

Ineichen Research and Management ("IR&M") is a research boutique focusing on investment themes related to absolute returns.

**September 2010**

www.ineichen-rm.com

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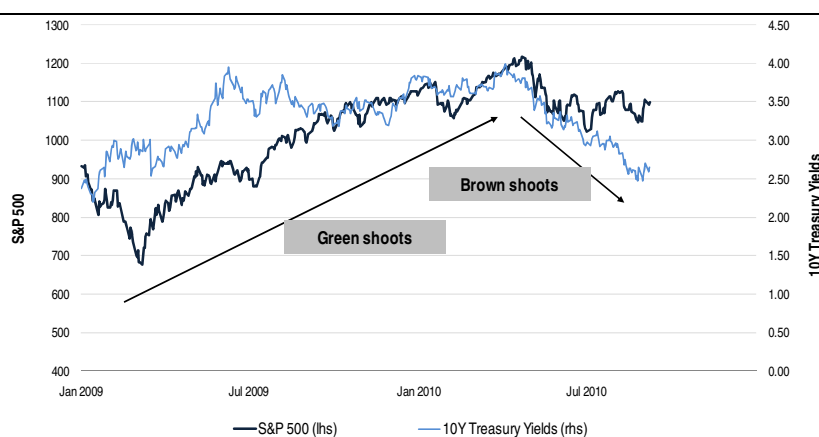
## Absolute Returns

# Equity hedge revisited

## Tipping over?

- *For equity investors, autumn has its perks. Many corrections occurred in autumn. Whether this will hold true in 2010 we do not know. However, self-fulfilling prophecy can work in mysterious ways.*
- *We recommend hedging directional equity risk for a while. The institutional investor has various options to execute such a view, two of which are (i) replace long-only exposure through long/short exposure, (ii) hedge by using simple overlay strategies.*
- Some of the proxies for risk aversion have been increasing lately, somewhat similar to autumn 2007.
- The lower the yield curves in the West-ex Japan, the higher is the probability that a Japan-like, deflationary environment is what we're up against.
- Inflation fears have been easing and don't seem to be a big worry at the moment.
- Many proxies for business and consumer sentiment have risen to April/May 2010 but are now off those interim highs.
- The "green shoots" phenomena lasted longer than most investors expected it would. The current "brown shoots" phenomena could too.

Chart 1: Economic shoots



Source: IR&M, Bloomberg

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*I would like to thank Dr. Werner Goricki and Wolfgang Stolz for reviewing earlier drafts of this document and helping me avoid some embarrassing mistakes. I also benefited greatly from discussions with Wolfgang Batt, Dirk Singer and Pascal Spielmann. The views expressed in this document are my own, and might or might not be shared with the gentlemen mentioned above. Factual errors, omissions and ambiguities are, of course, my responsibility.*

*Alexander Ineichen*

*10 September 2010*

## Introduction

***“It’s nonsense to think of the economy heading downward again into a double-dip recession when most Americans never emerged from the first dip. We’re still in one long Big Dipper.”***

—Robert Reich, Former Labor Secretary

## Risk management versus market timing

A price of a liquidly traded financial instrument on an exchange is—in most cases—the most factual and “honest” piece of information the investor can obtain. (This is one reason why short selling bans are a delicate matter; it distorts things.) Investors and other market participants might talk a lot but what they really think, perceive and feel is reflected through their actions in the market place. The impact of these market actions is dollar-weighted. We believe market prices to change according to three things:

1. Fundamentals
  2. Market psychology/sentiment
  3. None of the above, i.e., market technicalities
1. With fundamentals we mean fair value according to some (often ambiguous) metric. For example, the JPY has been expensive relative to the USD based on PPP (purchasing power parity) for some time. However, the market is moving away from “fair value” because other factors outweigh the fundamentals. We are at times astonished how long some investment professionals can keep pounding their case based on “fundamentals” while the market is telling them clearly that they should revisit their investment case. (A good investment case with poor timing is, more often than not, a bad investment.) In these instances the quote in the side text is referred to as the first line of defence.
  2. An economic system is a social construct and financial markets are places where agents of this social construct interact. There’s bound to be a human element to it. Bazaar merchants in Ancient times knew it. Venetian money changers in the 16<sup>th</sup> century knew it. Tulip bulb market makers in 17<sup>th</sup> century Amsterdam knew it. Candlestick chart inventing Japanese rice merchants in the 18<sup>th</sup> century knew it. Most investors throughout time to today knew and know it. Why the scholarly economics establishment has been taking such issue with it and why large parts of financial academia has been putting up such a fight against the behavioural finance movement is—in all modesty—beyond us.

**“Talk is cheap but it takes money to buy whiskey.”**

—American proverb

**“Financial markets can remain irrational far longer than you can remain solvent.”**

—John Maynard Keynes

**“Only two things are infinite, the universe and human stupidity, and I’m not sure about the former.”**

—Albert Einstein

3. Solvency II (essentially Basel II for European insurers) in its current draft form requires zero capital requirements for European government bonds (someone has to buy them) while a punitive capital requirement for equities (and hedge funds). The selling of equities and buying of bonds wouldn't fall in either 1. or 2. but nevertheless could have a material impact in the market place. Another example that neither falls into 1. nor 2., is the market impact of demographics. Ms Watanabe is buying (repatriating) JPY not because of the currency's fundamentals relative to fair value or because she feels bullish, but because changing demographics is changing risk preferences and appetite in a material way. With market "technicality" we therefore mean an endogenous market factor other than (fair value) fundamentals or sentiment that the risk manager needs to understand.

We believe this third aspect is becoming more important. The newly passed financial regulation in the US (Dodd-Frank) is 2319 pages long.<sup>1</sup> There's bound to be a lot of market distorting stuff in there.

Equity long/short (aka equity hedge) as a strategy hasn't really shot the lights out over the past couple of years (as we will show on page 20). Many investors are disappointed. Some market pundits are even referring to the equity long/short space with really foul language (typically involving the word "beta".) We believe one of the reasons for the recent sub-stellar performance has to do with the list just mentioned: Bullets 1. and 3. are environments which favour a bottom-up research process, especially 1, while 2. does not:

1. Bottom-up stock research reveals a divergence between fair value and what the market thinks is the right price. Over the medium term—under normal circumstances—prices "migrate" or revert to fair value. In such an environment good bottom-up stock research can add value in both, equity long/short as well as long-only space. (The former is the superior structure in this environment because the degree of freedom allows adding more value per unit of skill and per unit of capital at risk.) The research (ideally based on publically available information) essentially reveals a price-relevant information advantage.
2. The past couple of years do not qualify as "normal circumstances". Markets were largely driven by sentiment (or macro factors). This calls for a top-down approach, rather than bottom-up. We noticed, anecdotally, that equity long/short managers who complemented their bottom-up stock research efforts with a top-down view of the world, did better during the financial crisis than managers who dogmatically stuck to stock picking come rain or shine.
3. At the risk of talking our book, special circumstances require research. The research could involve a bottom-up and/or top-down effort. It is the research that either makes the investment case or provides the degree of conviction necessary to put capital at risk. Given that the world seems to becoming more complex—certainly from a legal and regulatory perspective—investment managers with research brain-power (and brain-power-man-hours) will most likely have an advantage over those with none.

<sup>1</sup> Glass-Steagall in 1933 was 37 pages and Sarbanes-Oxley in 1999 was 145 pages long. The new regulation is essentially TARP for the legal profession with investment banks most likely having the last laugh.

**"Either you understand your risk or you don't play the game."**

—Arthur Ashe (Tennis legend, from Barra advertisement)

**"If we knew what it was we were doing, it would not be called research, would it?"**

—Albert Einstein

## Reggae colour coding

In this publication we use a green-yellow-red colour coding which allows us to show large amounts of data across various economies in an eye-friendly fashion. Red marks the negative extreme, green the positive extreme and yellow the mean or average, in other words, normality. Unfortunately, this publication needs to be viewed onscreen or printed in colour. The colour coding format highlights mainly three elements related to risk and investors risk appetite or aversion:

- Trends;
- change; both short-term spikes as well as reversals in trends, and
- correlation

Below is an example showing the PMI for the US, the Eurozone and China. More detail is shown on page 15.

Example: PMI

	2005-		2009										2010									
	High	Low	01 09	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10
United States	60.4	32.5	35.5	35.7	36.4	40.4	43.2	45.3	49.1	52.8	52.4	55.2	53.7	54.9	58.4	56.5	59.6	60.4	59.7	56.2	55.5	56.3
Eurozone (3.2006-)	57.7	33.5	34.4	33.5	33.9	36.8	40.7	42.6	46.3	48.2	49.3	50.7	51.2	51.6	52.4	54.2	56.6	57.6	55.8	55.6	56.7	55.1
China (5.2005-)	59.2	38.8	45.3	49.0	52.4	53.5	53.1	53.2	53.3	54.0	54.3	55.2	55.2	56.6	55.8	52.0	55.1	55.7	53.9	52.1	51.2	51.7

Source: IR&M, Bloomberg

US: ISM; Eurozone: Markit; China: NBS

The illustration should show at a glance:

- The ISM Manufacturing PMI has improved from its lows at the end of 2008 to Q2 2010.
- A high was reached in April and the PMI has been falling ever since; i.e., the trend has reversed. We aim to highlight the fact that the PMI has been falling since April rather than guess where it might go next. The trend reversal is a fact, not an opinion.
- The colour coding visualises the correlation between the time series: the lows, the highs, even the trend reversals—in this case—are more or less synchronised with China leading a bit.

An additional piece of information is the recent levels relative to a historic high and low. Note that the extreme highs and lows of many economic and financial variables occurred within the past three or four years. In some cases we have added an average or median of all the numbers to get a feel for the global trend. The reason for looking at large quantities of data is to get an understanding for what is highly correlated and what leads and lags.

<sup>1</sup> Original quote probably stems from Thomas Fuller (1608-1661), British author and clergyman: "We never know the worth of water till the well is dry." Original quotes from Bob Marley quite often contain the term "herb" rather than "water".

**"You ain't gonna miss your water  
until your well runs dry."**

—Bob Marley<sup>1</sup>

## Correlation 1.0 environment and The Borg

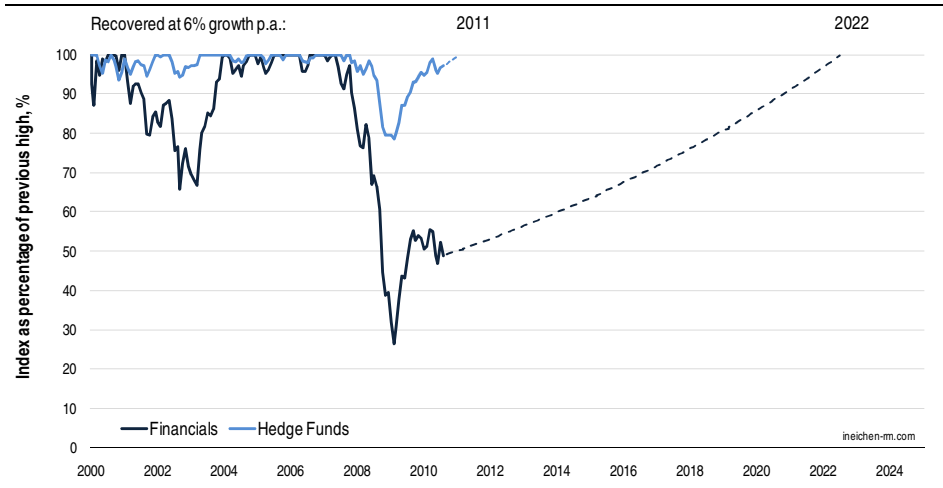
Correlation is—we are actually tempted to say “was”—the key variable in risk management. In our April report—Absolute Returns revisited<sup>1</sup>—we argued as follows:

*“When diversification matters most, correlation is roughly 1.0 and trying to squeeze certain viable investment choices into an optimizer is unwise.”*

Low correlation is most often a function of the lack of liquidity.<sup>2</sup> Real estate, infrastructure, and farm land are now perceived as (or pitched as) being of low correlation to the rest of the institutional investors portfolio. However, if physical real estate, infrastructure and farm land were traded with ample liquidity on the NYSE, the prices too would be correlated with other risky assets. In a flight to quality scenario like 1998 or in a flight to cash scenario like 2008/09 it was unorderly changes in risk appetite—or, more precisely, risk aversion—that was the driving force of prices. It seems there is such a thing as a “global collective mind” when it comes to risky assets and the rapidly increasing aversion thereof. In a sense, the global investor community resembles “The Borg.”

