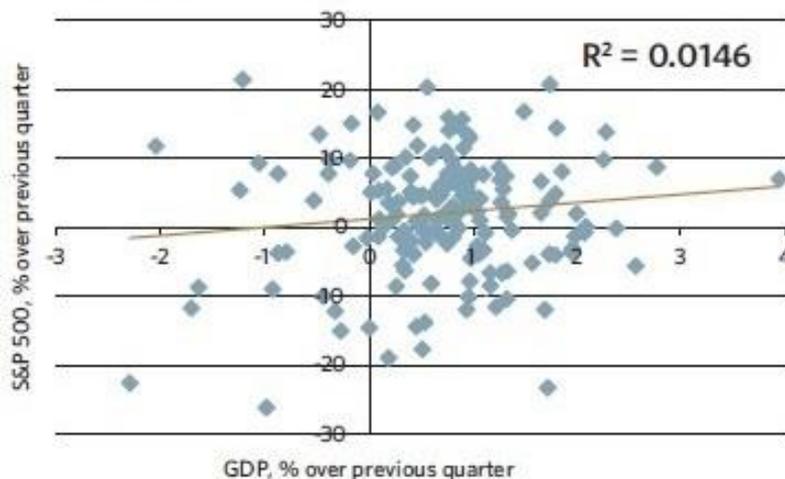
This letter will make the simple assumption that all of this *will* in fact happen and, before you scold me for being overly pessimistic, you should know that I am in pretty good company with this view. See for example [here](#). It raises some important questions for investors and for the industry as a whole. What will that do to investor behaviour? How will the asset management industry cope? Which asset classes will do best in a low growth environment? These and other questions will be answered in the following.

Does GDP growth matter at all?

It's great to get to write the Absolute Return Letter. We economists tend to think we know everything – at least as far as the economy and financial markets are concerned. Nothing is healthier than being knocked off your pedestal from time to time. Example: The link between economic growth and stock prices. One would assume that a growing economy makes it easier for companies as a whole to make money which should again manifest itself in rising stock prices. In other words, economic growth and stock prices should correlate reasonably well. Right? Wrong!

At least in the short term (quarterly numbers), the two are virtually uncorrelated (chart 1). If one looks at stock prices in one quarter vs. GDP growth the following quarter, the correlation improves somewhat, but it is nowhere near perfect (the correlation rises to about 0.3). The conclusion is obvious. As an investor, one should not overemphasise the overall economy. As the famous investor Peter Lynch once said (and I paraphrase): *“If one spends 13 minutes a year thinking about the economy, one has just wasted 10 minutes.”*

Chart 1: U.S GDP growth versus S&P 500 (1970-2012)



Source: BNY Mellon Asset Management, Ecowin.

I can do one of two things now. I can stop writing the Absolute Return Letter altogether (but I enjoy it too much!) or I can do what I have always done - at least since I 'grew up' as an investor. I can focus on the long term, as I have come to realise that the short term is mostly about luck - at least for the majority of us.

Herding is changing financial theory

Now that I am doing so well taking apart financial theory, I might as well continue. One of the first and most basic things I learned when I did the finance part of my economics studies was that, over the long term, investors can expect to earn the highest returns on the riskiest investments. Why else would they ever consider investing in high risk in the first place?

Right? Wrong again. Over the very long term (since 1926), the 25% highest risk stocks have indeed outperformed the 25% with lowest risk but, more recently, the relationship has been upended. Since 1984, the riskiest 25% have generated an annual return of 4.1% whereas the 25% most conservative ones have averaged 10.1% per annum (see details [here](#)).

One reason this might be true is that investors' interpretation of risk has changed. For as long as I recall, risk in financial markets have been measured by volatility, and the numbers in the example above are also based on volatility. Somehow investors may think differently of risk today. Volatility might no longer be thought of as a good measure of risk.

I don't buy that explanation, though. Volatility is still broadly recognised as the most quantifiable measure of risk in financial markets, even if some argue (and with good reason) that, to the long term investor, volatility shouldn't really matter. The problem with that view is that investors often do make what in hindsight turn out to be the wrong decision when volatility is high. Volatility therefore still matters.

