Absolute Return
Partners

The Absolute Return Letter

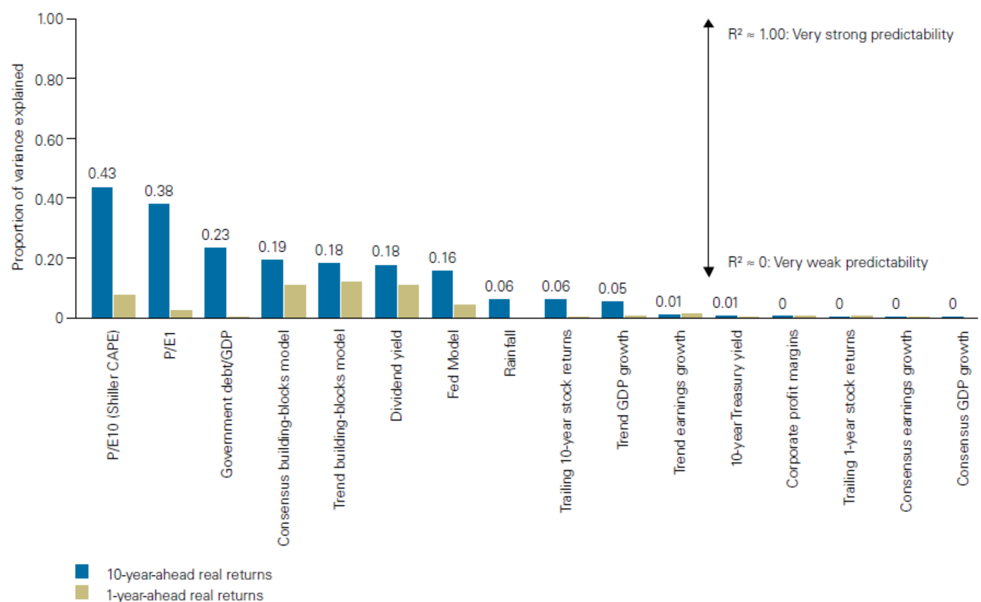
December 2012

In Search of the Holy Grail

"It's one thing to have an opinion on the macro, but something very different to act as if it's correct."
Howard Marks, Oaktree Capital Management

It can be a frustrating, and rather futile, experience to be an economist. Financial markets do not always behave as if there is a connection between economic fundamentals and stock prices, a subject I touched on in the October 2012 letter. In fact, if you believe the findings of a recent Vanguard study, rainfall statistics provide more value than either trend GDP growth or trend earnings growth in terms of their ability to predict future stock market returns (chart 1).

Chart 1: Most popular metrics are virtually uncorrelated with future stock returns



Notes: The bars display the R^2 of a regression model of 10-year-ahead and 1-year-ahead real annualised stock returns on each variable, fitted over the January 1926-June 2012 sample, with the exception of corporate profits, which are fitted for January 1929-June 2012 (because of data limitations).

Source: "Forecasting Stock Returns", Vanguard, October 2012 (via Mebane Faber)

Using U.S. market data going back to 1926, Vanguard analysed the predictive powers of a whole range of metrics. The rather depressing conclusion – at least from an economist's point of view – is that we are pretty much wasting our time by assigning

any value at all to what goes on in the real economy. Of all the metrics tested by Vanguard, only P/E ratios seem to explain some reasonable proportion of future (real) stock market returns, and that is only if you are prepared to take a very long term view (10 years in the Vanguard study).

I have been writing the Absolute Return Letter since October 2003. At least 75% (I haven't checked) of all those letters have focused on various aspects of the macro economy and a great many of them have gone on to make predictions on stock prices, interest rates, commodity prices and currencies. Have I been wasting my and, more importantly, your time during all those years?

I don't think so, but my answer does require some clarification. At Absolute Return Partners, when structuring portfolios for our clients, we distinguish between three different time horizons – the very near term (the next few months), the medium term (from a few months to a few years) and the long term (many years). Most mutual funds, pension funds and insurance companies allocate the majority of their capital to the medium term, making it a very crowded space and the more crowded the space, the more efficient it usually is, and the more difficult it will be to generate alpha.

The short term is often ruled by more aggressive investors. Hedge funds dominate this space, frequently at the expense of private investors. The long term is the least crowded; it is in fact distinctly un-crowded in the current environment. As I have repeatedly pointed out over the past couple of years, one of the most noticeable implications of the financial crisis is the craving for liquidity. This has driven more capital than ever before towards the short and medium term, creating very attractive opportunities for those investors who can take a long term view.

Despite the findings of Vanguard and others I maintain my long held view that it is possible to identify long term economic trends which are likely to have a quantifiable impact on asset prices; however, the effect is only measurable over the very long term[1]. Now, we cannot construct portfolios with only the long term in mind. If we did that, we would almost certainly go out of business before our ideas came to fruition.