Given that we live in a correlation 1.0 world (as in Thomas Friedman’s “The world is flat”), diversification is not as useful as the financial text books suggest. Whether diversification is the only and last free lunch is open to debate. For arguing that diversification is a free lunch we first need to accept that volatility is an intelligent and meaningful proxy for risk; which we think it isn’t.

Chart 2: Underwater perspective absolute versus relative return approach



Source: IR&M, Bloomberg

Financials: S&P 500 Global 1200 Financials; Hedge funds: HFRI Fund Weighted Composite Index; August 2010 inclusive. The dotted line shows an estimated path for recovery assuming 6% compound annual growth rate.

Absolute returns investors want to compound their capital positively. This means “risk” is simply the opposite, i.e., the prospect of compounding capital negatively. In other words, it is not volatility that matters, it is losses—or, more precisely, the avoidance thereof—that should be focus of the risk management process. It is sustainable and/or large losses that kill the rate at which capital compounds. The

<sup>1</sup> Available on [www.ineichen-rm.com](http://www.ineichen-rm.com)

<sup>2</sup> Note that extremely *high* correlation could be a function of *illiquidity* too. In a cataclysmic event liquidity of otherwise uncorrelated assets can dry up all at once with everyone trying to liquidate at the same time; hence high correlation.

**The Borg: a fictional pseudo-race depicted in the Star Trek universe. The Borg manifest as cybernetically enhanced humanoid drones of multiple species, organized as an interconnected collective, the decisions of which are made by a hive mind.**

unhedged investment style represented through the dark line in Chart 2 has compounded at -0.1% from January 2000 to August 2010 while the hedged investment style compounded at 6.1%. At the risk of sounding repetitious, we believe this to be a big difference. If all goes well and everything compounds at 6% the unhedged investment style will reach high water mark during 2022 while the hedged investment style should reach high water mark in H1 2011. We think this is a big difference too.

### **Bottom line**

Losses are not good for both, one's investment capital and one's mental capital. Large losses should be avoided at all cost.

Speaking of cost: If diversification doesn't work, the next best thing to reduce risk, is to hedge. The choices to the institutional investor are twofold:

- Do-it-yourself, or
- Outsource.

An institutional investor's allocation to say an equity long/short manager is essentially a form of outsourcing risk management: It is the long/short manager who is closer to the market and therefore should have an edge with regard to fundamentals, sentiment, and idiosyncratic market technicalities over the allocator. If these capabilities are internally available at the same quality and same nimbleness but at a lower price (cost), in-sourcing is of course the way to go.

In the next section we examine whether the market is "talking" to us.

**Risk management can be outsourced. Risk management responsibility cannot.**

## What the market is telling us

***“Nobody can be blamed for trying to be optimistic; however, in the money management business, we have a fiduciary responsibility to be as realistic as possible about the outlook for the economy and the markets at all times.”***

—David Rosenberg<sup>1</sup>

- ***Some of the proxies for risk aversion have been increasing lately, somewhat similar to autumn 2007.***
- ***The lower the yield curves in the West-ex Japan, the higher is the probability that a Japan-like, deflationary environment is what we’re up against.***
- ***Inflation fears have been easing and don’t seem to be a big worry at the moment.***

In this section we look at some proxies for risk and what changes in these proxies might be telling us. Table 1 shows a selection of proxies for market risk. The St. Louis Fed’s Financial Stress Index (Bloomberg: SLF FSI Index) is a composite of interest rates, yield spreads, and other indicators, some of which are shown separately in Table 1. We use it as a composite risk gauge.

Table 1: Market risk proxies as of 10 September 2010

Market	Risk proxy	10-year*			2009																	2010				
		High	Low	Median	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10	Last				
Composite	St. Louis Fed Stress	5.01	-1.01	0.21	2.92	2.07	1.76	1.30	1.16	0.86	0.77	0.59	0.39	0.33	0.29	0.18	0.14	0.87	0.70	0.54	0.72	0.70				
Liquidity	LIBOR 1M OIS Spread	338	1	10	23	13	10	9	9	10	10	10	9	9	9	5	7	13	16	12	7	7				
	TED Spread	464	-6	30	89	53	42	30	22	18	24	21	20	18	14	14	19	38	36	31	17	17				
	Swap Spread (2Y)	158	10	42	56	40	40	35	34	32	34	33	29	27	24	18	24	47	35	17	17	19				
Credit	AAA Spread	298	63	156	233	190	184	170	172	173	178	181	149	166	160	149	148	173	173	179	179	169				
	HY Spread	2055	233	564	1201	1025	875	804	792	700	664	657	522	538	554	464	446	600	623	543	599	545				
	EmMa Spread	1037	111	298	606	494	457	408	375	324	321	319	256	278	268	205	217	307	319	270	292	269				
	CDX.NA.IG	279	29	61	162	137	131	111	119	103	108	106	86	97	92	88	92	113	123	104	114	105				
	iTraxx 5Y Europe	217	20	44	138	121	112	88	91	88	88	88	76	83	85	79	87	118	129	105	118	107				
	iTraxx 5Y E. Crossover	1150	150	327	811	724	712	613	599	570	522	540	432	454	464	427	426	559	575	481	531	482				
Sovereign (5Y CDS)	Greece	1037	5	13	161	151	131	106	111	119	140	190	281	398	376	341	722	689	910	759	943	910				
	Ireland	386	6	134	233	210	190	136	149	133	133	163	156	149	144	142	190	233	267	208	341	374				
	Portugal	451	4	8	79	80	68	47	54	49	56	71	91	160	165	142	280	306	311	225	334	327				
	Spain	275	3	4	90	92	80	59	66	68	70	87	111	124	135	119	159	214	265	176	244	234				
Rates	BBOX (swaption volat)	138	68	94	94	106	115	116	113	111	113	105	111	106	99	95	102	101	96	90	91	91				
Bonds	MOVE (bond volat)	265	51	103	124	165	163	139	131	114	114	86	108	86	81	85	86	112	90	78	104	105				
Equities	VIX (equity volat)	81	10	21	37	29	26	26	26	26	31	25	22	25	20	18	22	32	35	24	26	23				
	S&P 500 trailing P/E	27.8	10.0	17.8	14.2	15.0	15.8	17.0	18.4	20.5	20.2	21.4	17.9	17.1	17.5	17.0	17.1	15.6	13.7	14.5	13.8	14.5				
FX	S&P 500 current DY	3.9	1.8	2.0	2.7	2.5	2.5	2.3	2.2	2.1	2.2	2.1	2.0	2.1	2.0	1.9	1.9	2.1	2.2	2.1	2.2	2.1				
	VXY (G7 FX volat)	24	6	10	14	15	14	13	13	13	14	14	13	12	12	11	11	14	14	11	13	12				

Source: IR&M, Bloomberg

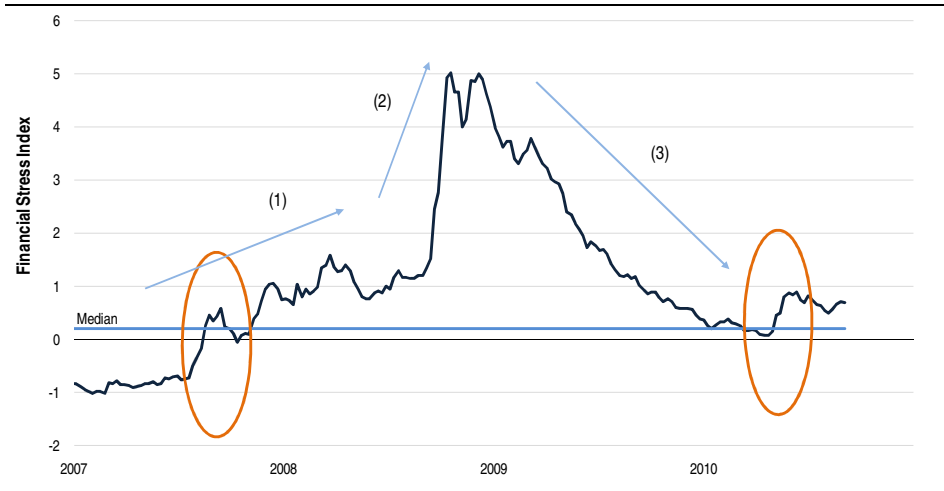
\* High, low and median are based on 10-year history or since available.

<sup>1</sup> Breakfast with Dave, Gluskin Sheff, August 24, 2010



- The St. Louis Fed's Financial Stress Index has been falling continuously to April, spiked in May a bit, fallen in June and July, and increased in August mainly due to falling interest rates. The May 2010 spike is nearly identical to a spike from October 2007 (see Chart 3 below). Most proxies eased a notch in the first days of September.
- Some risk managers pressed the panic button in May, taking off risk rather hastily.
- PIIGS spreads have widened lately. It seems a matter of time until the European debt situation is front-page news again. Irish bond spreads hit fresh peaks on 7 September, making the prospect of refinancing EUR26bn of bank paper this month a daunting task. The Finance Minister extended the guarantee for bank liabilities until year end, on fears, according to Reuters, that without the extension funds would be withdrawn.

Chart 3: St Louis Federal Reserve Bank Financial Stress Index as of 27 August 2010



Source: IR&M, Bloomberg

- The Stress Index shows a textbook pattern: (1) steady increase, (2) goes exponential (spikes), and (3) steady reversion to the mean/median.
- As every mariner knows, a quiet sea is just a storm in the making.<sup>1</sup> The pattern of the chart shows how apt this analogy is: A storm starts slow, the changing weather pattern revealing that something is brewing (1); the storm builds up and eventually—all of a sudden—reaches its apex, i.e., the peak of the “energy release” and destruction (2); and then calms down (3) and the quiet sea then is nothing else than the next storm in the making.

<sup>1</sup> See Absolute returns revisited, IR&M, April 2010, p47.

## Economic uncertainty

***“Things are getting better, except where they aren’t. The bailouts are working, except where they’re not. Things will slowly get better, unless they slowly get worse. We should know soon, unless we don’t.”***

—Thomas Friedman<sup>1</sup>

- ***“Throughout the summer, data signals have become more alarming. Current policy approaches here and abroad are unlikely to deliver a durable and robust U.S. recovery.”*** —Mohamed A. El-Erian, Pimco<sup>2</sup>
- ***US Banks continue to hoard cash.***
- ***Many proxies for business and consumer sentiment have risen to April/May 2010 but are now off those interim highs.***

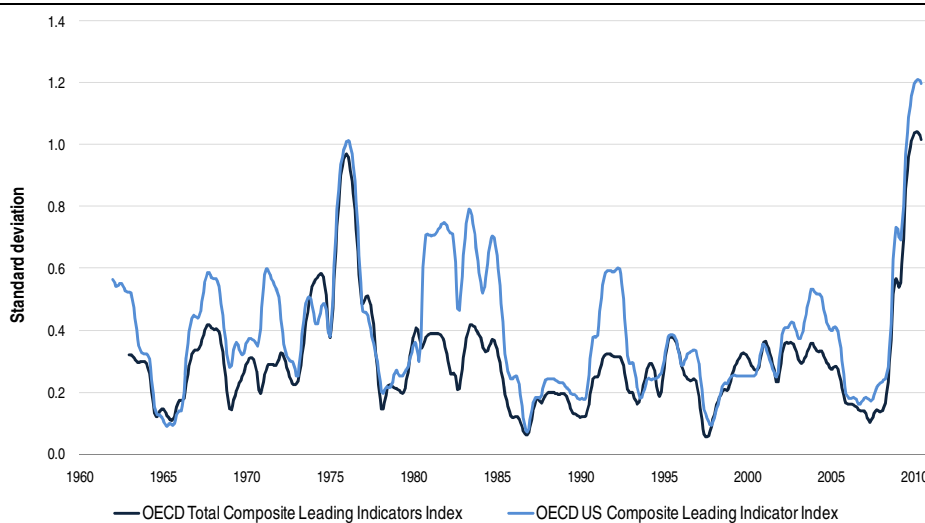
In this section we look at some economic variables. Again we look for change for the better or worse. The bottom line of this section is that many of these variables have been improving but now have reversed or stopped improving.

We quite often hear the notion that today’s investment landscape is difficult and that economic uncertainty is high. Chart 4 shows the standard deviation of two OECD leading indicators as a proxy for economic uncertainty. Based on this metric, economic uncertainty is indeed high.

***“All that makes earlier times seem simpler is our ignorance of their complexities.”***

—Thomas Sowell

Chart 4: Economic uncertainty measured by variability in the OECD leading indicator indices



Source: IR&M, Bloomberg

Lines show standard deviation over a rolling two-year period as of June 2010.