A more probable reason is the recent trend towards benchmarking and indexing (i.e. herding). As more and more money is managed either passively, or on a strict benchmark basis, more and more capital is allocated towards the biggest names regardless of (perceived) risk. I will return to this subject later in this letter; suffice to say for now that more and more capital managed passively is quite likely to have altered an important part of financial theory. The result? A potentially serious misallocation of capital.

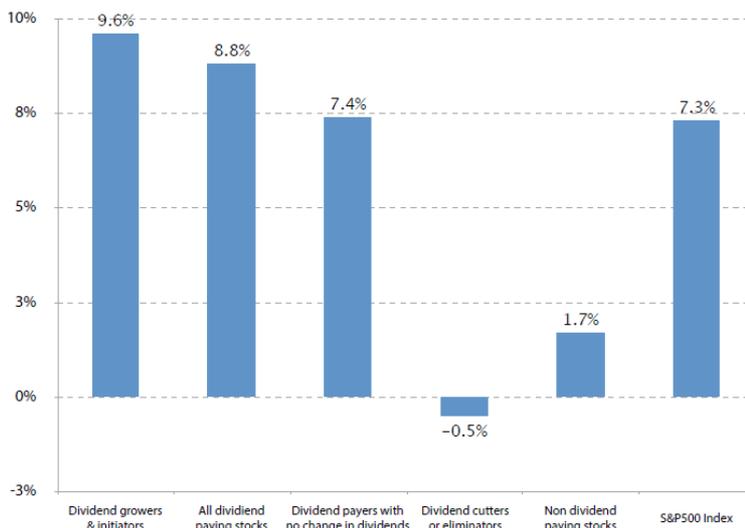
The dividend investor will return to glory

Let's look at dividends. Investors young enough to remember only the last 20-30 years can be forgiven for not paying too much attention to dividends; however, in

reality, dividends have accounted for a very large percentage of total returns on stocks over time. \$100 invested in U.S. stocks at the end of 1940 turned into \$174,000 by the end of 2011 if dividends were re-invested versus only \$12,000 if dividends were not included¹.

However it's not only in the distant past that dividends have mattered. Since 1972 dividend paying stocks have outperformed the S&P 500 by approximately 1.5% per annum (chart 2), and this period includes the mother of all bull markets (1981-2000), when dividends became very unfashionable.

Chart 2: Dividends still matter over the long term (1972-2010)



Source: Guinness Atkinson Asset Management, Ned Davis Research

When looking at dividends' contribution to total return over various decades, the 1940s and the 1970s stand out. In both of those decades dividends accounted for 75-80% of total equity returns, the highest of any decade since the 1940s (chart 3).

The noteworthy fact about those two decades is that they were also the slowest growing decades in the entire test period. Hence it is tempting to conclude that, in periods of slow economic growth, dividends assume a much more important role in terms of establishing the total return on equities².

Chart 3: S&P 500 returns for various decades since 1940

| | Total return | Price appreciation | Dividends | Dividends as % of total return |
|----------------|---------------|--------------------|---------------|--------------------------------|
| 1940s | 143.1% | 34.8% | 108.3% | 75.7% |
| 1950s | 467.4% | 256.7% | 210.7% | 45.1% |
| 1960s | 109.5% | 53.7% | 55.8% | 51.0% |
| 1970s | 76.9% | 17.2% | 59.7% | 77.6% |
| 1980s | 389.2% | 227.4% | 161.8% | 41.6% |
| 1990s | 432.2% | 315.7% | 107.5% | 25.4% |
| 2000s | -9.1% | -24.1% | 15.0% | Not meaningful |
| Average | 228.6% | 125.9% | 102.7% | 52.7% |

Source: Bloomberg, Guinness Atkinson Asset Management

If the next 5-10 years are going to be characterised by relatively slow GDP growth, equity investors are advised to pay more attention to dividends than has typically been the case since the great equity bull market took off in the early 1980s. I predict that dividend investing will become fashionable again.

¹ Source: Guinness Atkinson Asset Management. See [here](#).

² It is a strong indication, but it is strictly speaking not a proof.

