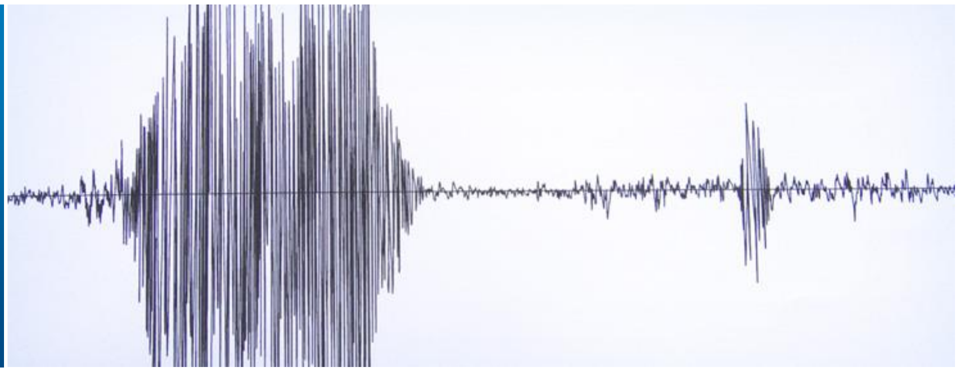
Absolute Return Partners

The Absolute Return Letter



July 2015

A Return to Fundamentals?

"In a world that is changing really quickly, the only strategy that is guaranteed to fail is not taking risks."

Mark Zuckerberg

Greece on the brink

A Greek, an Irishman and a Portuguese walk into a bar and order a drink. Who picks up the tab? A German . . .

Months (years!) of upheaval in Greece have taught me one important lesson. Don't take *anything* for granted in politics. The referendum scheduled for Sunday 5 July looks at first glance like it could form the climax of the Greek crisis – but with background rumblings that the referendum is unconstitutional, you never know what will happen next.

For simplicity's sake, let's assume that the referendum goes ahead, and let's assume that all sides behave like gentlemen and abide by the Greek people's verdict (not exactly a trivial assumption). What is then most likely to happen?

First, the referendum itself. The Greeks will vote on the following question[1]:

> *Greek people are hereby asked to decide whether they accept a draft agreement document submitted by the European Commission, the European Central Bank and the International Monetary Fund, at the Euro group meeting held on June 25 and which consists of two documents:*
>
> *The first document is called Reforms for the Completion of the Current Program and Beyond and the second document is called Preliminary Debt Sustainability Analysis.*
>
> *Those citizens who reject the institutions' proposal vote NO.*
>
> *Those citizens who accept the institutions' proposal vote YES.*

However, none of the said documents have been made available to the public. Nor have they been translated into Greek, so the Greeks have been asked to vote on something many of them won't understand. Therefore, it wouldn't be unreasonable

[1] *Source: Bloomberg*

to assume that a large percentage of the electorate will base their vote not on what they would like to vote but on what is actually happening around them, and in that respect events favour the 'Yes' camp.

Take last weekend. By midday Saturday, most banks ran out of cash, creating serious cash shortages all over the country. Sunday afternoon the ECB announced that it wouldn't raise the emergency funding to the Greek banking system. Monday morning the banks never opened and Tuesday evening Greece defaulted on a €1.6 billion payment to the IMF, only for the consequences still to be seen and felt. Whether you understand English or not, these sorts of incidents are quite serious and are likely to have a material impact on the outcome of the referendum, as many are likely to see them as an indication of things to come, if they vote 'No'.

Therefore I expect the Greeks to ultimately accept the creditors' proposal, although it probably won't be a very convincing 'Yes' (there are too many diehard Syriza supporters for that to happen) and, subsequently, I expect (as I have done all the time) the two sides to come to an agreement.

In short, there are four reasons why I think the ultimate outcome will be that Greece will stay in the euro zone and it will remain a member of the EU[2]. The four reasons are:

- Many Greeks fear (and for good reasons) that a life outside the euro zone and possibly even outside the EU could be even worse than the medicine prescribed by the creditors.
- Nobody in Europe (other than Putin) want the Greeks to establish closer ties with Russia which may be their only option if they are forced to leave the EU.
- The EU in general, and the euro in particular, are by far the most ambitious political projects in Europe since World War II, and it would be a massive mistake to underestimate the political desire and will to make them work properly.
- The creditors – and Germany in particular - actually benefit from the damage that Greece has done to the value of the euro. Poor domestic demand as a result of challenging demographics have made exports the most likely way to secure decent economic growth, and a relatively weak euro has been tremendously helpful in that respect. Imagine how much stronger the euro would have been if every member country had the fiscal discipline of Germany!