So, in practice, our client portfolios would usually consist of a backbone that reflects the long term strategic investment themes that we have identified, and the core would be surrounded by other holdings which fit with how we rate the short and medium term windows in terms of attractiveness. In the rest of this letter I will share with you some of the factors we look at when deciding on the portfolio composition for the short and medium term. The letter is longer than usual but don't despair. I am using many more charts than I normally do, and those charts take up a lot of space.

Flow of Funds

Let's begin with one of the most potent short term drivers of performance – flow of funds. Since late 2007, and, excluding emerging market funds, almost $600 billion has been pulled out of equity mutual funds worldwide. Over the same period, less than $200 billion has shifted into emerging market equity funds for a net loss of about $400 billion. At the same time, over $1 trillion has found its way into global bond funds[2].

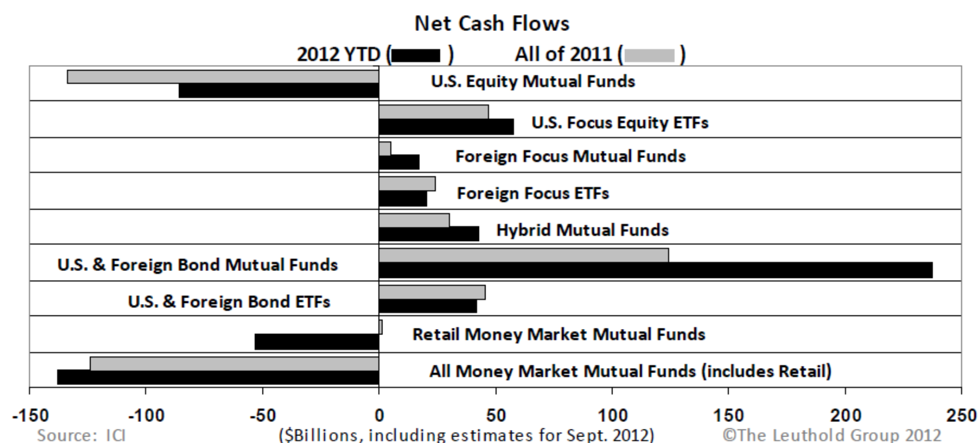
Now, let's drill one level deeper by providing a more detailed snapshot of flows in 2011-12 (chart 2). Not surprisingly, given the poor returns on offer, about $260 billion

[1] *On our new website, which will be launched over the next few days, we will discuss some of those investment themes. Please note that, at the same time, our URL will change from www.arpllp.com to www.arpinvestments.com. Please give it about a week; there are some technical reasons why the old website will continue to run for the next few days.*

[2] *This information is sourced from IMF's latest Financial Stability Report. You can find the chart on page 5 of our November 2012 letter.*

has left money market funds since early 2011, much of which has probably found its way into bond funds as investors have been seeking higher returns. Between actively managed bond funds and bond ETFs, a total of $450 billion has flowed into bond funds since early 2011.

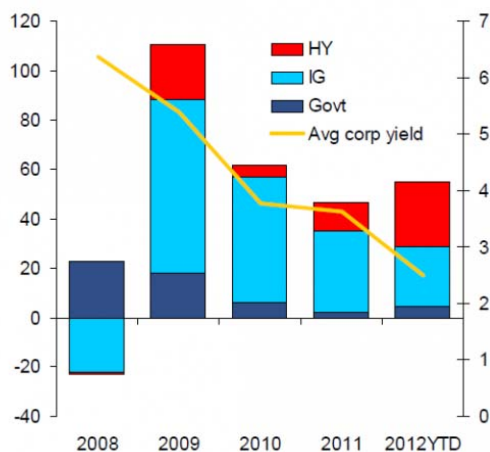
Chart 2: Net flows of funds, selected U.S. investment vehicles ($bn)



Source: The Leuthold Group (via Mebane Faber)

By adding chart 3 we can see that the $450 billion of inflows have been allocated almost entirely to corporate bonds. Investment grade dominated in 2011 whereas, this year, the mix between inflows into investment grade and high yield has been roughly 50/50. These are considerable amounts of money going into an asset class which have, at times, proven to be less liquid than investors would like it to be.

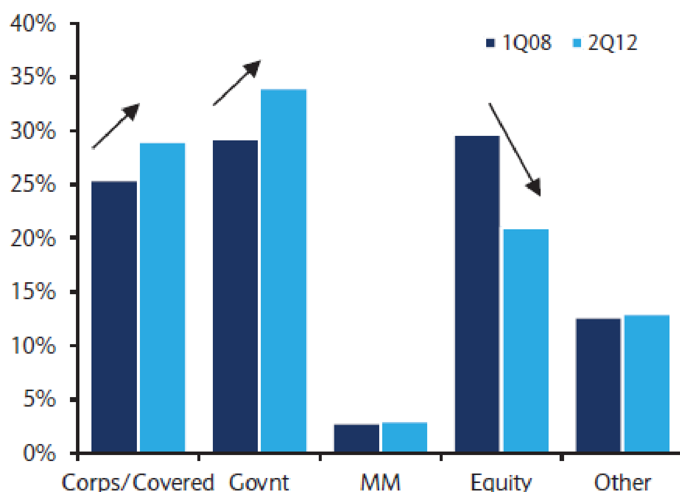
Chart 3: Yield-starved investors have compressed spreads