This raises a whole host of other issues. Is the dividend supported entirely by the company's internal cash flow generation or does the company need to borrow? If borrowing is required, what will happen when interest rates eventually rise? These and other issues will not be addressed in this letter.

Other asset classes will be affected too

It is not only the world of equities which is likely to be affected by slowing economic growth. Slow growth is likely to lead to below average interest rates for years to come. A very substantial part of the investor universe (e.g. pension funds) has a considerable part of their portfolio tied up in interest bearing instruments. If interest rates remain low for a sustained period of time, such investors will become more and more 'yield hungry'.

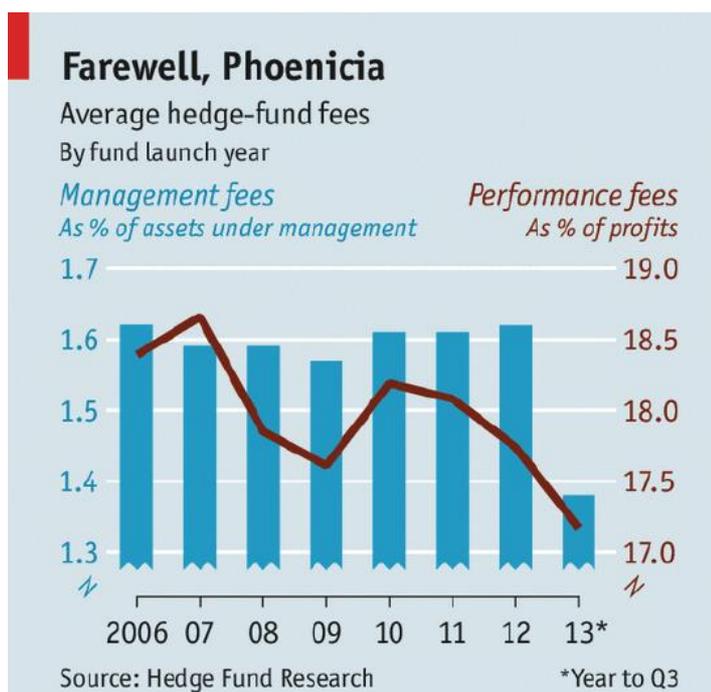
As investment grade bonds are likely to offer very poor yields in a low growth environment, a substantial migration to sub-investment grade could take place (a process which is already well underway) and, for that reason, we think a further narrowing of the yield spread is likely to happen. It is even possible, when the next recession eventually comes creeping, that high yield bonds will perform surprisingly well, as late-comers to the party take it as an opportunity to load up on high yield.

Alternative investments are likely to see meaningful changes too. The largest and most dominating alternative strategy today is equity long/short, which has been the case for many years. In many people's eyes alternative investments are synonymous with equity long/short (and, if we were to throw in global macro, that would definitely be the case). In a world characterised by low growth, equity long/short managers will find it increasingly difficult to defend their fee structure. More about alternative investments later.

Fees are likely to come down further

Admittedly, the pressure on fees started years ago (chart 4), but there is no sign of things getting any better for the 'poor' investment managers. At the end of the day, it is about performance. Hedge funds, on average, did return close to 20% per annum in the 1980s, about 9% between 1994 and 2011 and only 2% per annum more recently (I have these numbers from a couple of different surveys - see [here](#)).