<sup>1</sup> Really Unusually Uncertain, New York Times, 17 August 2010

<sup>2</sup> Bloomberg, 27 August 2010

Table 2 shows some higher frequency proxies for economic health, mainly in the US, still the leading economy.

Table 2: Selection of leading indicators for economic growth/environment as of 10 September 2010

Economic proxy	2007-			Mai			June					July					August				September	
	High	Low	Median	W19	W20	W21	W22	W23	W24	W25	W26	W27	W28	W29	W30	W31	W32	W33	W34	W35	Last	
Average percentile (1-6)*	76	28	53	63	62	62	59	58	56	55	54	55	50	53	50	49	48	49	49	52	53	
G10 Surprise Index	59	-107	7	52	51	58	46	39	27	21	23	21	7	18	16	11	9	1	4	13	20	
US Yield curve (10-2Y)	291	-15	185	267	247	253	248	251	251	246	235	243	234	241	236	231	214	212	210	219	220	
ECRI Leading (Growth)	28	-30	-3	12.3	9.0	5.0	0.1	-3.8	-6.0	-7.4	-8.4	-9.3	-9.9	-10.7	-11.0	-10.7	-10.2	-10.0	-9.9	-10.1	-10.1	
ABC News Cons Comfort	2	-54	-45	-47	-44	-45	-44	-43	-45	-43	-41	-42	-44	-45	-48	-50	-47	-45	-44	-45	-43	
Cons Discret vs. Staples	1.16	0.57	0.86	0.93	0.91	0.94	0.93	0.94	0.93	0.91	0.87	0.88	0.87	0.89	0.89	0.90	0.88	0.88	0.88	0.90	0.89	
US Jobless claims	651	296	454	446	474	463	459	459	476	459	475	458	427	468	460	482	488	504	478	478	451	
CRB RIND	526	316	474	490	483	481	469	476	476	483	473	473	470	476	487	498	498	500	503	510	512	
Dr. Copper	408	125	314	312	305	310	281	290	288	309	290	304	292	319	331	334	325	329	336	349	343	
Oil	145	34	75	72	70	74	72	74	77	79	72	76	76	79	81	75	73	75	75	75	76	
Baltic Dry Index	11793	663	3888	3929	3844	4078	3844	3288	2694	2501	2280	1902	1720	1826	1967	2030	2468	2756	2712	2876	2988	
Cash US Banks %	12.9	3.2	7.7	11.8	11.7	11.5	11.1	11.8	11.1	11.9	10.8	11.8	11.6	11.8	12.0	11.7	12.1	11.6	11.9	11.9	11.9	

Source: IR&M, Bloomberg

\* For "Average percentile (1-6)" we measure the percentile since 2007 and then average the first six line items to get a feel for the trend.

Notes: "W33" stands for the 33<sup>rd</sup> week in 2010. "Last" shows the latest figure and, in some cases where frequency is not daily but weekly, is the same as the week before.

"Cons Discret vs. Staples" stands for the relative performance between S&P 500 Consumer Discretionary and Consumer Staples. In an economically deteriorating environment the former typically underperforms the latter. "CRB RIND" is the Commodity Research Bureau/Reuters US Spot Raw Industrials index. This spot market price index is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions.

- The top line (average percentile) has been deteriorating throughout the summer and has been more or less stable through to August and ticked up a notch in the past two weeks.
- The ECRI Leading Growth Index has collapsed over the past months.
- New Jobless Claims in the US have—as Dennis Gartman from The Gartman Letter keeps pointing out—a good track record of spotting turning points. They have been turning for the better every time in the post-WWII era and they have turned in the spring of 2009. The measure has been going sideways more or less all year while surprising negatively in week #33 and positively on 9 September.
- The Commodity Research Bureau/Reuters US Spot Raw Industrials index (CRB RIND) suggests all is fine in the world; thus being somewhat inconsistent with some other proxies. The CRB Raw Industrials index is just 3% from an all time record high. The index includes copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, hogs, lard, steers, tallow, butter, soybean oil, corn, wheat, and sugar. It seems there is deflation in things we own and inflation in things we need.
- The Baltic Dry Index, long a leading indicator, collapsed in H2 and has since recovered from the lows a bit. Economic perma-bulls argue that the index has lost its predictive power because the movement of dry bulk cargo is supposedly less important in the current environment and because the demand/supply imbalance of barges of yesteryear has eased.
- US Banks continue to hoard cash.

Table 3 shows real annualised quarter-on-quarter GDP growth for a selection of economies compared to the highest and lowest figures since 2000.

Table 3: Real GDP QoQ (SAAR) as of 10 September 2010

	2000-		2005		2006				2007				2008				2009				2010	
	High	Low	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Median	8.5	-8.0	2.9	3.5	4.4	4.2	2.7	4.2	3.8	3.2	2.8	2.3	2.0	-0.1	-1.2	-6.6	-6.6	-0.1	1.4	3.2	2.5	3.7
US	8.0	-6.8	3.1	2.1	5.4	1.4	0.1	3.0	0.9	3.2	2.3	2.9	-0.7	0.6	-4.0	-6.8	-4.9	-0.7	1.6	5.0	3.7	1.6
China	13.0	6.0	9.8	9.9	11.4	11.5	10.6	10.4	13.0	12.6	11.5	11.2	10.6	10.1	9.0	6.8	6.2	7.9	9.1	10.7	11.9	10.3
Germany	9.0	-13.1	2.6	1.3	3.8	6.3	3.4	4.5	1.9	1.2	3.0	0.9	5.6	-2.8	-1.6	-8.5	-13.1	1.8	3.0	1.2	1.9	9.0
Japan	10.4	-16.6	2.7	1.1	-0.3	5.2	1.4	2.1	4.1	2.2	-0.7	1.7	0.6	-2.0	-5.4	-10.0	-16.6	10.4	-1.0	4.1	4.4	0.4
UK	4.9	-9.0	2.5	2.9	4.4	1.1	2.0	3.3	3.9	2.3	2.2	1.1	2.0	-1.1	-3.5	-8.1	-9.0	-2.8	-1.0	1.7	1.3	4.9
France	5.7	-6.3	2.3	2.3	2.6	4.3	0.2	2.5	3.3	1.9	2.6	0.8	2.0	-2.6	-0.8	-6.3	-5.8	0.6	1.1	2.3	0.7	2.5
Italy	5.6	-11.0	1.0	1.3	2.6	2.3	1.8	4.3	0.7	0.2	0.8	-1.7	1.7	-2.6	-4.4	-7.8	-11.0	-1.1	1.7	-0.4	1.6	1.5
Brazil	11.7	-12.6	-0.9	4.4	5.4	-0.1	8.5	5.6	7.3	4.8	5.4	9.8	6.0	4.8	6.9	-12.6	-5.9	6.0	9.0	9.3	0.0	5.2
Spain	6.2	-6.2	3.6	4.2	4.1	4.1	4.0	4.0	3.6	3.2	3.2	2.6	2.0	-0.2	-3.2	-4.2	-6.2	-4.1	-1.0	-0.7	0.6	0.7
Canada	6.8	-7.0	4.2	4.0	4.4	0.4	0.5	2.4	2.6	3.3	2.2	2.0	-0.7	-0.1	0.4	-3.1	-7.0	-2.8	0.9	4.9	5.8	2.0
India (2004-)	10.1	5.5	8.9	9.7	10.0	9.8	10.1	9.4	9.6	9.3	9.4	9.7	8.5	7.8	7.5	6.1	5.8	6.0	8.6	6.5	8.6	8.8
Russia	12.0	-11.0	6.0	7.8	7.3	8.1	8.2	8.9	8.1	8.6	8.2	9.2	9.1	7.7	6.4	-1.1	-9.3	-11.0	-8.6	-2.9	3.1	5.2

Source: IR&amp;M, Bloomberg

Source: US: Bureau of Economic Analysis; China: National Bureau of Statistics; Japan: Bloomberg; Germany, UK, France, Italy, Spain: Eurostat; Brazil: IBGE; Canada: STCA; India: India Central Statistical Organization; Russia: Federal Service of State Statistics.

Note: China, India, Russia are shown on a year-on-year basis.

- The world is flat; here shown in red around Q4 08 and Q1 09.
- All economies have recovered since the lows; albeit from different levels and at different speeds.
- This trend stalled in Q1 10 but picked up pace in Q2 mainly due to weak-currency benefits in the northern European economies.
- Japan disappointed on 16 August with a negative figure for Q2.

Table 4: Leading (monthly) indicators as of 10 September 2010

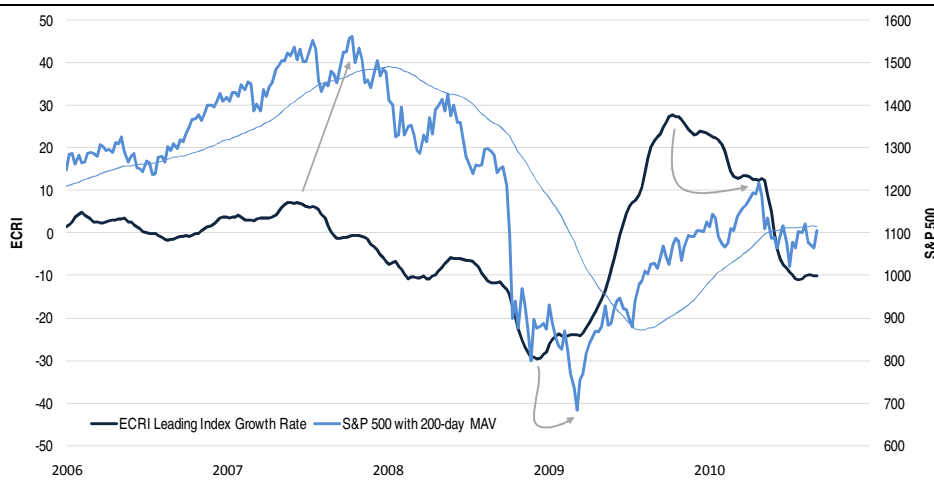
	1980-		2008		2009																	2010						
	High	Low	12 08	01 09	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10						
OECD Composite	103.5	91.3	92.2	91.5	91.4	91.7	92.6	93.7	95.0	96.3	97.6	98.7	99.8	100.7	101.5	102.2	102.8	103.2	103.4	103.5	103.4	n.a.						
US: LEI YOY	14.2	-11.0	-4.3	-4.2	-4.3	-4.6	-3.4	-1.9	-1.3	0.9	2.2	3.4	4.9	6.7	8.0	8.9	9.9	11.6	10.4	9.3	8.3	7.1						
US: OECD	105.2	89.8	91.4	90.3	89.8	90.0	90.7	91.9	93.2	94.6	96.0	97.2	98.4	99.5	100.5	101.4	102.2	102.7	103.1	103.1	103.0	n.a.						
Eurozone	104.4	91.5	91.8	91.5	91.6	92.3	93.3	94.6	96.1	97.5	98.9	100.1	101.1	101.9	102.6	103.2	103.6	104.0	104.2	104.3	104.4	n.a.						
China: NBS (1996-)	112.1	96.9	98.0	98.6	99.0	100.0	101.0	102.0	102.6	103.4	104.2	105.0	105.8	105.4	105.4	104.7	105.1	104.5	104.2	103.3	102.8	102.1						
China: OECD (1983-)	107.2	93.5	93.8	94.7	96.0	97.4	98.8	100.0	101.1	102.0	102.7	103.2	103.6	103.8	103.9	103.8	103.7	103.4	103.1	102.7	102.3	n.a.						
Germany	106.8	87.0	88.5	87.6	87.4	88.0	89.2	90.9	92.7	94.6	96.4	97.9	99.3	100.5	101.6	102.6	103.6	104.6	105.5	106.2	106.8	n.a.						
Japan: ESRI	104.5	69.1	78.7	76.2	74.1	75.5	76.6	77.7	80.9	82.8	84.0	87.2	88.9	91.0	94.2	96.9	98.1	101.9	101.7	98.6	99.0	98.2						
Japan: OECD	107.0	91.0	93.6	92.2	91.3	91.0	91.3	92.1	93.1	94.3	95.5	96.7	98.0	99.2	100.3	101.3	102.1	102.6	102.9	103.0	103.1	n.a.						
United Kingdom	104.4	93.2	93.4	93.2	93.3	93.8	94.6	95.7	97.0	98.4	99.8	101.2	102.3	103.1	103.8	104.1	104.4	104.4	104.2	103.9	103.5	n.a.						
France	104.9	93.6	93.6	93.8	94.4	95.3	96.4	97.7	98.9	100.2	101.5	102.6	103.6	104.3	104.8	104.9	104.7	104.4	103.9	103.3	102.7	n.a.						
Italy	105.4	91.7	91.7	92.0	92.7	93.8	95.2	96.9	98.6	100.2	101.5	102.6	103.5	104.1	104.5	104.6	104.6	104.5	104.3	104.2	104.1	n.a.						
Spain	104.5	92.4	92.5	92.4	92.7	93.3	94.4	95.6	96.8	98.1	99.3	100.2	101.1	101.7	102.3	102.9	103.4	103.8	104.0	104.1	104.1	n.a.						
Brazil (1989-)	111.6	84.3	85.2	84.3	84.7	86.1	88.2	90.5	92.8	94.7	96.2	97.4	98.4	99.0	99.5	100.0	100.4	100.7	100.9	101.0	100.9	n.a.						
Australia	105.6	92.5	97.7	97.0	96.3	95.9	95.7	95.7	95.9	96.5	97.1	97.9	98.7	99.4	100.0	100.6	101.0	101.3	101.5	101.5	101.5	n.a.						
South Korea (1990-)	111.1	89.1	91.7	93.2	95.0	97.0	98.9	100.6	101.9	102.9	103.7	104.3	104.7	104.8	104.7	104.5	104.2	103.9	103.6	103.5	103.5	n.a.						
Canada	106.3	87.7	91.5	90.6	90.3	90.7	91.6	93.0	94.6	96.4	98.0	99.5	100.7	101.8	102.6	103.3	103.8	104.1	104.1	104.0	103.7	n.a.						
India (1994-)	104.8	94.7	94.8	95.2	95.9	96.7	97.7	98.6	99.3	100.0	100.4	100.8	101.2	101.5	101.8	101.9	101.8	101.6	101.3	100.9	100.5	n.a.						
Russia (1992-)	108.4	86.4	87.7	86.6	86.4	86.9	88.1	89.8	91.8	93.9	95.9	97.5	98.7	99.6	100.3	100.8	101.3	101.6	101.9	102.2	102.3	n.a.						
Mexico (1982-)	109.2	82.1	93.5	93.7	94.1	94.9	95.9	97.0	98.4	99.9	101.4	102.7	103.6	104.1	104.3	104.2	103.9	103.5	103.3	103.2	103.2	n.a.						
Greece	104.7	97.2	98.3	97.9	97.7	97.6	97.8	98.1	98.5	98.9	99.2	99.4	99.5	99.5	99.4	99.2	98.9	98.7	98.3	98.0	97.7	n.a.						
Portugal	105.9	90.8	92.7	91.6	91.0	90.8	90.9	91.5	92.3	93.4	94.9	96.4	97.7	98.9	100.1	101.1	101.9	102.4	102.6	102.7	102.5	n.a.						
Ireland	106.6	94.8	96.3	95.6	95.1	94.9	94.8	95.0	95.2	95.3	95.5	95.6	95.8	96.0	96.5	97.2	98.0	98.7	99.4	100.0	100.5	n.a.						