One final note on Greece. Don't take everything you read in the newspapers at face value. As we all know, the media love to create a bit of drama. If you believe everything you read, it is crunch time virtually every day. My primary sources on Greece are the Financial Times and the Daily Telegraph, and those two newspapers (and the Telegraph in particular) are infatuated with the word 'crisis'. In reality, much of what is going on is simple positioning. Neither side wants to throw in the towel prematurely, so expect the show to go on for a bit longer, regardless of the outcome in the upcoming referendum.

That concludes my response to all those people who have contacted me in recent days and weeks, asking for my opinion on the situation in Greece. And now to

[2] *I am often asked why a Greek exit from the euro zone could possibly force them out of the EU as well. Because the introduction of a new currency in Greece could force the local central bank to monetize big budget deficits by printing more money than good is, and that is illegal under EU law.*

something far more interesting (another weak attempt by me to be funny). Not another word about Greece in this letter.

Absolute Return Research

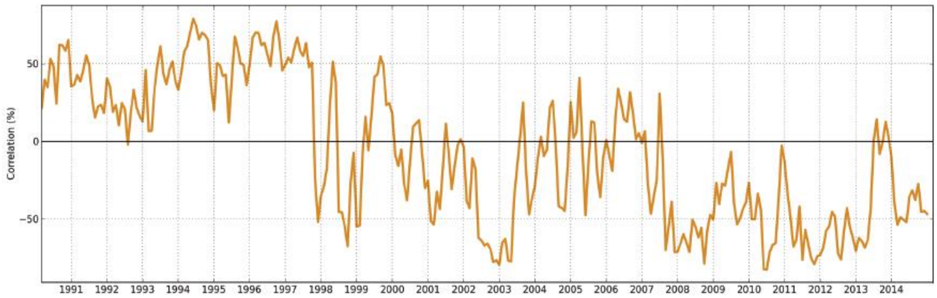
You should know that, in addition to the Absolute Return Letter, which we publish 11 times a year, I also write various research papers for our clients. These research papers are not usually published to a wider audience, but this month we will make an exception. If you are an advisory client of Absolute Return Partners, and you have already received a paper called *The Implications of Risk On, Risk Off on Portfolio Construction*, you need not read any further. You will have seen it all before.

Financial markets have in many ways behaved oddly since the near meltdown in 2008. The objective of this Absolute Return Letter is to look at whether we are finally beginning to see some sort of normalisation - as in a return to the conditions we had prior to 2008, and what that would mean in practice.

Correlation matters

Traditional portfolio theory assumes static correlations between asset classes and much portfolio construction is based on this simple assumption. The reality is very different. To see that, one needs to look no further than how U.S. equities have correlated with U.S. bonds since 1990. Whereas the correlation was positive during most of the 1990s, it was very unstable and quite unpredictable between 1998 and 2008, only to turn decisively negative after 2008 (chart 1).

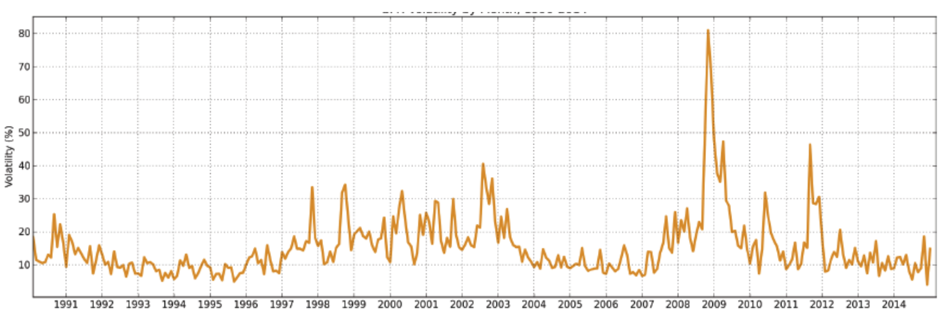
Chart 1: Correlation between U.S. equities and bonds, 1990-2014



Note: S&P 500 represent equities. 10-year T-bonds with constant maturity represent bonds.
Source: PhaseCapital LP

Not surprisingly, as a consequence, a static 60-40 portfolio (60% in equities and 40% in bonds), which is sort of a 'benchmark' portfolio in our industry, has not at all been the optimal solution in more recent times it is often portrayed as. In terms of risk-adjusted returns, if only equities and bonds are at our disposal, a 35-65 portfolio has actually done considerably better since 1990.