Chart 4: The '2 and 20' fee structure is under increasing pressure



Source: *The Economist*

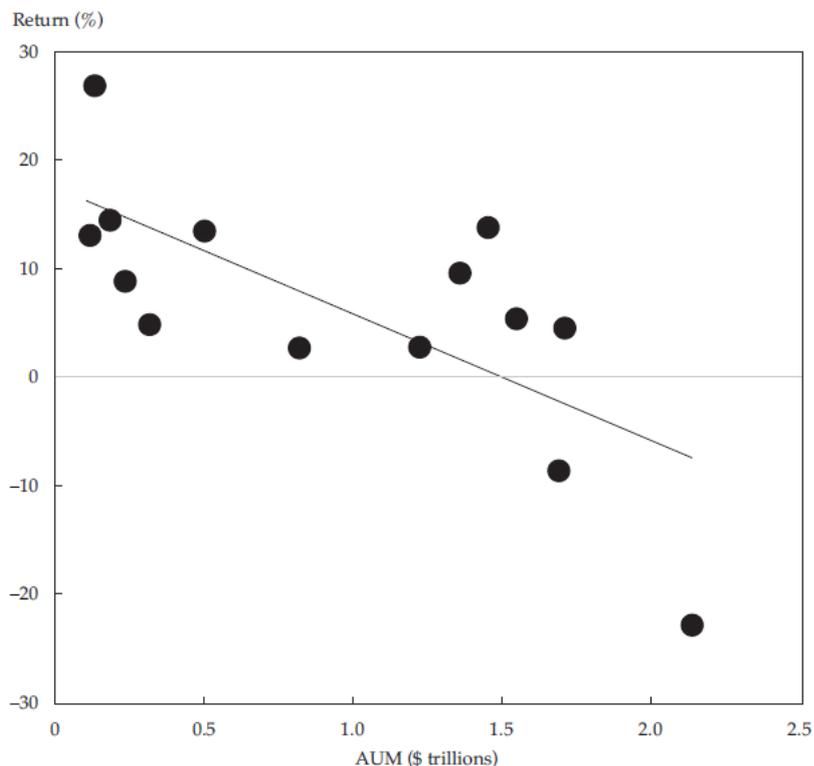
Since 1998, hedge fund managers have taken 84% of total returns as fees (a combination of management fees and performance fees) with only 16% going to investors, whose capital is at risk every day (see [here](#)). This is clearly unacceptable and explains why fees are under rising pressure. My own guess (and it is no more than a guess) is that equity long/short as a percentage of the total hedge fund industry will fall significantly over the next decade or so. The '2 and 20' model will increasingly move towards a 'cost and 10/15' model, i.e. investors will continue to allow a management fee to be charged but only to the extent that it covers costs. There is likely to be less pressure on performance fees - but more and more investors will demand some sort of hurdle return, before a performance fee can be charged.

Only a couple of weeks ago, the large Dutch pension fund PMT decided to pull out of hedge funds altogether. They said in the press release that whilst hedge funds only account for about 2% of all assets under management, fees paid to hedge fund managers account for 32% of all investment fees, and that is not acceptable. Within days of that announcement, the large U.S. pension fund Calpers made a similar statement.

As a result of all of this, I predict a lower growth rate for equity long/short strategies, but a rising growth rate of strategies that are truly uncorrelated to equity returns.

And finally, some good news for the beleaguered investment management industry. The '2 and 20' model is far more likely to survive in strategies that can realistically offer something that is truly different. But it is hard to satisfy investors so long as returns deteriorate more or less in tandem with growing AUM in the industry (chart 5). Effectively, investors are increasingly distinguishing between alpha and beta and will no longer pay massive performance fees for beta.

Chart 5: Hedge fund returns have deteriorated as AUM have grown



Source: Simon Lack

Before anyone jumps to the conclusion that it is in the hedge fund industry you find the biggest problems, let me share with you some simple numbers. In 2011 a whopping 84% of all U.S. domestic mutual fund managers underperformed the S&P

500³. Although the number of underperformers improved to ‘only’ 66% in 2012, the percentage of poor performers was still massive. If active managers can do no better than that, no wonder investors are increasingly going passive.

Don’t expect the numbers to be dramatically different in Europe. In a recent study it was revealed that European pension funds are looking to increase their passive investing from about 20% of all equity mandates to 40% within the next few years. I predict that it will become increasingly difficult to win active equity mandates unless you have a true edge. Simple long-only equity management will turn overwhelmingly passive, if not forever then at least as long as economic growth remains moderate.