Source: IR&amp;M, Bloomberg

OECD Composite, Eurozone, Germany, UK, France, Italy, Spain, Brazil, Australia, South Korea, Canada, India, Russia, Mexico: OECD (CLI amplitude adjusted); US: Conference Board and OECD; China: NBS and OECD; Japan: Economic and Social Research Institute (ESRI) and OECD.

- Most of the (so called) leading indicators have either stopped rising or falling slightly since May.
- China seems to have some leading indicator properties in the most recent past. The leading indicators in Table 4 peaked early. Also, the stock market fell first in 2008 and started to recover before other major stock markets followed suit in March 2009. The stock market also peaked in August 2009, i.e., eight months before other stock markets.

Chart 5: ECRI Weekly Leading Index Growth Rate vs. S&amp;P 500 Index as of 3 September 2010



Source: IR&M, Bloomberg

- It seems leading indicators are lagging other metrics. The ECRI Leading Growth index peaked last October and has been in decline more or less ever since. Chart 5 shows the ECRI Weekly Leading Index Growth Rate with the S&P 500 Index.

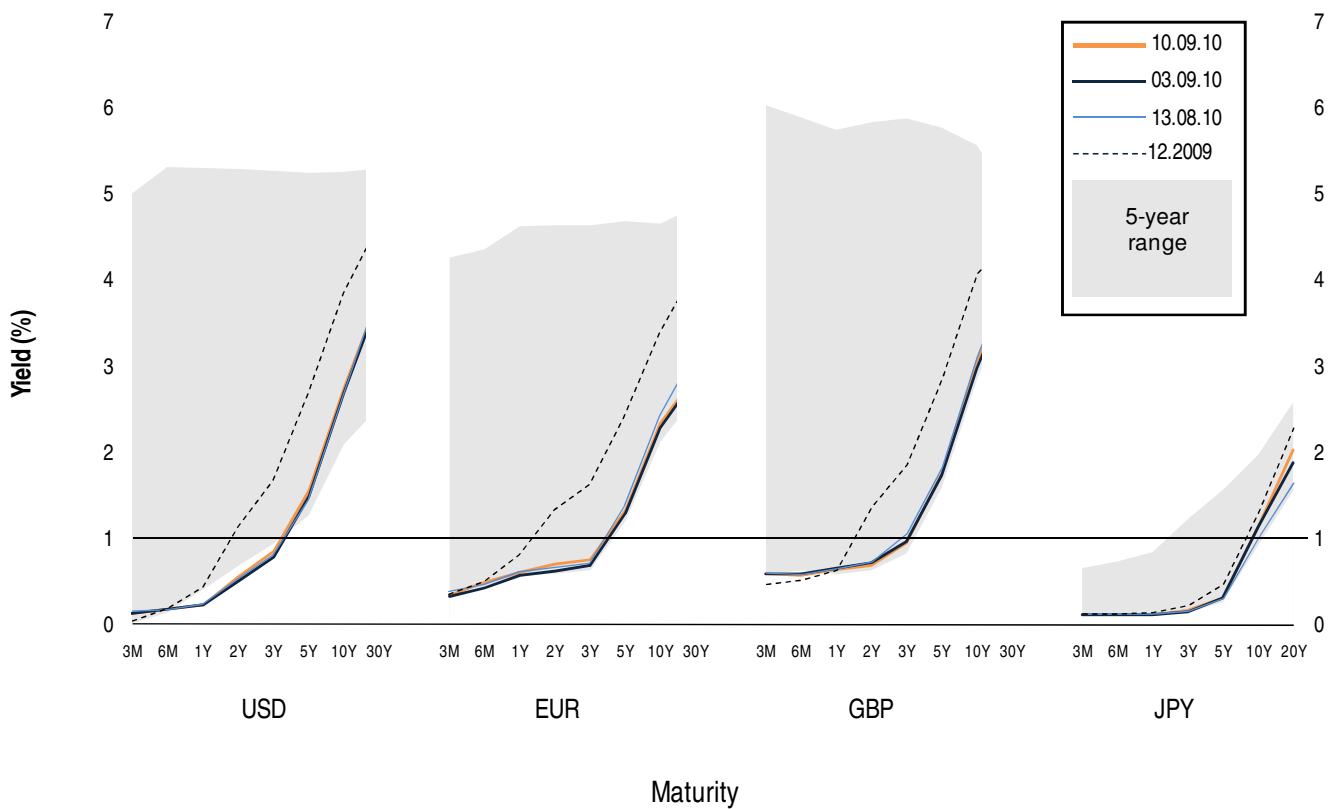
## Inflation versus deflation

The ongoing debate regarding inflation or deflation is interesting and—unfortunately—is not going to be solved here. We lean toward the belief of deflation being a problem first while potential inflation being a problem further down the road. As Niall Ferguson pointed out, only one major economy has ever escaped from a debt burden similar to the size of the projected US debt burden without either defaulting or inflating, and that was Britain between 1815 and 1914, where circumstances were materially different than in the US today.<sup>1</sup>

Chart 6 shows current USD, EUR, GBP, and JPY yield curves relative to one week ago, one month ago, end of 2009 and 5-year range.

<sup>1</sup> Ferguson, Niall (2010b) "History in the Making: Lessons and Legacies of the Financial Crisis," CFA Institute, September.

Chart 6: Yield curves as of 10 September 2010



Source: IR&M, Bloomberg

- Yield curves have been falling relentlessly this year, even in places where one might have thought that they cannot fall any further. The short end of the curve remains low and static and will, according to most market pundits, remain so (i.e., will be kept low) for the indefinite future.
- The lower the yield curves in the West-ex Japan, the higher is the probability that a Japan-like, deflationary environment is what we're up against.

Table 5 shows a selection of breakeven yields (nominal yield minus real yield of inflation-linked bond). The yields shown are therefore the market's implied inflation rate for the given maturities. We have added US 10-year Treasury as ultimate risk gauge on prices.

Table 5: Breakeven yields as of 10 September 2010

	2007-		2009										2010									
	High	Low	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10	Last
Median	2.72	-1.05	0.25	0.49	0.80	1.22	1.19	1.04	1.02	1.21	1.41	1.34	1.43	1.42	1.53	1.56	1.48	1.04	0.88	0.89	0.85	0.95
US: 1Y	4.25	-7.14	-1.08	-0.10	-1.06	-0.28	-0.37	0.08	-0.67	-0.52	-0.18	0.86	0.68	1.27	1.53	1.35	1.33	0.12	-0.04	0.24	0.02	0.09
US: 2Y	2.94	-6.95	-1.48	-0.60	-0.31	0.23	0.21	0.48	-0.04	0.30	0.62	1.02	1.30	1.42	1.42	1.56	1.48	0.60	0.51	0.75	0.51	0.53
US: 5Y	2.72	-0.86	0.25	0.49	0.80	1.53	1.35	1.34	1.02	1.21	1.53	1.67	1.95	1.84	1.70	1.81	2.02	1.67	1.48	1.46	1.17	1.23
US: 5Y	2.61	-0.02	0.99	1.31	1.47	1.84	1.77	1.77	1.66	1.77	2.02	2.12	2.41	2.32	2.16	2.26	2.40	2.05	1.84	1.77	1.55	1.74
Germany: 5Y (since 11.08)	1.57	0.28	0.35	0.95	1.00	1.22	1.19	1.04	1.17	1.35	1.41	1.34	1.43	1.22	1.02	1.54	1.40	1.04	0.88	0.89	0.85	0.95
Japan: 6Y (since 04.08)	0.60	-4.02	-2.75	-2.06	-1.76	-2.28	-2.40	-1.76	-1.64	-1.42	-1.42	-1.26	-1.11	-0.82	-1.06	-0.89	-0.74	-1.26	-1.01	-0.94	-0.97	-0.82
UK: 5Y	3.80	-1.05	1.14	1.18	1.52	1.63	1.62	1.83	1.83	1.84	2.22	2.07	2.30	2.50	2.66	2.66	3.00	2.49	2.40	2.16	2.03	2.22
US 10Y Govt Yield	5.29	2.05	3.01	2.66	3.12	3.46	3.53	3.48	3.40	3.31	3.38	3.20	3.84	3.58	3.61	3.83	3.65	3.28	2.93	2.91	2.47	2.74

Source: IR&M, Bloomberg

- Inflation fears have been easing and don't seem to be a big worry at the moment.
- It seems the inflation/deflation debate jumped from inflation to deflation in May this year.

## Sentiment

The next phase of the current crisis (we assume we're not yet over the hill) may begin when markets begin to reassess the credibility of the monetary and fiscal measures in the U.S. Neither interest rates at zero nor fiscal stimulus can achieve a sustainable recovery if the market collectively decides, that such measures will lead to much higher inflation or outright default. The long end of the yield curve as well as breakeven yields will need to serve as proxies for swift changes in market sentiment in that regard. Once the tide changes it is self-fulfilling prophecy that takes over: it is not the base supply of money that determines inflation but the velocity of its circulation, which in turn is a function of expectations and sentiment. In the same way, it is not the debt-to-GDP ratio that determines government solvency but the interest rate that investors demand.<sup>1</sup>

**“Financial history is generally a succession of sovereign debt crises.”**

—Niall Ferguson

Table 6 shows PMI data. (A PMI index over 50 indicates that the economy is expanding while anything below 50 suggests that the economy is contracting.) We can use the PMI as proxy for credit conditions. The strength or weakness in the PMI surveys is a function of credit conditions being perceived as favourable or not.