Chart 2: Monthly volatility of S&P 500, 1990-2014



Source: PhaseCapital LP

For that reason alone (but it is not the only one), the period since the financial crisis in 2008 has presented investors with extraordinary challenges. The traditional – and widely accepted – 60-40 approach to portfolio construction has been plain wrong. Either risk has been 'on' or it has been 'off'. Correlations across risk assets have been very high, and volatility has been plagued by at least a couple of extreme bursts (chart 2).

What does risk on, risk off really mean?

A risk on, risk off environment is characterised by much higher correlations than you would normally expect to see, at least as far as risk assets are concerned. Low volatility prevails when risk is 'on', but occasionally it is replaced by relatively short, but very sharp, bursts of much higher volatility when risk goes 'off'. Risk off assets like U.S. Treasuries (which have been a risk off asset at least since 2008) are negatively correlated with risk on assets in such an environment.

Global markets have been sucked into a risk on, risk off environment since 2008. This Absolute Return Letter will look at which behavioural factors have been impacted the most, and whether there are any signs of a return to some sort of normality.

In a (theoretical) world where the correlation between two assets is perfect (i.e. it equals one), the risk-adjusted return (the Sharpe ratio) of the two assets must be exactly the same[3]. Practically, even if correlations are not perfect, in a risk on, risk off environment risk-adjusted returns on most risk assets should be quite similar.

This implies that investor behaviour changes when such dynamics apply. Remember what I just said. Correlations between risk assets will be much higher than usual in a risk on, risk off environment. As a consequence, the trade-off between risk and returns is now perceived to be very similar across asset classes (and rightly so). Therefore investors don't distinguish much. They buy when risk is on and sell when risk is off – and they do so across the board because the choice of risk assets matters little. Hence the expression risk on, risk off.

One further implication: In a world where all Sharpe ratios are virtually the same (i.e. when all risk assets are nearly perfectly correlated), the only way investors can outperform is by taking more or less risk. If investors all take the same amount of risk, they will all deliver exactly the same return.

Please note that this logic does not consider other risk factors than volatility – an issue I shall come back to later.

A snapshot of behavioural dynamics that have changed.

A number of behavioural factors changed markedly in the aftermath of the financial crisis, which peaked in 2008. If we assume that a return to some sort of normality will drive those dynamics back to how they used to be like pre-2008, then it is probably worth taking a closer look at them in order to assess how far down the road we are in terms of normalisation.

You hear the argument virtually every day that the crisis isn't over yet but, when it eventually is, interest rates will rise dramatically. It is therefore only reasonable to expect investor behaviour to gradually change as a rising number of investors subscribe to the view that the financial crisis is finally over, even if it is still a minority who think so.

The risk on, risk off environment has ruled the world for nearly 7 years now, and I have compiled a list of dynamics that have changed as a result. With the caveat that

[3] *I shall not tire you with the mathematical proof. Suffice to say that when the correlation between two assets is perfect, the less risky asset can always be synthetically created by combining the riskier asset with a risk-free asset.*

my list is by no means all encompassing, below you will find my leading candidates (in no particular order).

Only one caveat: A thorough and proper analysis of each and every one of them would turn this into a 50 page document which few people have the appetite for, myself included. I shall therefore shamelessly skate over one or two issues.

Risk off assets change

Risk off assets tend to originate from the larger and more established economies around the world. As most investors would know, U. S. Treasury bonds have been a favourite risk off asset during the post crisis years.

A more surprising risk off asset in recent times has been Japanese Yen (JPY) which rose in value when risk assets fell out of bed in 2008 and again in 2011 when Japan ran into trouble as a result of the earthquake and tsunami. Since late 2011 JPY has been very weak, in particular vis-à-vis USD, as risk assets have continued to rise.