Source: http://www.zerohedge.com/news/2012-11-14/four-charts-corporate-bond-managers-fear-most

This is only part of the story, though. Mutual funds are predominantly held by retail investors, so let's see if we can get some idea as to what institutional investors have been up to. Unfortunately, I do not have access to the same amount of detail, but we do know, courtesy of Barclays Capital, that European pension funds and insurance companies have been net sellers of equities in recent years whilst at the same time loading up on bonds (chart 4). Unlike retail investors, though, they have been big buyers of government debt. I suspect, but cannot prove, that much of the buying of government bonds originates from Italy and Spain where local institutions are known to have been buyers of their own sovereign debt. Only time can tell if that will come back and bite them in the rear.

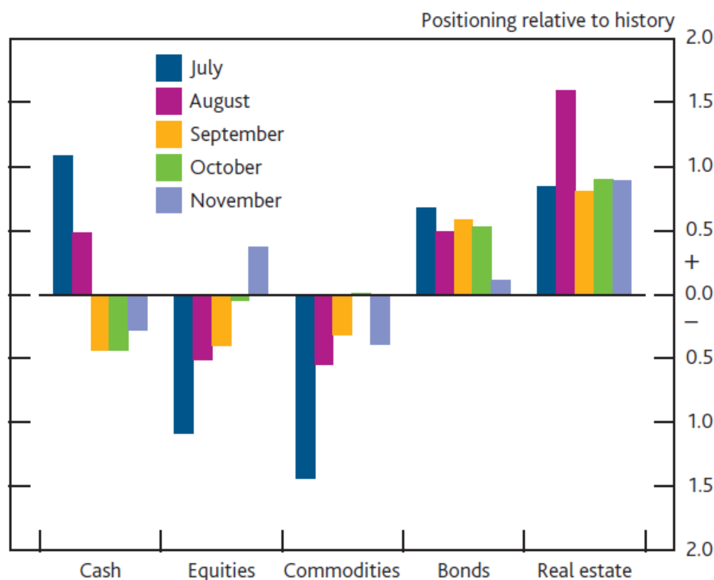
Chart 4: Asset allocation at European pension funds' & insurance companies



Source: "European Credit Alpha", Barclays Capital, November 2012

Courtesy of the Bank of England we also happen to know what institutional fund managers have been up to more recently. Since last summer institutional fund managers have put more emphasis on equities again whilst their relative allocation to bonds has diminished somewhat, although they remain overweight (chart 5).

Chart 5: Asset class positioning by global fund managers



Source: "Financial Stability Report", November 2012, Bank of England. Positioning captures whether funds are overweight (positive scores) or underweight (negative scores) in each asset class relative to historical asset allocations.

That was a lot of data about what has *already* happened. What does that convey to me in terms of what is likely to happen going forward? More than anything, it confirms what I already knew – that there is huge appetite out there from both retail and institutional investors for anything that pays a half decent yield. However, there are early signs that institutional investors have begun to lose a bit of interest for bonds and have begun to put money back into equities. As of yet, private investors do not yet appear to have jumped on that band-wagon. If history repeats itself, they will. Eventually.

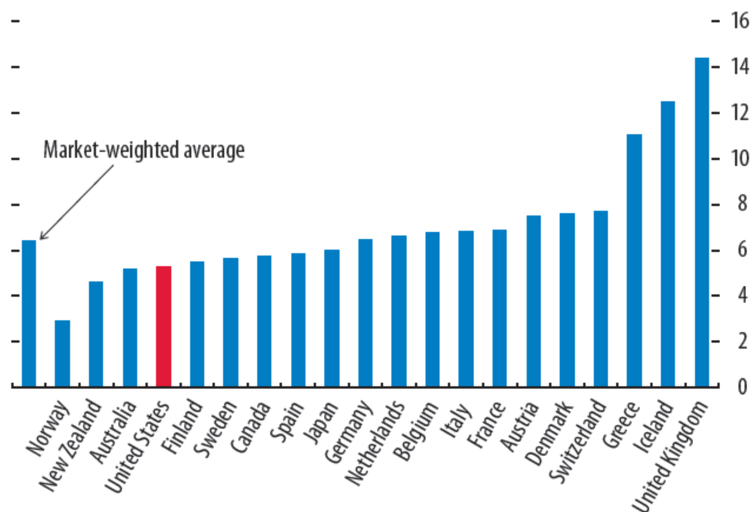
It also tells me that Charles Prince (then CEO of Citigroup) was ever so right when he said back in 2007 that "*as long as the music is playing, you've got to get up and dance.*" I have no idea when the music will stop in the bond markets, but it will at some point. It always has done and always will. When it happens, and the move

towards the exit becomes a stampede, investors in high yield bonds will find that the trade was far more crowded than they ever realised.