Table 6: PMI (Purchasing Manager Index) as of 10 September 2010

	2005-		2009												2010							
	High	Low	01 09	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10
Average	58.0	34.5	36.1	37.0	38.1	42.1	44.5	46.9	48.4	50.7	52.8	54.0	53.4	53.1	54.6	54.6	57.4	57.9	57.4	56.5	55.8	55.4
United States	60.4	32.5	35.5	35.7	36.4	40.4	43.2	45.3	49.1	52.8	52.4	55.2	53.7	54.9	58.4	56.5	59.6	60.4	59.7	56.2	55.5	56.3
Eurozone (3.2006-)	57.7	33.5	34.4	33.5	33.9	36.8	40.7	42.6	46.3	48.2	49.3	50.7	51.2	51.6	52.4	54.2	56.6	57.6	55.8	55.6	56.7	55.1
China (5.2005-)	59.2	38.8	45.3	49.0	52.4	53.5	53.1	53.2	53.3	54.0	54.3	55.2	55.2	56.6	55.8	52.0	55.1	55.7	53.9	52.1	51.2	51.7
Germany	61.5	32.0	32.0	32.1	32.4	35.4	39.6	40.9	45.7	49.2	49.6	51.0	52.4	53.7	57.2	60.2	61.5	58.4	58.4	61.2	58.2	
Japan	57.0	29.6	29.6	31.6	33.8	41.4	46.6	48.2	50.4	53.6	54.5	54.3	52.3	53.8	52.5	52.4	53.8	54.7	53.9	52.8	50.1	
UK (3.2006-)	58.0	34.5	35.8	34.7	39.5	43.1	45.4	47.4	50.2	49.7	49.9	53.4	51.8	54.6	56.6	56.5	57.3	58.0	58.0	57.6	56.9	54.3
France (3.2006-)	57.2	34.8	37.9	34.8	36.5	40.1	43.3	45.9	48.1	50.8	53.0	55.6	54.4	54.7	55.4	54.9	56.5	56.6	55.8	54.8	53.9	55.1
Italy (3.2006-)	57.5	34.6	36.1	35.0	34.6	37.2	41.1	42.7	45.4	44.2	47.6	49.2	50.1	50.8	51.7	51.6	53.7	54.3	54.0	54.3	54.4	52.8
Brazil (4.2007-)	57.8	38.1	38.1	41.6	42.2	44.8	47.8	48.1	48.0	50.6	52.3	53.7	55.5	55.8	57.8	55.8	55.4	53.8	52.4	52.7	51.8	49.5
Canada	75.0	36.1	36.1	45.2	43.2	53.7	48.4	58.2	51.8	55.7	61.7	61.2	55.9	48.4	50.8	51.9	57.8	58.7	62.7	58.9	54.0	65.9
Switzerland	67.0	31.7	35.8	33.4	33.9	37.1	40.0	43.7	43.8	48.4	55.7	54.5	54.7	49.8	56.0	57.6	66.5	66.9	65.6	67.0	65.1	60.2

Source: IR&M, Bloomberg

US: ISM; China: NBS; Eurozone, Germany, UK, France, Italy: Markit; Japan: Markit/Nomura; Brazil: NTC Economics; Canada: Ivey; Switzerland: Credit Suisse

Notes: One month lag.

- Colour-coding of a selection of PMI indices shows the pattern of going from cataclysmically bad to moderately high in a reasonably short period and in a synchronised fashion.
- The peak of the average PMI was in April and has been in decline ever since. However, the PMI indices are still all above 50 in most cases, suggesting positive growth. Brazil, somewhat surprisingly, fell below 50 with Japan just a tick above. Canada surprised on the upside.

Table 7 and Table 8 below show business climate and consumer sentiment based on surveys.

<sup>1</sup> We have written a lot over the years about non-linearities in finance, the importance of history, complexity, critical state, chaos, accidents, and collapse. We recently came across an article we would like to have written ourselves: “Complexity and Collapse—Empires on the Edge of Chaos,” by Niall Ferguson. We recommend googling this article which appeared in *Foreign Affairs* this year.



Table 7: Business climate as of 10 September 2010

	10-year		2009												2010							
	High	Low	01 09	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10
Percentile	100	0	9.7	5.5	7.7	21.3	28.8	34.3	38.0	46.1	52.2	54.8	56.2	56.0	59.8	60.2	65.1	73.0	71.9	69.0	65.7	64.7
<i>Monthly surveys:</i>																						
US: AIM	63.3	33.3	36.7	33.3	33.5	35.4	39.0	38.2	40.1	40.6	42.4	43.3	44.9	45.7	45.8	44.1	46.8	47.5	51.5	53.7	48.5	47.7
US: NFIB (small biz)	107.7	81.0	84.1	82.6	81.0	86.8	88.9	87.8	86.5	88.6	88.8	89.1	88.3	88.0	89.3	88.0	86.8	90.6	92.2	89.0	88.1	n.a.
US: Empire State	40.6	-32.3	-25.8	-31.6	-32.3	-14.6	-5.6	-9.5	-0.8	10.2	16.7	33.4	22.3	4.5	15.9	24.9	22.9	31.9	19.1	19.6	5.1	n.a.
US: Philadelphia Fed	37.1	-38.8	-29.6	-36.1	-31.4	-22.3	-21.7	-5.0	-8.9	0.0	10.5	11.8	18.8	22.5	15.2	17.6	18.9	20.2	21.4	8.0	5.1	-7.7
US: Richmond Fed	30.0	-55.0	-49.0	-51.0	-20.0	-9.0	4.0	6.0	14.0	14.0	14.0	7.0	1.0	-4.0	-2.0	2.0	6.0	30.0	26.0	23.0	16.0	11.0
US: Dallas Fed	47.7	-58.9	-51.5	-55.6	-51.4	-36.2	-31.3	-22.5	-22.7	-9.3	-6.6	-5.3	-1.1	3.2	8.3	-0.1	7.2	21.1	2.9	-4.0	-21.0	-13.5
Eurozone: Economic	112.4	70.6	72.7	71.2	70.6	73.0	75.6	78.3	80.8	84.8	86.7	89.6	91.9	94.1	96.0	95.9	97.9	100.6	98.4	98.9	101.1	101.8
Eurozone: Business	1.5	-3.7	-3.1	-3.6	-3.7	-3.4	-3.2	-2.9	-2.6	-1.9	-1.8	-1.5	-1.2	-0.8	-0.7	-0.5	-0.1	0.3	0.4	0.4	0.6	0.6
Germany: ZEW	73.4	-63.9	-31.0	-5.8	-3.5	13.0	31.1	44.8	39.5	56.1	57.7	56.0	51.1	50.4	47.2	45.1	44.5	53.0	45.8	28.7	21.2	14.0
Germany: IFO	108.9	82.3	83.1	82.8	82.3	83.7	84.4	86.1	87.4	90.5	91.4	92.0	93.9	94.7	96.0	95.4	98.3	101.7	101.6	101.9	106.2	106.7
UK	114.7	65.4	68.5	65.6	65.4	69.9	73.6	75.9	79.8	87.7	88.1	91.3	88.9	95.0	98.2	98.3	100.9	101.7	102.4	99.4	100.8	102.3
France	113.0	70.0	75.0	71.0	70.0	75.0	76.0	79.0	80.0	83.0	86.0	87.0	88.0	88.0	91.0	90.0	93.0	96.0	97.0	96.0	98.0	n.a.
Italy	112.4	71.1	76.0	73.7	71.1	74.5	77.6	78.0	80.0	85.8	85.3	86.9	89.3	92.0	93.2	94.4	94.9	96.1	96.5	96.2	98.3	100.5
Japan: Small biz	5.5	-44.6	-37.4	-44.6	-42.7	-23.2	-23.9	-17.5	-13.8	-20.8	-10.8	-16.2	-11.3	-13.2	-10.5	-10.2	-6.1	-8.3	-7.0	-0.9	-7.9	-9.1
South Korea	107.0	44.0	49.0	50.0	60.0	71.0	76.0	78.0	80.0	93.0	94.0	93.0	85.0	90.0	92.0	101.0	105.0	107.0	104.0	104.0	102.0	104.0
<i>Calendar quarterly with linear interpolation:</i>																						
China	146.0	105.6	106.5	106.1	105.6	109.0	112.5	115.9	118.7	121.6	124.4	126.5	128.5	130.6	131.4	132.1	132.9	133.9	134.9	135.9	n.a.	n.a.
Japan: Tankan	26.0	-58.0	-35.3	-46.7	-58.0	-54.7	-51.3	-48.0	-43.0	-38.0	-33.0	-30.0	-27.0	-24.0	-20.7	-17.3	-14.0	-9.0	-4.0	1.0	n.a.	n.a.
Brazil	68.7	45.5	48.1	48.7	49.4	52.3	55.3	58.2	60.8	63.3	65.9	66.8	67.8	68.7	68.1	67.5	66.9	66.6	66.3	66.0	n.a.	n.a.

Source: IR&amp;M, Bloomberg

US: AIM, NFIB (Small Business Optimism Index), NY Fed (since Aug 2004), Philadelphia Fed, Richmond Fed, Chicago Fed (Chicago Fed National Activity Index); Eurozone: EC (Economic Sentiment Indicator and Business Climate Indicator); UK: EC; Germany: ZEW, IFO; France: INSEE (conducted every month except August (no one around; hence linear interpolation)); Italy: ISEA; Japan: Japan Finance Corp for Small Business, Tankan; South Korea: BoK; Brazil: CNI

Note: Last percentile figure is based on latest figure from all monthly surveys.

- Business climate based on survey material—and generally speaking—has been improving up until April and since then has been in decline.
- The lower ZEW figure for Germany was largely ignored by the market place. However, the -7.7 figure of the Philadelphia Fed survey (together with disturbing jobless claim data) had a negative impact. The latest print from IFO (which was up and close to the highs from December 2006) for Germany is inconsistent with ZEW.

Table 8: Consumer confidence as of 10 September 2010

	2007-		2009												2010							
	High	Low	01 09	02 09	03 09	04 09	05 09	06 09	07 09	08 09	09 09	10 09	11 09	12 09	01 10	02 10	03 10	04 10	05 10	06 10	07 10	08 10
US: Conf Board	111.9	25.3	37.4	25.3	26.9	40.8	54.8	49.3	47.4	54.5	53.4	48.7	50.6	53.6	56.5	46.4	52.3	57.7	62.7	54.3	51.0	53.5
US: Michigan	96.9	55.3	61.2	56.3	57.3	65.1	68.7	70.8	66.0	65.7	73.5	70.6	67.4	72.5	74.4	73.6	73.6	72.2	73.6	76.0	67.8	68.9
Eurozone	-0.9	-34.2	-30.5	-32.9	-34.2	-30.5	-28.2	-25.1	-23.0	-22.0	-19.0	-18.0	-17.0	-16.0	-16.0	-17.0	-15.0	-18.0	-18.0	-17.0	-14.0	-11.0
China	113.7	100.3	101.3	101.0	100.3	100.5	101.2	101.0	102.1	102.7	102.8	103.2	103.3	103.9	104.7	104.2	107.9	106.6	108.0	108.5	107.8	n.a.
Germany	8.6	1.5	2.3	2.5	2.5	2.6	2.7	3.0	3.4	3.8	4.2	3.9	3.6	3.4	3.3	3.2	3.4	3.7	3.5	3.7	4.0	4.1
Japan	48.4	26.2	26.4	26.7	28.9	32.4	35.7	37.6	39.4	40.1	40.5	40.5	39.5	37.6	39.0	39.8	40.9	42.0	42.8	43.5	43.3	42.4
United Kingdom	-2.0	-39.0	-37.0	-35.0	-30.0	-27.0	-25.0	-25.0	-25.0	-25.0	-16.0	-13.0	-17.0	-19.0	-17.0	-14.0	-15.0	-16.0	-18.0	-19.0	-22.0	-18.0
France	-12.0	-46.0	-43.0	-44.0	-43.0	-40.0	-39.0	-36.0	-37.0	-36.0	-35.0	-34.0	-30.0	-31.0	-30.0	-33.0	-34.0	-37.0	-38.0	-39.0	-39.0	n.a.
Italy	-13.8	-31.9	-26.0	-28.0	-31.9	-23.5	-23.9	-20.4	-17.0	-15.0	-16.0	-18.0	-17.0	-16.0	-17.0	-22.0	-22.0	-21.0	-25.0	-22.0	-20.0	-21.0
Spain	-10.0	-47.6	-44.1	-47.6	-41.5	-36.7	-25.1	-22.2	-20.0	-20.0	-22.0	-21.0	-21.0	-18.0	-14.0	-19.0	-22.0	-20.0	-24.0	-25.0	-26.0	-20.0
Brazil	120.8	95.6	96.9	96.0	98.4	100.2	103.1	108.1	111.0	110.7	110.8	113.2	115.0	112.3	113.1	110.8	111.6	115.7	116.4	118.7	120.0	120.8
Canada	111.4	53.5	57.8	55.8	57.7	63.8	71.8	74.2	74.7	83.9	87.9	87.1	81.3	85.1	99.4	91.1	95.0	87.6	91.5	86.4	82.3	n.a.
Australia	24	-21	-10.0	-14.0	-14.0	-7.0	-11.0	0.0	9.0	13.0	19.0	21.0	18.0	14.0	20.0	17.0	17.0	16.0	8.0	2.0	n.a.	n.a.
South Korea	117	81	84.0	85.0	84.0	98.0	105.0	106.0	109.0	114.0	114.0	117.0	113.0	113.0	113.0	111.0	110.0	110.0	111.0	112.0	112.0	110

Source: IR&amp;M, Bloomberg

US: Conference Board; Eurozone, Italy, and Spain: EC; China: NBS; Germany and UK: GfK; Japan: Economic and Social Research Inst.; France: INSEE; Brazil: FGV; Canada and Australia: OECD

Note: Subject to one-month lag.