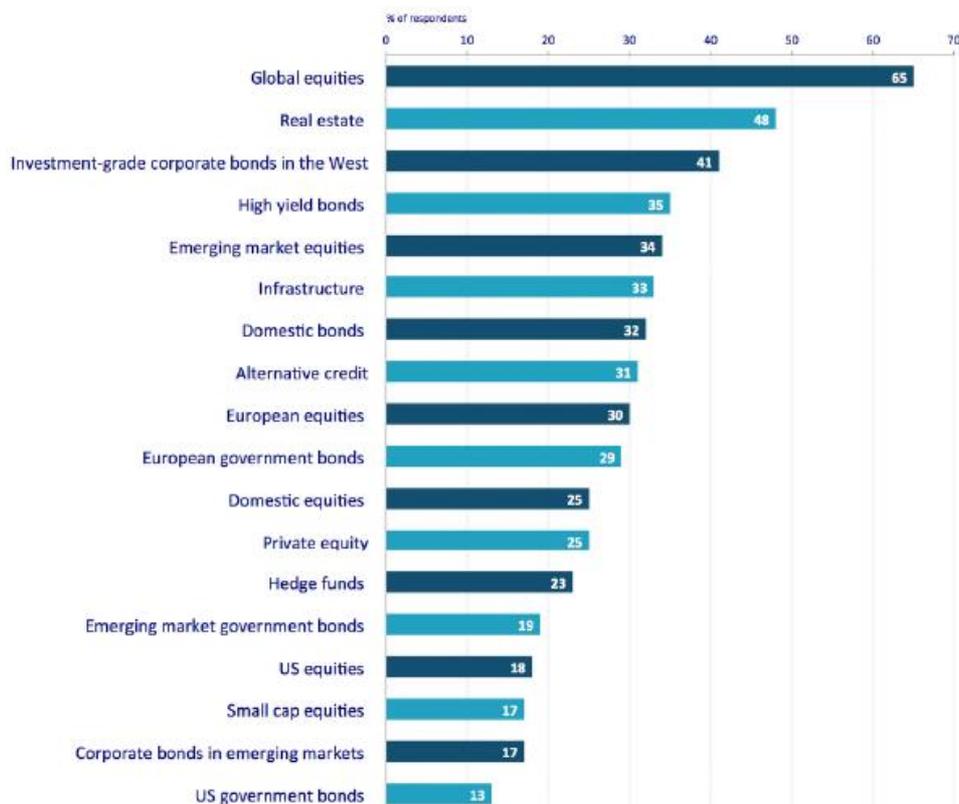
Is timing right for equities?

The issue that concerns me the most is whether investors are going passive at the right time? As an active investment manager, I have always found it hardest to outperform when everything is gung-ho and equity markets just go up and up. In my opinion, that is the perfect time to go passive. Not now, when everything is far from easy, and one could make a very persuasive argument for active management.

Also, you have to question whether now is at all the right time to overweight equities? In a recent study amongst European pension plans, they were asked which asset classes are likely to be the most suited to meet their goal over the next three years. This is a euphemism for asking where they would expect to achieve the best returns.

Global equities came out as a clear number one (chart 6). Over the years, I have learned (the hard way) that when investors’ opinions are largely undivided, they are more often than not wrong. It is not at all about the average investor being stupid.

Chart 6: Question to European pension plans: Which asset classes will be the most suited to meet your plan’s goal over the next three years?



Source: Amundi Asset Management, CREATE Research

³ Source: Forbes. See [here](#).

Far from it. It is quite simply the result of herding. When smart investors express a view, they have already ensured that they are appropriately positioned before going public. Then the rest follow.