Maturity Profile

Another factor we follow closely is the maturity profile of already outstanding debt. Being forced to refinance one's debt in the midst of a financial crisis is not necessarily the most enviable position to be in. In the sovereign space, the UK has avoided much of the turmoil that countries in peripheral Europe have had to deal with, partly, but not only, because its debt profile is the longest in the developed world (chart 6).

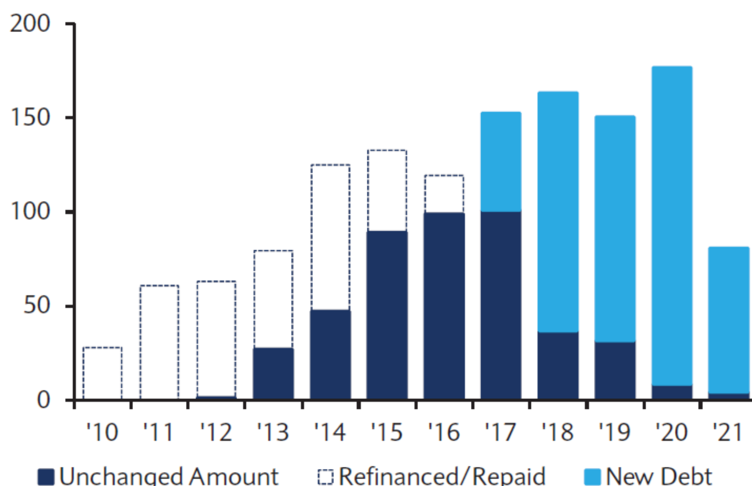
Chart 6: Weighted average maturity of outstanding sovereign debt (in years)



Source: IMF Global Financial Stability Report, October 2012

In the corporate debt market, issuers have taken advantage of the very benign refinancing conditions in 2011-12. In the high yield market issuers have not only refinanced existing debt but also issued considerable amounts of new debt, scheduled to mature in 2018-20 for the most part (chart 7).

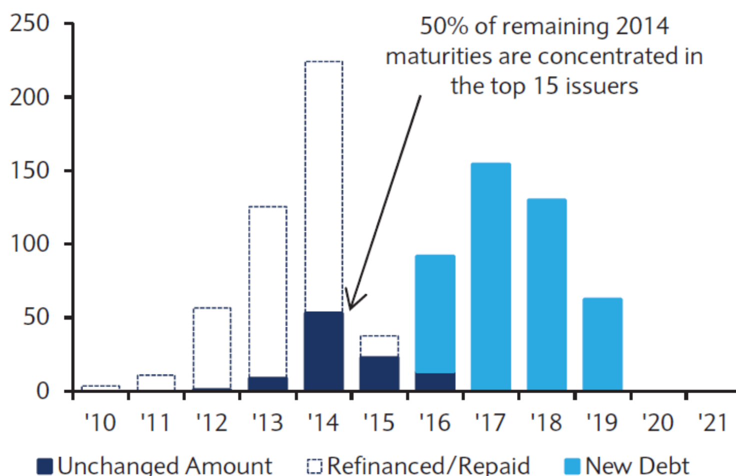
Chart 7: U.S. high yield bond maturity profile ($bn), change since 2009



Source: "U.S. Credit Alpha", Barclays Capital, November 2012

In leveraged loan market, most of the debt has been refinanced to 2016-19, but not much new debt has been issued (chart 8). What does all of this tell us? That, all other things being equal, if (when) we have an accident in what I believe to be an overvalued high yield market, it probably won't be a hectic refinancing schedule that causes the blow-up.

Chart 8: U.S. leveraged loan maturity profile ($bn), change since 2009



Source: "U.S. Credit Alpha", Barclays Capital, November 2012

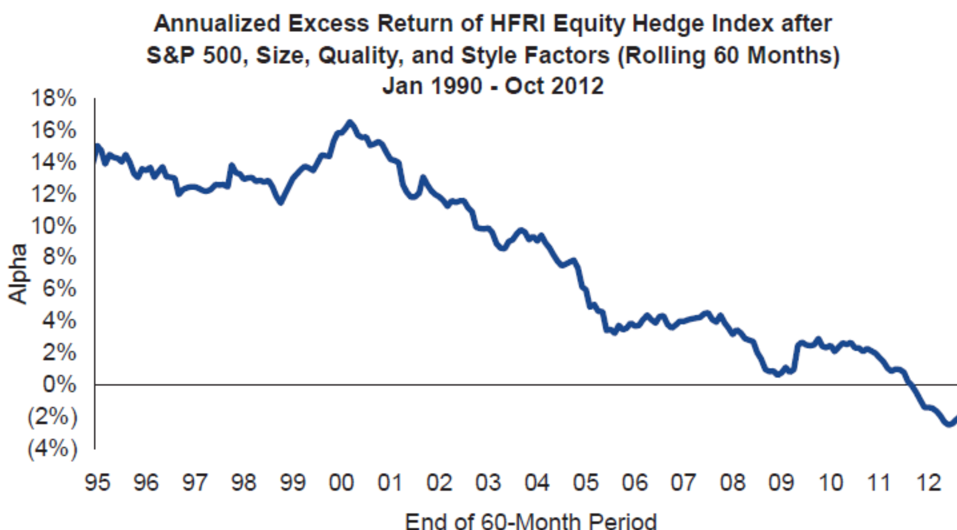
In fact, I am more concerned about the growing use of leverage. Following the 2008-09 collapse in high yield and leveraged loan prices, leverage facilities vanished almost from one day to the next. The use of 5-6 times leverage was not uncommon back then and made already difficult conditions much worse when everybody wanted out at the same time. I do not yet have data to prove it, but market contacts here in London are telling me that at least two global banks have begun to provide leverage again at a significant scale.