- Consumer sentiment has been improving; off the lows of the Great Recession but in many cases remains low by historical standards.
- In some of the cases shown in Table 8 consumer sentiment has been deteriorating since May/June. However, overall sentiment in the Eurozone has more or less gradually been improving.
- Consumer sentiment in Brazil reached a new all-time-high (measured since 2005).



## Time to go fishing?

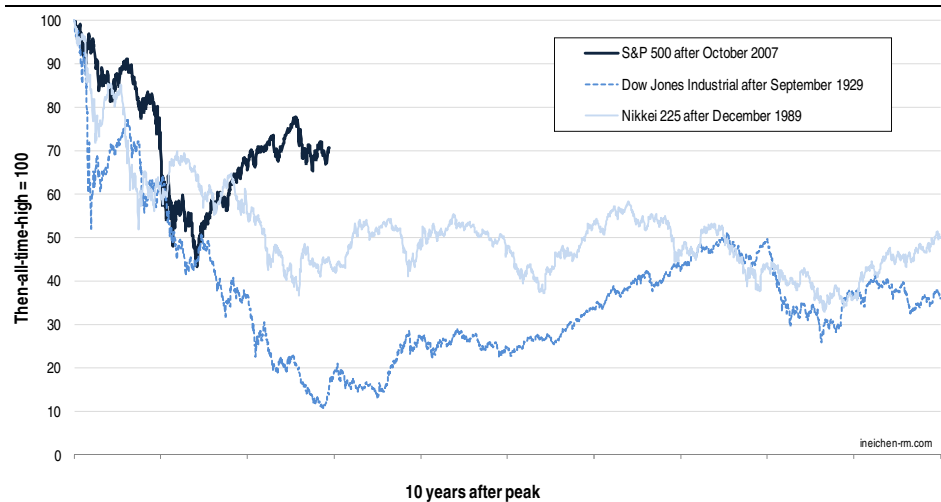
*“There’s a time to go long...there’s a time to go short...and there’s a time to go fishing.”*

—Jesse Livermore

- ***For equity investors, autumn has its’ perks. Many corrections occurred in autumn. Whether this will hold true in 2010 we do not know. However, self-fulfilling prophecy can work in mysterious ways.***
- ***We recommend hedging directional equity risk for a while. The institutional investor has various options to execute such a view, two of which are (i) replace long-only exposure through long/short exposure, (ii) hedge by using simple overlay strategies.***

In this section we show a more or less random selection of charts related to equity markets. Chart 7 shows current secular bear market relative to Great Depression and Japan’s Lost Decades.

Chart 7: S&P 500 relative to other secular bear markets as of 9 September 2010<sup>1</sup>



Source: IR&M, Bloomberg  
Then all-time-high was set to 100.

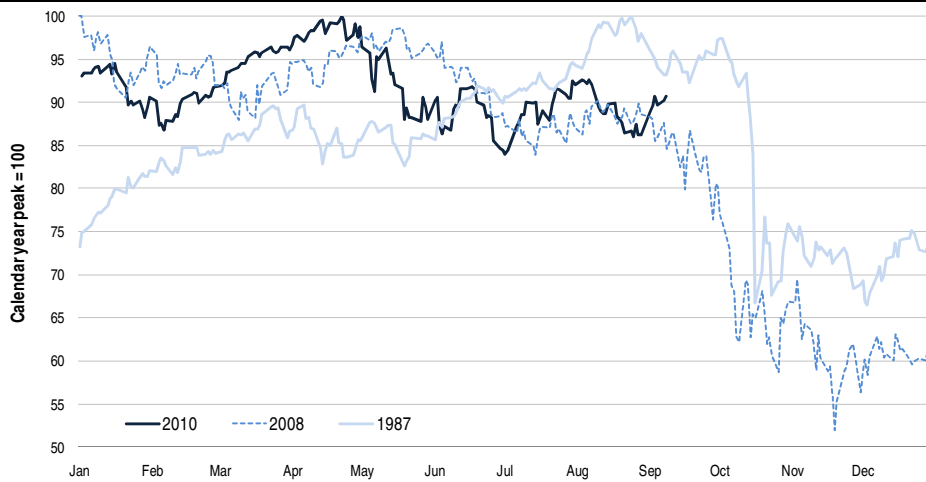
- Either things are not that bad or equity investors think things are not that bad.
- Risk to the absolute returns investor is not volatility (as in annual standard deviation of periodical returns) but compounding capital negatively for a very long time.

Chart 8 shows the S&P 500 (as a proxy for global equity markets in correlation 1.0 space) relative to 2008 and 1987.

<sup>1</sup> This graph is sometimes shown in real terms with the peak in the S&P 500 being in March 2000 and not, as shown here in nominal terms, in October 2007. The message is the same though, namely that secular bear markets are unpleasant and long.

**A random market movement causing the average investor to mistake himself for a financial genius.**  
—Alternative definition of an equity bull market

Chart 8: S&amp;P 500 relative to 2008 and 1987 as of 9 September 2010

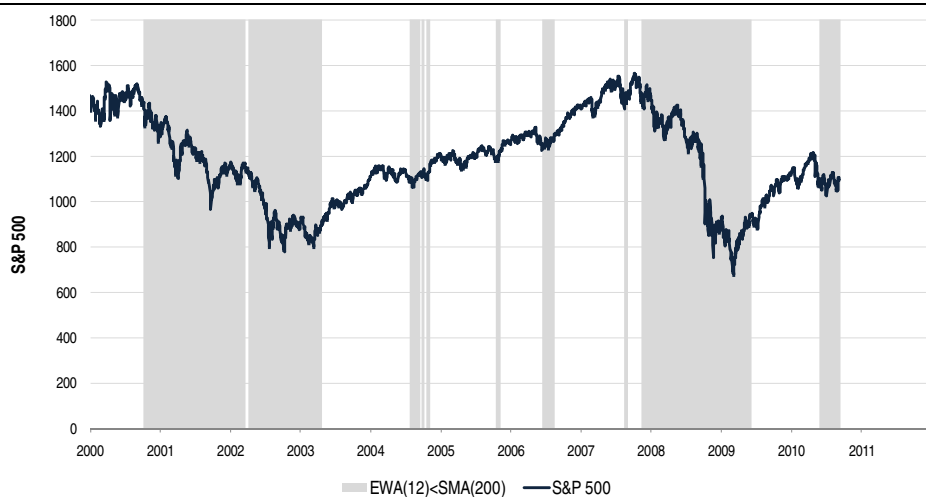


Source: IR&M, Bloomberg  
Calendar-year-high was set to 100.

- Equity markets tank in autumn every now and then. Whether at one stage this becomes a self-fulfilling prophecy we are uncertain; it could.
- A bull market is sometimes characterised as having higher highs and higher lows, whereas a bear market is characterised as having lower highs and lower lows. 2008 and 2010 resemble the latter.

As we pointed out in our April report, managed futures quite often have a positive return when the MSCI World experiences a negative return that is larger than 7%.<sup>1</sup> We believe some of the techniques from the managed future space can easily be applied to risk management, as a (tactical) overlay. The grey area in Chart 9 shows the periods where the 12-day exponentially weighted moving average (EWA) was below the famous 200-day simple moving average (SMA).

Chart 9: S&amp;P 500 as of 9 September 2010



Source: IR&M, Bloomberg

- No combination of moving averages is perfect. However, the combination shown in Chart 9 keeps the investor hedged (or out of the market) in

<sup>1</sup> Absolute returns revisited, IR&M, April 2010, p40.



# Performance and value proposition

*"The world is full of willing people, some willing to work, the rest willing to let them."*

—Robert Lee Frost (1874-1963), American poet

- **Recent hedge funds performance was sub-stellar. Neither the hedge fund industry nor equity long/short has reached its high-water mark.**
- **Investors are growing tired of hearing that the performance of hedge funds looks pretty good given circumstances. They shouldn't.**
- **Equity long/short seeks to benefit from opportunities within the equity market.**

In this section we examine recent performance, revisit the value proposition of equity long/short, and, in the next section, wonder whether the equity risk premium is a function of positive population growth.

The table below shows recent hedge fund performance by strategy for a selection of indices over the past 24 months with equity and a bond index as reference. The last column indicates whether the index has surpassed the high water mark set prior to the crisis.

Table 9: Recent hedge fund performance (August 2008 – July 2010)