How to approach alternative investments

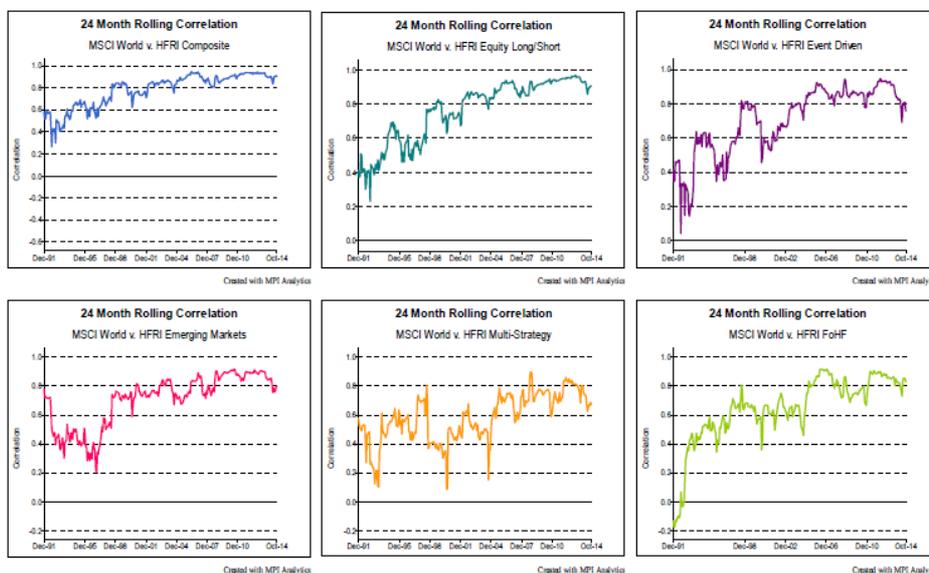
Using the same argument, nothing could be better for hedge funds than a couple of major investors pulling out. If that trend continues, hedge funds as a whole may not be the best performing strategy, but they will almost certainly be near the top.

But one needs to be selective. Equity long/short will certainly struggle to deliver sparkling returns in a low return environment for equities, but it is not as simple as that. Take two alternative strategies that we have done a lot of work on, both of which are seriously capacity constrained – insurance linked securities (ILS) and direct lending.

Both are interesting strategies and should theoretically do relatively well in the kind of environment we expect to unfold. However, whereas ILS investment managers have been relatively disciplined about how much capital they have accepted, many (though not all) direct lending investment managers have not, resulting in significant return compression in that strategy.

The other problem facing many hedge fund strategies is the rising correlation with long-only equities (chart 7). In the early days of alternative investing (the 1980s), one could fairly safely assume that capital being allocated to alternatives would act as a proper diversifier in one’s portfolio, but one can no longer make that assumption. It is not a universal trend, but one needs to be careful which alternative investment strategies to include.

Chart 7: The heightened correlation between equities and alternative investments



Source: MPI Stylus, Absolute Return Partners LLP.

The obvious conclusion is that some ‘alternative’ strategies are no longer truly alternative. The herding mentality referred to earlier has caused a major migration into alternative strategies by the ‘herd’ without any recognition of what ‘alternative’ really means or is. So it is no surprise that there is something of a reshuffle going on as investors rethink and revise their exposure to alternatives. As a natural consequence, some (like PMT and Calpers) will leave but in any case the search for alternative investment strategies is an evolving process.

Final remarks

As a consequence of all of the above, I think that, over the next several years, there is very good reason to look for your star performers away from equities – whether

long-only or long/short. As already stated, nor do I expect them to be bonds. Real estate could possibly do well (number 2 in the study above), assuming interest rates stay low and growth continues in the right direction. However, residential real estate, which pension plans rarely invest in anyway, has demographic trends working massively against it over the next 10-15 years. If I were forced to bet on real estate (which I am not), my focus would be on commercial real estate.

Some of the more esoteric alternative investment strategies are also likely to do comparatively well, but those strategies are not large enough to take all the money that will be looking for a new home over the next few years, which is why they will more likely be able to defend their fee structure. But, as a consequence of accepting too much capital, some of them will also disappoint.

I should also point out that the above relates to global growth. Some countries will do better and some will do worse. In my book, the U.S. economy is a favourite to outperform and the continental European economy looks the most likely to be named the tortoise of the race. It is (almost) all about demographics. In other words, it is a structural and not a cyclical trend, and not a million well-meaning words from Mario Draghi can change that.

Phrased slightly more succinctly, it won't matter one iota what politicians or central bankers say or do. Several European countries are facing a fall in the number of working people in their country, and there is not much anyone can do about that, short of massive immigration which there is no appetite for. The only good news, from a European point of view, is that the demographic profile is not quite as bad as it was in Japan. There is therefore good reason to believe that the consequences won't be quite as bad either.

Have a fabulous Christmas and successful 2015. We will return in early February.

Niels C. Jensen
3 December 2014

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