Hedge Fund Activities

Now, let's shift gear and look at hedge funds and their activities. Hedge funds used to be small and nimble, accounting for a microscopic share of assets under management and a not much bigger share of trading volumes. This effectively allowed them to move around swiftly, generating a respectable amount of alpha in the process.

Not anymore. All you need to do is to read the research reports of large Wall Street firms such as Morgan Stanley and Goldman Sachs. Whereas their research used to be written for mutual fund managers and chief investment officers of pension funds and insurance companies, it is now obvious that their target audience is the hedge fund community. None of this would matter if hedge funds produced good returns but they don't.

Chart 9: Equity long/short funds no longer generate positive alpha

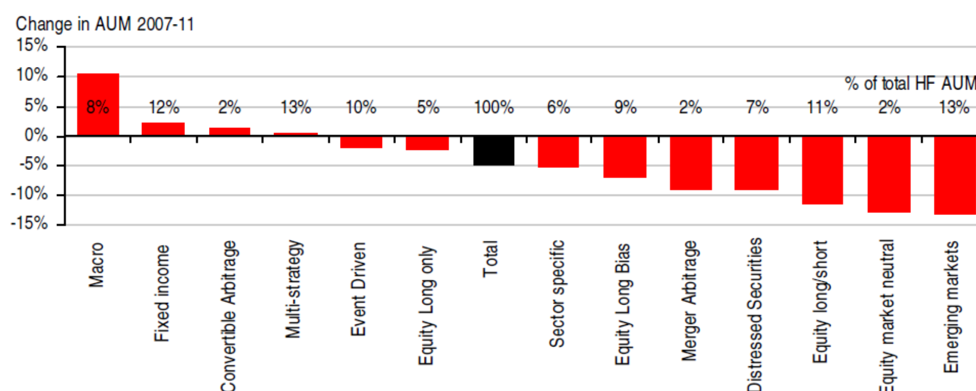


Source: "The 2013 Playbook", Morgan Stanley Research, November 2013

Perhaps that requires some clarification. Many hedge funds actually deliver what they say on the tin but equity long/short – easily the largest hedge fund strategy with over 50% of all hedge fund assets under management – is having a torrid time. Morgan Stanley found in a recent study that alpha generation (i.e. outperformance) in the equity long/short space has actually turned negative more recently (chart 9) which is a far cry from the 'golden age' of hedge funds 10-15 years ago.

There are many reasons for this. The high correlation environment, over-crowding, a rapidly thinning talent pool and high fees have all contributed to the change in fortunes, but it has caused a crisis of sorts for the industry as a whole with assets under management dwindling (chart 10).

Chart 10: Growth in hedge fund assets under management, end-2007 to end-2011



Source: "The 10 key trends changing investment management", HSBC, September 2012 (via Mebane Faber)

What are the consequences of this poor showing? Despite the meagre returns generated more recently, the industry is likely to be around for many years to come. After all, only 2.5% of all assets under management worldwide (approximately $80 trillion) is managed by hedge fund managers, so there is plenty of scope for the industry to grow.

Having said that, investment strategies suffering from the current phenomenon of high correlation between risk asset classes of all sorts will probably continue to experience shrinking assets under management, as smart investors increasingly allocate to more esoteric hedge fund strategies where the alpha pool is still substantial and the competition from long-only is minimal.