	2008					2009												2010							YTD	-12M	-24M	HWM*
	08	09	10	11	12	01	02	03	04	05	06	07	08	09	10	11	12	01	02	03	04	05	06	07				
MSCI World TR Gross, USD	-1.4	-11.9	-18.9	-6.4	3.3	-8.7	-10.2	7.6	11.3	9.2	-0.4	8.5	4.2	4.0	-1.8	4.1	1.8	-4.1	1.4	6.2	0.1	-9.5	-3.4	8.1	-2.20	10.4	-12.9	N
BarCap Global Aggregate TR, USD	1.0	-1.4	-2.6	3.7	3.6	-0.9	-0.4	1.4	0.5	0.7	0.6	1.6	1.1	1.1	0.5	1.3	-1.6	1.5	0.4	-0.1	1.0	0.8	1.6	1.1	6.44	9.0	17.5	Y
HFRI FW Composite	-1.4	-6.1	-6.8	-2.7	0.2	-0.1	-1.2	1.7	3.6	5.1	0.2	2.5	1.3	2.8	-0.2	1.5	1.3	-0.8	0.7	2.5	1.2	-2.9	-0.9	1.7	1.34	8.3	2.2	N
HFRI FoHF Composite	-1.5	-6.5	-6.2	-2.6	-1.5	0.7	-0.4	0.0	1.1	3.3	0.4	1.5	1.1	1.7	-0.1	0.8	0.8	-0.4	0.1	1.7	0.9	-2.6	-0.9	0.9	-0.35	4.0	-8.0	N
CS Tremont Multi Strategy	-1.3	-7.3	-6.9	-4.6	-1.5	3.4	-0.1	0.4	2.2	4.3	1.6	3.0	1.4	2.9	1.1	1.0	1.2	0.6	0.6	1.4	1.0	-2.2	-0.8	1.7	2.15	10.1	1.8	N
HFRI Relative Value (Total)	-0.1	-5.9	-8.0	-2.8	-0.2	2.1	0.5	1.0	3.1	3.9	1.5	3.0	1.8	2.5	1.3	0.6	2.1	1.5	0.6	1.6	1.4	-1.8	0.4	1.8	5.65	14.5	11.4	Y
HFRI RV: CB Arbitrage	-1.1	-11.8	-16.0	-2.8	1.1	4.8	2.4	3.5	6.0	9.7	2.8	7.0	3.4	4.3	0.7	1.0	2.8	0.1	0.4	2.5	2.0	-2.7	0.1	2.5	4.81	18.2	20.9	Y
CS Tremont Fixed Income Arbitrage	-0.7	-6.8	-14.0	-5.6	-0.8	0.5	1.0	1.7	1.9	4.3	1.8	3.6	2.4	2.8	1.9	1.7	0.8	2.0	0.1	1.4	1.8	-0.8	0.9	1.2	6.79	17.4	1.4	N
HFRI Event Driven (Total)	-0.5	-6.0	-8.2	-3.7	-1.5	0.4	-1.4	1.3	3.2	4.7	1.5	2.8	2.3	3.8	0.5	1.3	2.4	0.7	0.8	3.0	1.8	-2.6	-1.1	2.3	4.81	15.9	6.8	N
HFRI ED: Distressed/Restructuring	-0.8	-5.9	-7.9	-5.2	-3.8	1.2	-1.6	-0.2	3.2	5.5	1.7	2.8	2.8	4.3	1.5	1.5	2.5	1.9	0.3	2.8	2.1	-2.2	-0.8	1.4	5.57	19.6	6.0	N
HFRI ED: Merger Arbitrage	0.3	-2.9	-2.5	-0.3	1.2	0.2	0.2	2.1	1.1	1.4	1.0	0.7	1.1	1.2	0.4	0.8	0.9	0.3	0.6	0.6	0.3	-1.2	0.2	1.3	2.01	6.5	9.2	Y
HFRI Equity Hedge (Total)	-2.2	-8.1	-9.5	-3.8	0.2	-0.9	-2.2	2.9	5.4	6.4	0.2	3.2	1.4	3.2	-0.7	1.6	2.1	-1.3	0.9	3.2	1.2	-4.0	-1.8	2.5	0.45	8.2	-1.8	N
HFRI EH: Quantitative Directional	-1.4	-7.5	-9.1	-3.7	0.8	-2.7	-4.0	2.7	4.7	3.6	0.5	3.1	1.1	2.3	-0.9	1.8	1.6	-2.1	1.2	2.6	0.3	-1.9	-2.3	3.0	0.61	6.6	-7.4	N
HFRI Equity Market Neutral	-1.4	-2.9	-0.5	0.0	-2.6	0.2	-0.9	0.1	-0.4	1.1	0.2	0.3	0.5	0.3	-0.1	-0.3	0.5	-0.2	0.4	0.6	-0.1	-0.7	-0.7	0.9	0.15	1.1	-5.7	N
Eurekahedge L/S North America	-0.6	-6.4	-6.2	-3.5	0.5	0.6	-2.4	3.0	4.5	4.8	0.7	2.7	1.5	3.0	-1.4	1.9	2.2	-1.4	1.7	2.9	1.9	-3.6	-2.4	2.3	1.15	8.6	5.4	Y
Eurekahedge L/S Europe	-1.8	-6.8	-5.8	-1.7	-1.6	-0.9	-1.0	1.9	4.6	4.7	-0.5	2.0	3.1	3.8	0.1	0.1	1.2	0.8	-0.4	3.0	0.5	-3.5	-1.0	1.5	0.81	9.4	1.2	N
Eurekahedge L/S Japan	-1.9	-2.6	-2.1	0.8	2.1	-1.4	-1.9	0.8	1.6	3.6	2.3	0.8	1.3	-0.3	-0.9	-2.1	1.4	0.9	-0.2	2.9	2.8	-3.2	-1.6	-0.2	1.22	0.5	2.4	N
Eurekahedge L/S Asia ex-Japan	-2.8	-6.6	-8.5	-1.1	3.2	-0.8	-1.0	3.7	5.5	9.8	1.6	6.1	-1.1	3.7	1.2	2.8	2.1	-2.4	0.2	3.4	0.8	-4.9	-0.1	2.6	-0.78	8.1	16.5	N
HFRI Macro (Total)	-1.2	-1.2	1.6	0.7	1.1	-0.1	-0.1	-0.6	-0.1	3.3	-1.2	0.5	0.4	1.7	-0.5	2.2	-1.3	-2.0	0.2	1.6	0.8	-1.3	-0.1	-0.2	-1.20	1.2	4.2	Y
CS Tremont Global Macro	-1.4	-6.6	-5.1	1.5	1.1	2.3	0.2	0.0	0.2	1.5	-0.8	1.8	0.9	2.8	0.2	3.5	-1.4	1.1	1.1	0.4	1.7	-0.6	0.6	0.7	4.88	11.2	4.9	Y
CS Tremont Managed Futures	-2.5	-0.6	5.0	3.2	2.4	-0.6	-0.2	-2.2	-3.2	0.9	-2.3	-0.4	0.9	3.0	-2.2	4.9	-5.0	-3.8	1.8	4.2	1.9	-4.0	0.4	-1.5	-1.24	0.1	-0.8	N
HFRI Emerging Markets (Total)	-4.9	-10.4	-14.4	-4.0	-0.4	-1.8	-1.3	4.3	7.7	9.6	0.7	4.5	1.4	5.5	1.1	1.5	1.7	-1.2	0.0	4.7	1.2	-5.4	-0.4	3.2	1.86	13.8	-0.4	N
HFRI EM: Asia ex-Japan	-4.2	-8.4	-11.0	-1.7	3.3	-1.3	-1.3	3.9	6.5	10.3	1.5	5.6	-1.0	4.1	0.3	2.2	2.1	-2.5	0.0	4.0	1.3	-5.2	-0.2	2.5	-0.49	7.4	8.5	N

Source: IR&M, Bloomberg

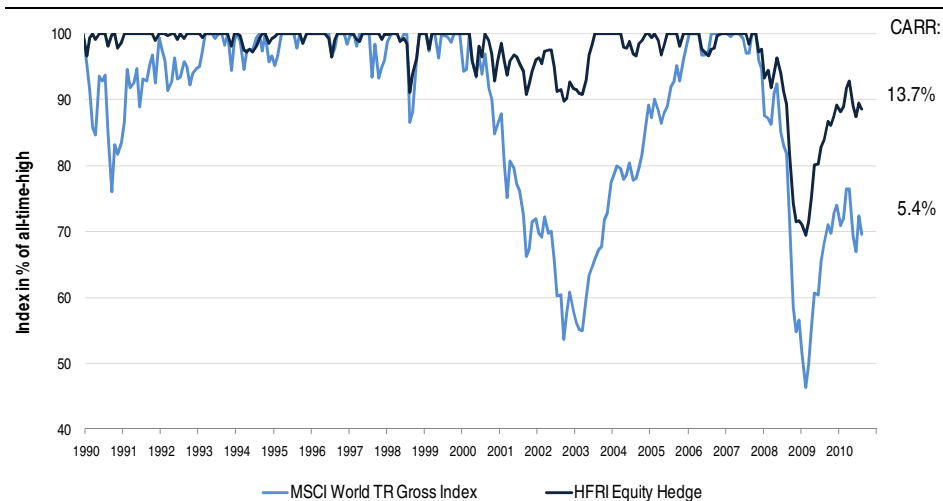
\* High water mark (HWM): Y = index has passed high of 2007-2008; N = index hasn't.

Note: Colour-coding for monthly returns is applied horizontally. We applied the colour-coding vertically for YTD, -12M and -24M returns, to show best and worst for the three given time frames.

- Most indices related to equity hedge have not yet reached their high-water mark. Note, as always, there is great dispersion around those index figures.
- Equity hedge has been a good substitute for long-only year-to-date (YTD) and over the past 24 months but not over the past 12 months.
- May 2010 was again a pretty bad month with correlation between the equity market and most hedge funds indices being very close to 1.0.

It has been clear (to mainly non-hedge fund financial professionals) that the term “alpha” mutated into a marketing term some time ago. It is now increasingly becoming apparent to everyone that the marketing one-liner of hedge funds in general having low correlation to equity markets doesn’t hold up very well with market reality either. This idea plus the (revisited) value proposition of equity long/short can be shown in the chart below.

Chart 12: HFRI Equity Hedge versus MSCI World as of August 2010



Source: IR&M, Bloomberg

CARR: Compound annual rate of return

- The correlation between equity and equity hedge is close to 1.0 in most market dips since the start of time (which in HFRI space is 1990); especially in the period since 2000 which we believe is best characterised as the institutionalisation of the hedge fund industry and is therefore the more relevant period for the institutional investor.
- It is the magnitude of the losses that are the big difference between an investment style on autopilot and an active risk management process in absolute return space.<sup>1</sup> It is losses—especially large ones—that kill the rate at which capital compounds.

<sup>1</sup> Note that when we delever the long-only investment in Chart 12 to 58% for the two investments to have the same volatility, the compounding rate of the long-only investment falls from 5.4% to 3.5%.

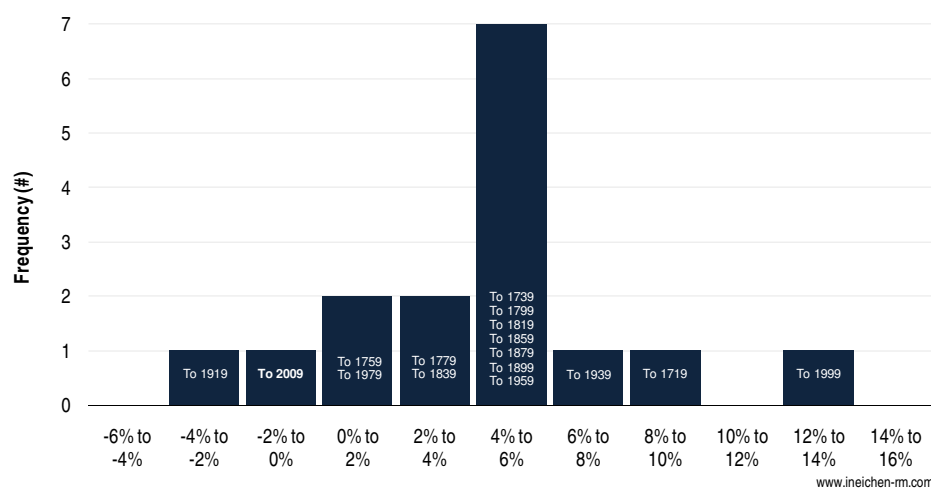
## Equity hedge value proposition briefly revisited

We have started avoiding the term “alpha” in relation to hedge funds in 2001.<sup>1,2</sup> We argued then that skill-based strategies are different from market-based strategies. Hedge funds are involved in the former. The return is a function of skill exploiting investment opportunities and skill preserving capital if something goes wrong. (Note that we never said it was easy.<sup>3</sup>) The idea is to compound capital positively. Given that it is large losses that kill the rate at which capital compounds, active risk management is the key discipline.<sup>4</sup> Even with the gloss of marketing one-liners such as “low correlation to equity markets” or “hedge funds can make money under all market conditions” gone, we believe equity hedge still has a powerful value proposition. The idea goes back to the origins of hedge funds; to 1949 and the Jones model.

Alfred Jones merged two speculative tools, short sales and leverage. Short selling was employed to take advantage of opportunities. Jones used leverage to obtain profits, but employed short selling through baskets of stocks to control risk. Jones’ model was devised from the premise that performance depends more on stock selection than market direction. He believed that during a rising market, good stock selection will identify stocks that rise more than the market, while good short stock selection will identify stocks that rise less than the market. However, in a declining market, good long selections will fall less than the market, and good short stock selection will fall more than the market, yielding a net profit in all markets. To those investors who regarded short selling with suspicion, Jones would simply say that he is using “speculative techniques for conservative ends.”

Throughout the 1980s and 1990s no one really cared about long/short. No one needed to, as equity markets kept going up. Chart 13 shows these two decades in relation to the “long-term”.

Chart 13: Annualised 20-year real total return of UK equities (1700 – 2009)



Source: IR&M, Bloomberg, Global Financial Data

Note: “To 2009” marks the ten year period from 2000 to 2009

<sup>1</sup> See Ineichen, Alexander (2001) “The Search for Alpha Continues,” Global Equities, UBS Warburg, September.

<sup>2</sup> That said, we dropped the term “alpha” from our publication titles much later. Alpha is such a positive term. The term alpha is to the investment management profession what the terms “AIFMD” or “Dodd-Frank” are to the legal profession.

<sup>3</sup> Active risk management is a craft, neither a science nor an art. A craft is learnt on the job, i.e. it’s “learning by doing.”

<sup>4</sup> See older reports for more detail, e.g., “Absolute returns revisited,” IR&M, April 2010.

### Speculative techniques for conservative ends

Chart 13 shows a return distribution of annualised 20-year (i.e., the compound annual rate of return over twenty years) real (i.e., adjusted for inflation) total (i.e., dividends reinvested untaxed) returns for UK equities since January 1700

- The twenty year period to 1999 was arguably a statistical outlier; an historical accident, so to speak. (The long-term distribution for the U.S. stock market has obviously fewer observations but looks quite similar.)
- The whole asset management industry today still has a strong bias towards “equities” as an asset class and “long-only” as a strategy. Chart 13 shows why.
- A lot of the research of the “equities for the long-run” fraternity is conducted on a short time period when compared to Chart 13 and is biased towards equity markets that survived the various storms reasonably unharmed.

