Economics and Portfolio Strategy

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The guest contributor of this issue, Theodore D. Seides, CFA is Director of Investments at Protégé Partners, LLC, a New York-based fund of funds he co-founded that invests in small, specialized hedge funds. Ted learned his trade at the feet of David Swensen of the Yale endowment, where he started his career in the early 1990s.

LET'S DON'T WAIT TIL THE WATER RUNS DRY*

Liquidity: the ability to buy or sell an asset quickly and in large volume without substantially affecting the asset's price.

Barron's Dictionary of Finance and Investment Terms, 1995.

The liquidity available in financial markets over the last five years is unlikely to persist over the next five. The degree of ease Liquidity has been abundant where we expect it – in stocks and bonds – and has been flowing in places we might not – in structured credit products and pre-sold Florida condominium developments. Liquidity in the capital markets has been increasing for so long that we have difficulty in remembering what happens when markets distinguish between assets that are in fact liquid from those that are not.

If we apply to liquidity the theory of environmental change Peter Bernstein introduced last month, we will see a dark cloud on our previously sunny skies. As we have come to understand why the world is awash in liquidity, perhaps we are on the cusp of a new regime where we no longer are so lucky. The Greenspan put, debt financing, credit derivatives, and Asian growth all played a role in fueling liquidity. In the event the water runs dry, and the spigot has dialed down since May, we should remember that in more normal times, liquidity is usually uneven across investment securities or asset classes. In times of crisis, liquidity disappears when we need it most.

What follows are some thoughts about how we have come to experience such abundant liquidity today and a warning of the costs of ignoring our past. Both risk and opportunity are involved.

*Lyrics from Boyz II Men, "Water Runs Dry," 1994.

The Ability to Sell an Asset Quickly Close to its Current Price

Risk is a daily consideration in the lives of portfolio managers. Employing sophisticated financial technologies to measure risk with just the click of a mouse, many managers fool themselves into believing they understand all the risks they face. Peter has reminded us on more than one occasion that risk means more things can happen than will happen: we don't know what will happen. Yet the wide range of possible outcomes has not stopped investment managers from confusing an accurate statistical measurement of risk with confidence in their ability to manage risk.

Understanding and taking risk are closely tied to the importance of liquidity – that is, the ability to reverse decisions at minimal cost. Investment risk is quantified as the potential for loss and permanent impairment of capital. Liquidity is the characteristic of the asset that lets investors minimize losses by getting out of the way when their view changes from the market consensus. Over the last five years, sellers have presumed buyers will always exist at current market prices and have held little fear of experiencing significant capital loss. They are, in other words, ignoring risk.

A Theory of Liquidity Refraction[†]

Introductory economics and historical precedent teach that a wide range of liquidity characteristics typify the ends of a liquidity continuum. In normal times, investments in less liquid instruments – such as small cap stocks or asset-backed bonds – take longer to convert into cash than investments in more liquid assets like large cap stocks or high-grade corporate bonds. Similarly, a liquidity continuum exists across asset classes, where investments in timber, real estate, or private equity are less liquid than those in stocks, bonds, or cash.

The abundance of liquidity in recent years has obscured the differences in quality grades along the continuum. Small companies teetering on the edge of financial collapse can tap the over-indulgent junk bond, second lien loans, private investment in a public company (PIPE), or direct lending markets to preserve the option value of positive changes in their future. In credit markets, the advent and rollout of financial derivatives have forever changed the way credit trades. Issuance of credit default swaps exceeds $17 trillion of notional value, far eclipsing the outstanding value of reference bonds.[‡] Not long ago, even Florida condominiums served as the new rage for paper-flipping speculators.[§]

Just as refraction of light by water in the physical world causes objects to appear shorter than they actually are, perhaps a liquidity expansion and bubble in the capital markets compresses the appearance of the liquidity continuum. Liquidity vapors create the mirage of a safety net, causing natural elements like dry sand to look liquid when in fact they are not liquid. When the liquidity tide goes out, as it always does, a large volume of this paper may turn to sand or even worse, quicksand.

[†] The application of refraction to liquidity in markets is the brainchild of my partner, Jeffrey Tarrant.
[‡] ISDA 2005 Year-End Market Survey. Summary of Market Survey Results at www.isda.org.
[§] "Behind Zooming Condo Prices: New Demographics, or a Bubble?" *Wall Street Journal*, August 18, 2005, Page 1.

In a normal environment, the time required to exit an illiquid investment without a severe loss of capital, if such a market exists at all, takes much longer than current participants expect. This is not the moment to confuse perceived liquidity with actual liquidity. As Keynes reminds us, liquidity for everyone is a logical impossibility.

Finding Returns in a Low Return World

Many of the strategists whose work I read agree we are in a low return environment for equities and debt around the world. Financial assets have had a remarkable run for over twenty years and appear priced to deliver modest returns going forward. Painting some color around this theme, Jeremy Grantham of GMO predicts annual real equity returns over the next seven years ranging from -1.6% (small cap U.S. equities) to +3.9% (emerging market equities) and real bond returns ranging from +1.3% (international bonds) to +2.6% (Inflation Indexed Bonds). Across every traditional asset class, GMO forecasts returns well short of the historical long-term real return on U.S. equities of 6.5%.[**] Should these results come to pass, endowments and foundations with 5.0% spending rates and pension funds with actuarial expected returns even higher will be hard pressed to meet their obligations.