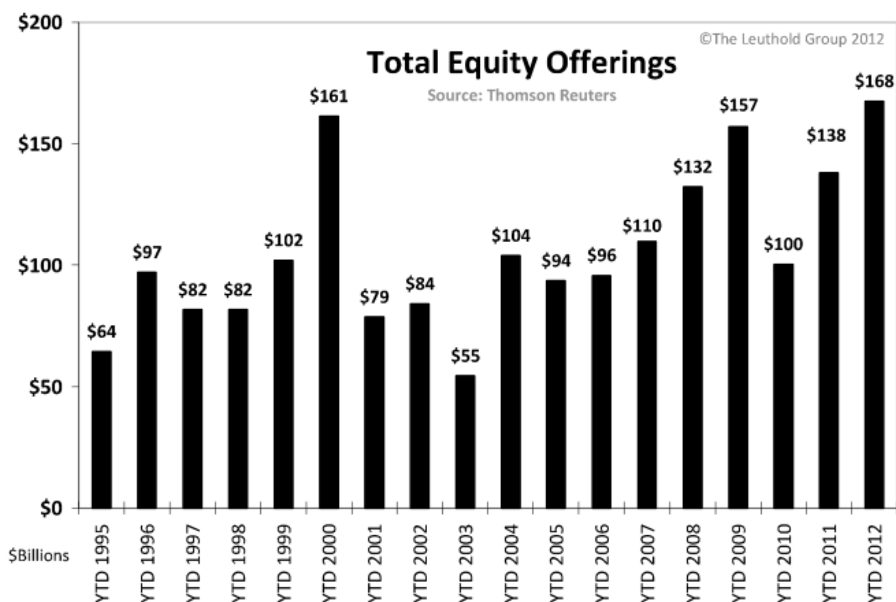
Primary & Secondary Offerings

2012 has been a good year for equity underwriters. Through the month of September, total equity offerings stood at $168 billion, on target to exceed the all-time high of $214 billion set in 2009 (chart 11). The picture is broadly similar in the high yield market with 2012 already assured of setting a new record for the industry (chart 12).

What does that tell us in terms of future market behaviour? In order to answer that question, we need to bring the private equity industry into the equation. Going into 2012, the industry had almost $1 trillion of 'dry powder', i.e. committed but not yet invested capital (chart 13). I suspect, but have no proof, that private equity managers will enter 2013 with at least $800 billion of dry powder.

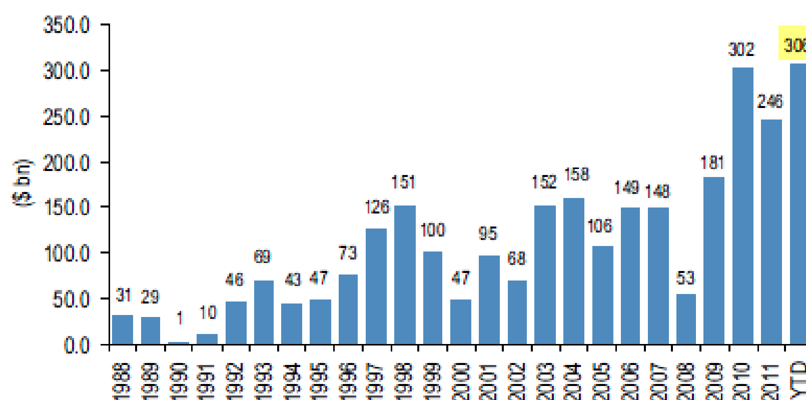
When you combine this information with the knowledge that much of the dry powder relates to private equity funds started years ago, the managers of those funds will soon be confronted with an interesting dilemma. Should they return the committed capital to investors, knowing that their fees will be reduced as a result, or should they step up and make acquisitions? I suspect I know what the more likely outcome is. This weighs heavily in favour of increased equity exposure.

Chart 11: 2012 has been a strong year so far for equity offerings



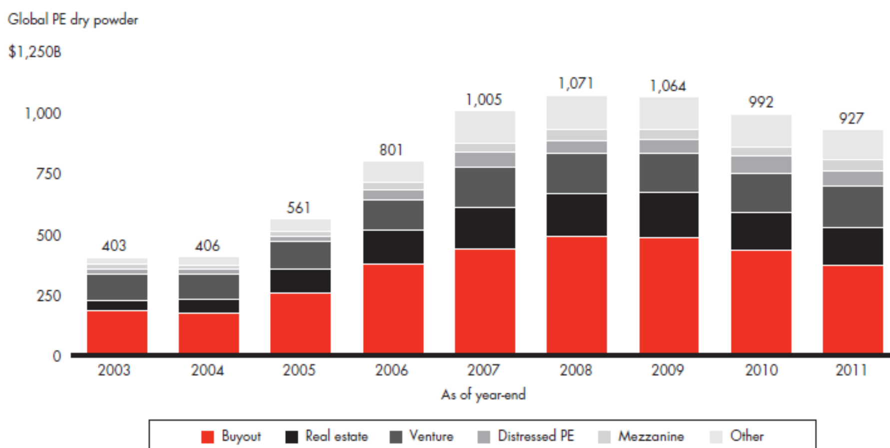
Source: The Leuthold Group (via Mebane Faber). Previous years' numbers have been adjusted to only include the first 9 months of the year.

Chart 12: High yield debt issuance hits an all-time high in 2012



Source: http://soberlook.com/2012/11/2012-high-yield-debt-issuance-hits-all.html:

Chart 13: Private equity firms have substantial dry powder



Source: "Global Private Equity Report 2012", Bain & Company

The Importance of Dividends

There is a growing recognition amongst investors that dividends actually make a meaningful contribution to total returns over time even if they vary greatly from year to year and even from decade to decade. During more exuberant market conditions (e.g. the 1990s) dividends matter less, whereas in low return environments (e.g. the 1970s), dividends are likely to account for a large part of the total return (chart 14). I also note with some considerable enthusiasm that dividends have made a meaningful contribution to equity returns worldwide; it is not merely a U.S. phenomenon (chart 15).