**“The only thing we learn from history is that we learn nothing from history.”**

—Friedrich Hegel (1770-1831)<sup>1</sup>

We don't think historical returns are really a good basis for making investment decisions. In case we're alone on this, we added some relative returns data below. We compare the equity hedge indices from EurekaHedge for North America, Europe, Japan, Asia ex-Japan, and Emerging Markets with a regional equity total return index as a proxy for a long-only strategy.

Table 10: Regional performance comparison of equity long/short (January 2005 to July 2010)

(%)	2005	2006	2007	2008	2009	YTD*	05 - 10**
<b>S&amp;P 500 TR</b>	4.9	15.8	5.5	-37.0	26.5	-0.1	2.0
<b>EurekaHedge North America Long Short</b>	8.3	12.4	12.9	-16.8	23.1	1.1	42.5
<i>relative performance</i>	3.4	-3.4	7.4	20.2	-3.3	1.2	40.5
<b>FTSE World Series Europe TR</b>	10.0	34.9	14.9	-46.0	37.4	-6.7	18.0
<b>EurekaHedge Europe Long Short</b>	18.7	16.8	8.2	-19.4	20.5	0.8	46.9
<i>relative performance</i>	8.7	-18.1	-6.7	26.7	-16.9	7.5	28.9
<b>Topix TR</b>	45.2	3.0	-11.1	-40.6	7.6	-5.5	-19.6
<b>EurekaHedge Japan Long Short</b>	22.4	-2.7	-0.9	-8.4	5.1	1.2	15.0
<i>relative performance</i>	-22.8	-5.8	10.2	32.2	-2.5	6.7	34.7
<b>MSCI Asia ex-Japan TR</b>	23.2	33.7	40.5	-52.2	72.5	2.1	94.7
<b>EurekaHedge Asia ex-Japan Long Short</b>	12.8	29.1	32.1	-27.4	38.3	-0.8	91.7
<i>relative performance</i>	-10.4	-4.6	-8.4	24.9	-34.3	-2.9	-3.0
<b>MSCI Emerging Markets TR</b>	35.8	28.9	33.5	-45.7	62.8	1.8	110.1
<b>EurekaHedge Emerging Markets Long Short</b>	22.2	32.6	30.7	-32.6	43.5	0.2	105.1
<i>relative performance</i>	-13.6	3.7	-2.9	13.1	-19.3	-1.6	-5.1

Source: IR&M, Bloomberg

TR: total return gross index

\* Year-to-date to July 2010

\*\* January 2005 to July 2010

- Our thesis of active risk management to protect capital in difficult market circumstances holds reasonably well. Note that a loss of 52.2% in one year (Asia ex-Japan) and a gain of 72.5% in the next takes a USD100 investment to USD82.5 over the two-year period. Whereas a fall of “only” 27.4% followed by a gain of “only” 38.3% brings the USD100 to 100.4 over the two-year period. This is actually quite funny because many people take equity hedge managers to task for not fully participating in the 2009 rebound. If equity hedge loses half of the stock markets' performance on the way down and then makes half of the rebound on the way up, the strategy is still ahead over the full cycle. As we like to say at every occasion: A fall of 50% and a subsequent gain of 50% only takes you to 75. You need a 100% return to recover from a 50% loss.

<sup>1</sup> Quoted at the start of the last chapter of “The Secondary Banking Crisis 1973-1975: The Inside Story of Britain's Biggest Banking Upheaval” (Macmillan Press, 1982).

- Long short managers focussing on Japanese shares delivered a positive return for the period from 2005 to July 2010 despite their underlying market falling. The marketing one-liner of being able to make money in all market conditions is easily ridiculed. However, there is empirical evidence that the one-liner is not entirely without merit.
- Some investors argue that the emerging markets and Asia growth story is best executed with a long-only strategy. Table 10 shows that—in the past—one could indeed have been more or less indifferent. The Eureka hedge Asia ex-Japan and EmMa long/short indices have not outperformed their long-only brethren. The pattern is: outperformance when markets fall and underperformance when markets rise strongly. A reasonable extrapolation of this pattern would be to assume that these managers will deliver absolute returns when all goes well with the growth story while protecting capital when the story falters.

In essence, this is what one should expect: absolute returns when all goes well, some capital protection when it doesn't. Anything else doesn't deserve the moniker of active investment management.



## ERP a function of population growth?

*“What have future generations ever done for us?”*

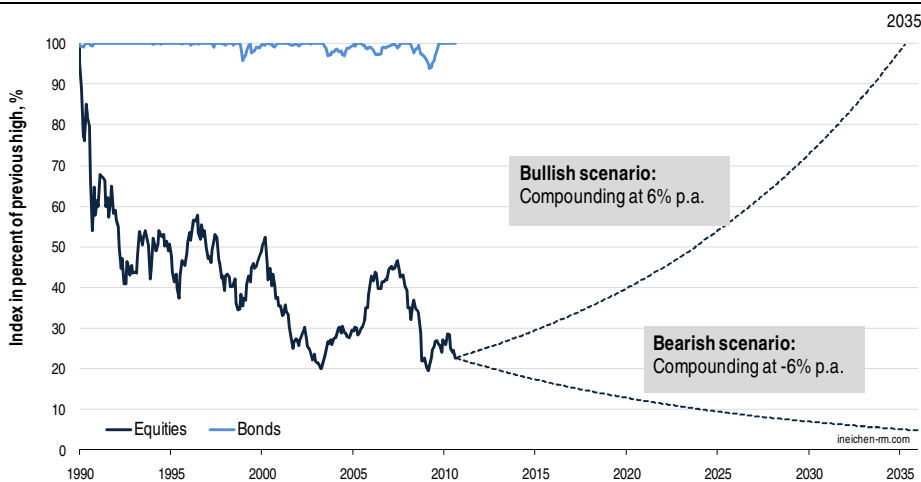
—Groucho Marx

- **The equity risk premium could be regime-specific, i.e., a function rising population.**
- **Japan has a falling population and a negative equity risk premium. Coincidence?**

This is not the time and place to discuss at length the debate/myth of the equity risk premium (ERP). The argument—in a nutshell—is that equities outperform bonds in the long-term because they are more risky. But if equities really were more risky, wouldn't that mean that there is the possibility that equities actually do not outperform in the long-term? It remains a puzzle.

Chart 14 shows an underwater perspective of Japanese equities and bonds.

Chart 14: Japanese equities and bonds (Jan 1990 – Aug 2010)



Source: IR&M, Bloomberg  
Equities: Nikkei 225; bonds: BoA Merrill Lynch.

- The Nikkei 225 compounded at an annual nominal rate of -6.8% from January 1990 to August 2010. Bonds compounded at a rate of around 3.8% over that same period. This would mean the equity risk premium was not a premium but a discount of 10.6% per year over a 20+ year period.
- If the Nikkei starts compounding at +6.0%, it will reach breakeven (or the peak of Dec 1989) as early as 2035. However, it has not picked up the ominous equity risk premium by then.
- Assuming bonds start compounding at 2% (after all, interest rates could start rising in Japan one day too) while equities compound at an assumed rate of +7.0% the equity risk premium would be 5.0% which is a figure quite often

**“That men do not learn very much from the lessons of history is the most important of all the lessons that history has to teach.”**  
—Aldous Huxley (1894-1963)

quoted in the literature. With this equity risk premium, it would take to 2041 for equities to catch up with bonds. With these assumptions the equity risk premium for the whole period from 1990 to 2041 would be 0.0%.

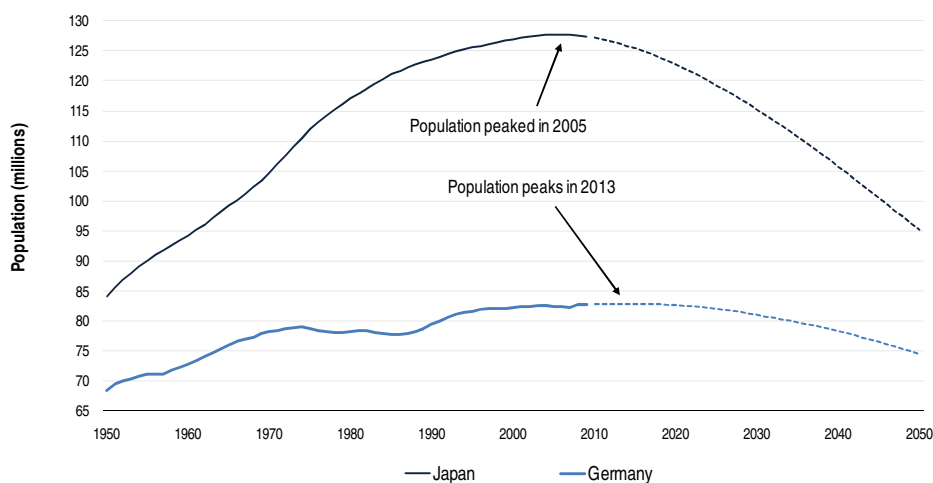
- If bonds start compounding at 2% and equities start compounding at 7% (for an equity risk premium—going forward—of 5%), the equity risk premium for the 50-year period from 1990 to 2039 will be -1.6% (i.e., still negative), for the 100-year period to 2089 1.8% and for the 150-year period to 2139 2.9%.<sup>1</sup>
- For the Japanese stock market to experience an equity risk premium of 5% for the 150-year period from 1990 to 2139, the Nikkei 225 would need to compound at 9.3% (assuming bonds compound at 2% henceforth) from now to December 2139. Equities then would have compounded over the whole period at 7.2% while bonds at 2.2% for an annual equity risk premium of 5.0%.<sup>2</sup>

In Chart 13 (UK distribution) we have shown more than 300 years of data. What was special about this “regime” was that it was characterised—among other things—by rising populations. It is possible that all we know about economics in general and financial economics in particular is regime specific. In a different regime, e.g., one of population decline, many of our beliefs could turn out to be false and dangerous.

**“History does not repeat itself. The historians repeat one another.”**

—Max Beerbohm (1872-1956),  
English essayist

Chart 15: Population growth in Japan and Germany



Source: IR&M, OECD  
Estimates are from OECD.

Japan is currently in a new regime (Chart 15). Population (as well as working population) is in decline. New rules might apply. The negative equity risk premium in Japan over the past decades could well be the market anticipating a regime shift. This ought to have implications elsewhere.

### Bottom line

Equity long/short seeks to benefit from opportunities *within* the equity market. Equity markets going up is just one such opportunity; albeit a risky one.

<sup>1</sup> Given these assumptions, the Nikkei 225 would stand at 73,461,159 in 2139 and would have a CARR (compound annual rate of return) from January 1990 to December 2139 (150 years) of 5.2%. It goes without saying that—given demographics in Japan—these calculations are, sadly, rather theoretical.

<sup>2</sup> Using a total returns index rather than the Nikkei 225 will change the math a bit but not the bottom line.

## Conclusions

***“Man had always assumed that he was more intelligent than dolphins because he had achieved so much... the wheel, New York, wars, and so on, whilst all the dolphins had ever done was muck about in the water having a good time. But conversely the dolphins believed themselves to be more intelligent than man for precisely the same reasons.”***

—Douglas Adams<sup>1</sup>

- Some of the proxies for risk aversion have been increasing lately, somewhat similar to autumn 2007. The lower the yield curves in the West-ex Japan, the higher is the probability that a Japan-like, deflationary environment is what we're up against. Inflation fears have been easing and don't seem to be a big worry at the moment.
- Throughout the summer, data signals have become more alarming. US Banks continue to hoard cash. Many proxies for business and consumer sentiment have risen to April/May 2010 but are now off those interim highs.
- For equity investors, autumn has its perks. Many corrections occurred in autumn. Whether this will hold true in 2010 we do not know. However, self-fulfilling prophecy can work in mysterious ways.
- We recommend hedging directional equity risk for a while. The institutional investor has various options to execute such a view, two of which are (i) replace long-only exposure through long/short exposure, (ii) hedge by using simple overlay strategies.
- Recent hedge funds performance was sub-stellar. Neither the hedge fund industry nor equity long/short has reached its high-water mark. Investors are growing tired of hearing that the performance of hedge funds looks pretty good given circumstances. They shouldn't. Equity long/short seeks to benefit from opportunities within the equity market.
- The equity risk premium could be regime-specific, i.e., a function of rising population. Japan has a falling population and a negative equity risk premium. Coincidence? Hardly.

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<sup>1</sup> Rephrased: "Long-only managers had always assumed that they were more intelligent than long-short managers because they achieved so much... benchmarks, tracking errors, performance attribution analysis, and so on, whilst all the long-short managers had ever done was muck about making money. But conversely the long-short managers believed themselves to be more intelligent than long-only managers for precisely the same reasons".

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