The JPY story is multi-dimensional, but one explanation could be that, going into the financial crisis, JPY had become a favourite funding currency for investors involved in the carry trade. Hence, when the underlying risk on assets were offloaded as a result of the sudden crisis environment, JPY had to be bought in considerable amounts to unwind all the leverage. More recently, the weakness of JPY is probably a function of Japanese monetary policy under Abe.

The simple lesson from all of this is that one cannot necessarily assume that risk off assets are always the same. What has worked in one crisis may not work in the next. CHF looks to me like a favourite risk off asset going forward. After untying it from EUR, the Swiss have created what will probably prove a future safe haven asset.

Passive investing increasingly dominates active investing

When risk assets are highly correlated, investment managers struggle to find alpha, and nowhere has it been more painful than in the equity space. The result? An uproar amongst clients who can't understand why they should pay the higher fees for active management when results are no better, and in many cases worse, than when investing passively. Consequently, large sums of money have moved from active to passive equity mandates. Other asset classes have suffered as well but not to the same degree (chart 3).

Chart 3: Outflows from active funds and inflows to passive funds

	Active			Passive		
Estimated Net Flows* $Mil	**Mar 2015**	**1 Year**	**Assets** $Bil	**Mar 2015**	**1 Year**	**Assets** $Bil
U.S. Equity	(15,399)	(137,620)	3,722	9,484	177,980	2,386
Sector Equity	1,067	21,786	410	6,320	44,581	362
International Equity	8,166	35,535	1,560	26,507	129,443	784
Allocation	3,037	35,686	1,225	566	3,349	50
Taxable Bond	7,910	(18,173)	2,320	4,745	120,559	696
Municipal Bond	1,576	33,807	577	383	4,670	19
Alternative	1,037	8,299	160	1,624	4,424	46
Commodities	189	2,025	28	(991)	1,635	58
All Long Term	**7,583**	**(18,826)**	**10,001**	**48,665**	**486,667**	**4,409**
Money Market	(33,276)	20,176	2,642			

*Includes liquidated and merged funds.
Source: Morningstar Direct

The significant flow of funds from active to passive mandates implies a risk that is not widely understood. Passive equity funds pay no attention whatsoever to valuations. They simply buy the constituents that make up the index. It is therefore conceivable that, over time, the largest companies will become disproportionately expensive as a result. I have looked at projected PEs on the ten largest U.S. companies and conclude that, whilst valuation is not a major issue yet, it certainly has the potential to become one.

One final note on passive investing: It is not just in mature markets like the U.S. that passive investing promises to cause problems down the road. Foreign investments, many of which are passive, are flowing into China in big numbers. That illustrates how passive investing can potentially reward bad behaviour. China, after all, has the world's biggest crisis of corporate governance. Recent scandals have highlighted:

- failure to enforce securities laws;
- abuse of conflicts of interest in state-owned enterprises;
- seriously deficient property rights.

In other words, any investor in a passive fund investing in China will be exposed to serious corporate governance risk. When companies in the index raise capital, as they do regularly, that exposure will increase. To make matters worse, when China is eventually added to the MSCI EM index, the affect will be accentuated.

Growth stocks outperform value stocks

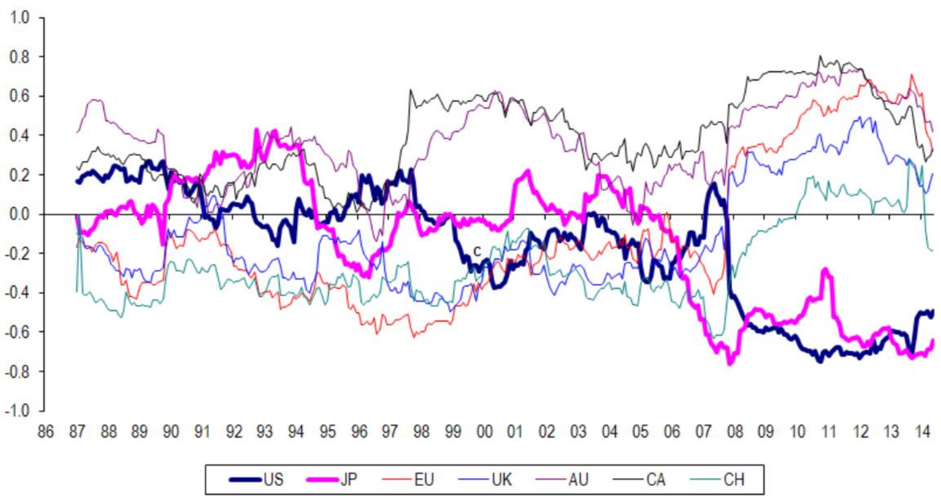
For the very same reason that capital has parted company with active investment managers in recent years, growth stocks have outperformed value stocks. Only in 2012 did value outperform growth. In all other years since 2008 value underperformed.