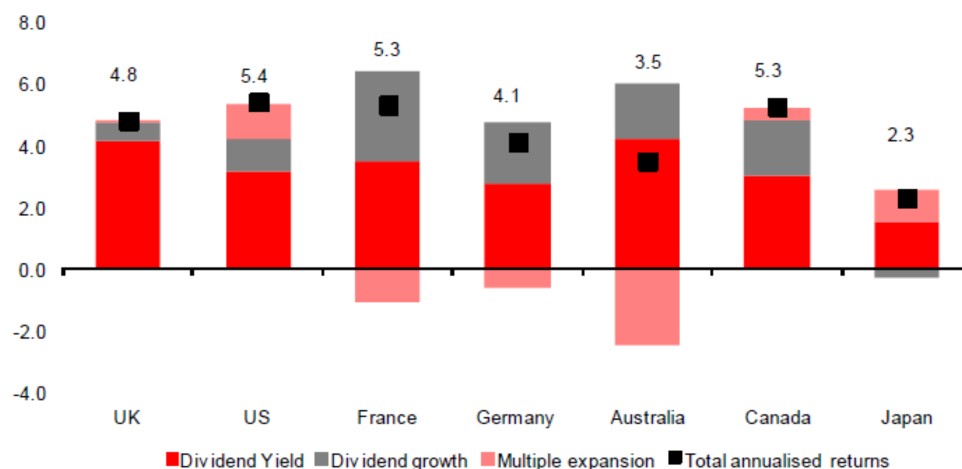
Chart 14: Dividends have accounted for over 40% of total return since 1930

S&P 500 Total Return: Price and Dividend Contribution

	Total Return	Price Appreciation	Income Return	As a Share of Total Return	
				Price App.	Div. Income
1930's	0.1%	(5.3%)	5.7%	na	na
1940's	8.9%	3.0%	5.7%	33.6%	64.5%
1950's	18.9%	13.6%	4.7%	72.0%	24.7%
1960's	7.7%	4.4%	3.1%	57.2%	41.0%
1970's	5.8%	1.6%	4.1%	27.8%	71.1%
1980's	17.2%	12.6%	4.1%	73.2%	23.8%
1990's	18.0%	15.3%	2.3%	85.1%	12.9%
2000's	(0.9%)	(2.7%)	1.8%	na	na
2011	2.1%	(0.0%)	2.1%	0.0%	100%
2003-2011	6.2%	4.0%	2.0%	65.8%	32.9%
1930-2011	9.2%	5.1%	3.9%	55.5%	42.4%

Source: "The 2013 Playbook", Morgan Stanley Research, November 2013

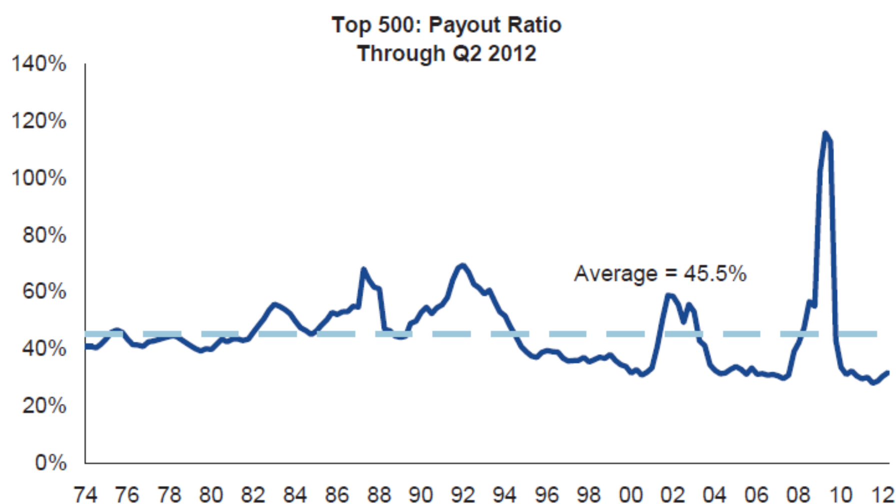
Chart 15: Decomposition of real equity returns since 1970



Source: SocGen Cross Asset Research

Why all this excitement about dividends? Because corporate balance sheets are generally in excellent shape, providing corporate treasurers with plenty of room for manoeuvring. And because pay-out ratios are near all-time lows (chart 16). When it dawns on corporate treasurers that dividends are actually sought after again, following years of neglect, pay-out ratios will begin to rise and investors will reward those companies that pay a respectable dividend.

Chart 16: Dividend pay-out ratios are near an all-time low



Source: "The 2013 Playbook", Morgan Stanley Research, November 2013

Wriston's Law

Finally a note on Wriston's Law. The first reference to it can be traced back to a 2006 article in Forbes Magazine authored by Rich Karlgaard; however, I credit Alexander Ineichen of Ineichen Research and Management AG with introducing it to me. You can read more about Alexander's work here.