The reason is straightforward. As ever larger amounts of capital are managed passively, more and more capital flows towards the largest companies, and the majority of those are growth stocks – not value stocks. The underperformance of value vs. growth has created significant opportunities in the value space. Having said that, in the short term, the drive towards passive investing may cause the underperformance to continue for a while longer.

Equity markets correlate with their local currency

Before you read any further, take a quick look at chart 4. What does that chart tell you? If you are like me, not a lot at first sight. Then look at it again, but divide it into two parts - before and after 2008. An interesting picture emerges. It becomes evident that equity markets correlate very differently with the local currency today than they did prior to the financial crisis.

Chart 4: Rolling 3-year correlation of equity market and currency returns



Source: Neuberger Berman

Take the U.S. equity market vs. USD. Prior to 2008 the correlation between the two was in a range of -0.25 to 0.25. Since 2008 the correlation has been very negative – almost -0.8 at one point, even if it has moderated a little bit more recently.

A similar kind of story has developed in Japan, although the trend changed earlier there, probably because the crisis unfolded earlier in Japan. In almost all other countries in the survey, the correlation has risen post 2008.

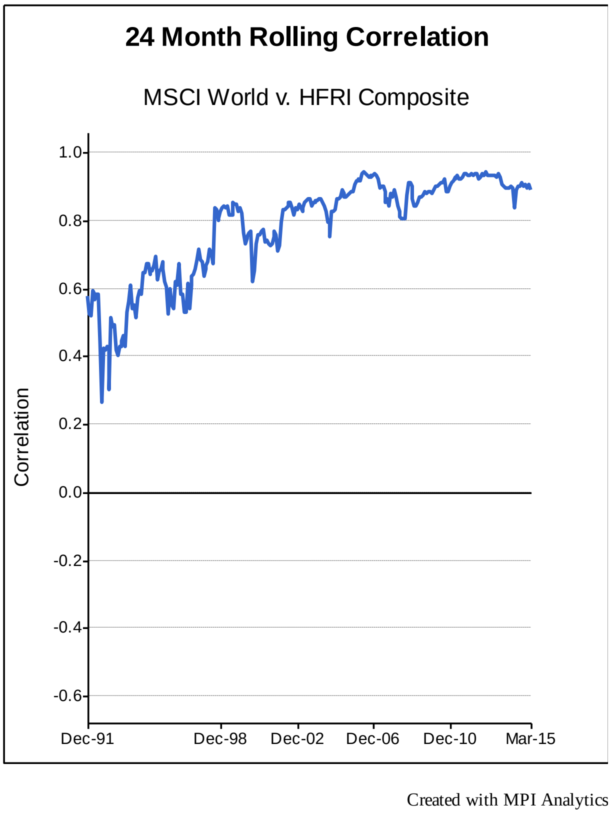
There have effectively been two clusters since 2008. One cluster around the risk off assets USD and JPY, where the correlation has been, and continues to be, strongly negative, and another cluster around the risk on assets, where the correlation is very high. This may continue until we leave the risk on, risk off environment.

Various investment strategies correlate with equities

Correlations between risk assets in general have been very high in the post-crisis environment, *and* global equities have also been highly correlated with most alternative investment strategies (and the two are definitely related).

One of the best proxies for hedge funds is probably the HFRI Composite Index and, as is pretty obvious when you look at chart 5, it is fair to say that global equities have been extraordinarily highly correlated with hedge funds in recent years. Now, we all know that a small number of strategies represent a high percentage of the hedge fund universe. Equity strategies (long only, long biased and long/short) and macro strategies between them account for about 50% of all hedge fund AuM, and it is therefore not fair to conclude that, on this basis alone, all hedge funds are highly correlated with equities, but a surprisingly high number of them have been in recent years – and still are.