Walter Bigelow Wriston (1919-2005) was Chairman and CEO of Citibank from 1967 to 1984 and, in his heyday, arguably the most influential banker in the world. He was also an astute observer of markets and human behaviour more generally and once made the following observation about capital movements which has since become known as Wriston's Law of Capital or just Wriston's Law:

"Capital will always go where it's welcome and stay where it's well treated."

In a crisis environment where governments are prepared to take increasingly desperate steps to mollify the electorate, the wise words of Walter Wriston should not be ignored. What exactly goes through President Hollande's mind when he threatens to nationalise the French assets of ArcelorMittal unless they are prepared to guarantee French jobs? Capital will indeed go where it feels welcome – and safe – and all countries, France included, need every penny of foreign investment they can attract to see them through the current crisis.

If German and French earnings multiples are broadly similar (which they are), and if the spread between the 10-year Bund and the OAT is only 65 basis points (as it currently is), I know where my capital will go, and I am probably not alone in reaching that conclusion.

Conclusion

Now, how do I put all this together? Let me begin with what I haven't talked about. The topics discussed in this letter list (in no particular order) factors that I believe are important when determining the outlook for asset prices in the short to medium term. That doesn't imply that the list is complete. For starters, I won't give all my secrets away. Secondly, the letter is already too long. Thirdly, some factors are so complex in nature that a brief mention wouldn't do them any justice.

For example, I have not mentioned QE and other *monetary policy initiatives* such as Operation Twist and OMT. Monetary policy has had a massive impact on asset prices in recent years and is likely to continue to play an important role. It is, however, a complicated subject which deserves a letter on its own.

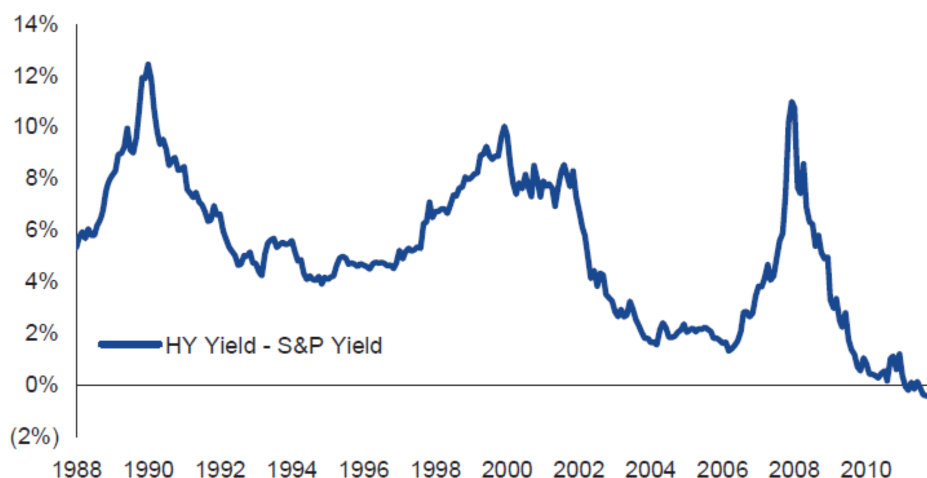
I haven't discussed *policy uncertainty* either. It is an established fact that uncertainty affects economic growth as well as asset prices. Businesses invest less, consumers spend less and investors' appetite for risk diminishes when uncertainty rules.

Nor have I mentioned *unintended consequences*. For example, monetary policy in the U.S. increasingly looks like it is manifesting itself as inflation in Asia – in particular in those countries whose currency is closely tied to the value of the U.S. dollar. I learned last week that a parking space in Hong Kong changed hands recently for the meagre sum of $387,000. By the way, that is USD, not HKD. Residential mortgage loans are currently on offer for about 2.1-2.2% annual interest with consumer price inflation running at almost twice that level. All because Hong Kong has to set its interest rates according to U.S. policy because the two currencies are tied. I am old enough to remember the real estate bubble in Japan in the late 1980s but not old enough to have lost my sense of smell, and I can smell a rat from far away.

Summing up my earlier findings, I make the following observations:

1. High yield has never looked more expensive when compared to equities (chart 17).

Chart 17: The U.S. earnings yield is now higher than the HY yield



Source: "The 2013 Playbook", Morgan Stanley Research, November 2013

2. Investors with an appetite for income should therefore consider high income equities as an alternative to corporate bonds but, at the same time, remind themselves that the companies they invest in need to have a balance sheet of sufficient quality to maintain and possibly even increase the dividend over time.

3. Investors interested in riding the buy-out wave (which is a forecast, not a fact), should focus at the value/quality end of the market where private equity funds are more likely to be active.

4. If investing in hedge funds, doing what more than half of all hedge investors do (i.e. investing in 'vanilla' strategies such as equity long/short) could very well lead to disappointment. Investing in more esoteric, less crowded, strategies is likely to lead to better results.

Happy 2013. We will be back on or around the 1st February.

Niels C. Jensen
4 December 2012

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