Chart 5: The correlation between global equities and hedge funds



Source: MPI Stylus, Absolute Return Partners LLP

In our ongoing search for low correlation alternative investment strategies, we have only managed to identify two in the liquid space which have a correlation profile that looks profoundly different from the one depicted in chart 5. One is Volatility and the other one is Systematic Macro.

As it is a relatively new addition to HFR's universe of hedge fund indices, Volatility's history is much shorter than Systematic Macro's, so one would have to be a little bit careful as far as conclusions are concerned, but both strategies appear to deliver that all important low correlation with equities in times of distress.

In that context I should also mention that a few strategies, although their correlation profile in principle look very similar to chart 5, have experienced a more significant recent drop in the correlation with global equities than most hedge fund strategies have. Emerging Markets, Multi-Strategy and Funds of Hedge Funds would all fall into this category.

One final comment re correlated returns: If you take another look at chart 5, you may note that the correlation between global equites and hedge funds has finally started to dip, even if the drop so far is minimal. When we looked at about 15 alternative investment strategies that were all highly correlated with global equities, we found the same pattern developing in most cases.

As a result, the obvious question to ask is the following: Has the world finally begun to return to some sort of normality, or is it a statistical fluke? I shall return to this question in my concluding remarks.

Other risk factors come into the equation

Let me raise a valid question: If correlations are so high, in theory narrowing the range of Sharpe ratios that investment managers can possibly deliver, why do Sharpe ratios still vary considerably in practice? The answer is simple. Because volatility is only one of many risk factors that impact returns, and that range of factors has expanded quite significantly since 2008.

A few examples: Investors have assigned much importance to instant liquidity since the bad days of 2008. This has had the effect of establishing rather large illiquidity premia on less liquid risk assets. Where the equity risk premium is probably around 4-5% (as a proxy for the risk premium on an asset class offering instant liquidity), if you would be prepared to tie up your risk capital for 7-10 years, it is not unusual for the risk premium to be at least twice that level.

Regulatory arbitrage would be another example. The financial crisis led regulatory authorities in many countries to tighten the rules that govern banks. The result of that has been that more and more lending takes place outside the banking sector, which has also affected the risk premium.

I could go on. Absolute Return Partners have identified a good handful of factors which allow investors to pick up higher returns than you would strictly speaking expect, assuming you look at the highly correlated investment environment in isolation.

Concluding remarks

Overall, I don't see any clear signs that the risk on, risk off mentality, which has ruled since 2008, is finally coming to an end. Yes, correlations have begun to recede a little bit here and there; however, if it is indeed a sign of bigger things to come, it is still very early days.

Part of the problem for investors is that events in the real economy are not doing them any favours. Economic growth continues to disappoint, and incidents like the Greek tragedy leave an impression – rightly or wrongly – that the crisis is still very much on.

The only good news in that respect is that, should Greece vote 'No' (which I don't expect), the rest of Europe could once and for all draw a line under Greece and move on. I was in Spain only a couple of weeks ago and noticed a material improvement in business activity since last time I visited. Although not all problems in Spain and Portugal have been resolved yet (e.g. high unemployment), things are clearly improving and cannot be compared with the situation in Greece. I don't agree at all with all the doomsayers who predict that a Greek exit will effectively finish off the euro. I think a Greek exit would result in a stronger euro over time, even if the short-term kneejerk reaction would undoubtedly be negative.

Having said that, the fact that some alternative strategies have experienced a material drop in their correlation vis-à-vis global equities can be explained and is not necessarily a sign of a return to 'normal'.

For example, many emerging markets have been in a bear market over the last couple of years, as the combination of a strong U.S. dollar and record high EM dollar borrowing has created significant investor concerns. This probably explains the falling correlation more than anything else.

Meanwhile, Funds of Hedge Funds and Multi-Strategy have both benefitted from the fact that they have multiple tools at their disposal, and being stuck in a high correlation environment for many years has undoubtedly taught them one or two things.

So my conclusion is unequivocal. 'Risk on, risk off' continues to rule and many of the things they taught us at university may as well be warehoused for a little longer.

Niels C. Jensen
1 July 2015

Important Notice

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

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 and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

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 Conduct Authority in the UK.

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

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