So what is an investor to do? One tool in the shed of investors is patience. Individual and institutional investors alike have seen tangible evidence that taking a long time horizon is conducive to achieving superior results. We receive repeated lessons from Warren Buffett about the wisdom of long-term thinking, and academic research has supported similar conclusions about the value of low turnover, long-term oriented portfolios.[††]

Furthermore, the pursuit of a long-term philosophy encourages investors and allocators to accept illiquidity in exchange for the hope of higher returns. This strategy applies in particular to institutions with long duration liabilities, such as endowments with perpetual assets or pension funds with long liability streams. For these investors, any liquidity required above the amounts necessary for spending needs serves as a drag on long-term performance, presuming they can earn a risk premium for accepting illiquidity. The evidence supporting a long-term perspective has provided fiduciaries with the ammunition to increase allocations to less liquid, "alternative" asset classes.

The urgent search for returns that might give investors a fair chance at meeting their needs has created liquidity in previously illiquid areas of the capital markets and asset classes. Investors have stretched for yield, making life easy and pleasant for sellers and issuers in junk bonds, structured credit, and real estate. Private equity investors expect excess returns from an illiquidity premium, and many hedge funds strategies are predicated on providing liquidity to the market.[‡‡] The tremendous surge in interest in alternative ways of making a buck has

[**] GMO 7-Year Asset Class Forecasts (June 2006) available at www.gmo.com.
[††] Louis Lowenstein, "Searching for Rational Investors in a Perfect Storm," Columbia Law and Economics Working Paper #255. (Social Science Research Network abstract #625123), October 2004. See also Jeremy Grantham, "Risk and the Passage of Time: The Extreme Importance of a Long Time Horizon," GMO Special Topic, April 2006.
[‡‡] The late Hunt Taylor wrote a wonderful piece entitled "The Function of Money," describing efficiency capital. (HedgeWorld, July 11, 2005).

increased the valuation of these securities and the competitiveness of these strategies, calling into question whether investors are receiving adequate compensation for the risks they are assuming.

End points matter a lot in any stream of investment results, and that creates a problem. In order to achieve Jeremy Siegel-like results in "stocks for the long run," investors must purchase underlying assets at least at an historical average price. If the prognostications for a low return world prove correct, long-term allocations to traditional stock and bond portfolios will fail to deliver spending targets for many years to come. Similarly, venture capital results vary greatly depending on the vintage year of the fund, forming a cyclicality of returns inversely correlated to the amount of capital chasing a finite number of ideas – the more money available to entrepreneurs for a limited number of new business ideas, the lower the prospective returns earned by investors. Investors may achieve the desired long-term results some years later, but the waiting time will put even the most patient to the test.

The greatest risk in our industry, job risk, causes many investors in pursuit of lofty benchmarks in a low return world to stretch for returns, winning a battle at the potential cost of losing the war. The investment officers watching over relatively long duration assets typically have far shorter tenures in their post. The human desire to make their mark and the ever-present reality of job risk encourage these investors to take action before their time runs out, even if accepting illiquidity comes without an appropriate risk premium. Last month, Peter argued that the core of a portfolio should be based on optimistic assumptions, concluding that equities are still the way to go. While I agree with his contention, the optimists may be wrong longer than their present employer will allow.

The Ability to Buy an Asset Quickly

If we are living in a low return world for the foreseeable future, the best investment prospects over the coming decades are sure to arise some time tomorrow – that is, to those with the patience to wait for the inevitable arrival of a high-return world. Seth Klarman eloquently described this quandary in December 2003.

> Investors' immediate problem is being too short-term-oriented. One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Limiting your investment opportunity set to only the one immediately at hand would be like being required to choose your spouse from among the students you met in your high school homeroom. Indeed, for almost any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities; but it would be foolish to ignore them as if they will not exist.[§§]

Klarman's discussion fell under the topic of holding cash in the absence of attractive investment alternatives, which I address further below. *But with capital already allocated to investments or asset classes that are relatively illiquid, a problem arises in taking advantage*

[§§] Reprinted with permission from Seth Klarman, Baupost Limited Partnerships 2003 Year End Letter, page 15.

of Klarman's advice. When future compelling opportunities arise, liquidity may not be as prevalent as investors believe it is today, and the inability to buy an attractive asset quickly could create a wasted opportunity.

Caveat Emptor - Risks in the System

Should the environment change, the widespread craze for illiquid assets leaves investors holding positions they will not be able to replace with more attractive and more liquid ones. From top to bottom across the food chain of capital, I find examples of these positions in institutional asset allocation, manager incentives, hedge fund and private equity convergence, and credit markets. Each example poses risk to those accepting illiquidity without adequate compensation.

Asset Allocation

By adopting allocations to alternative asset classes, institutions have made longer-term commitments to increasingly competitive areas. If aggregate asset class returns are lower in the upcoming years, these allocations will compel institutions to make do with mediocre results. Peter's thought-provoking March 1, 2003 E&PS ("Are Policy Portfolios Obsolete?") addressed the possibility that portfolios constructed using long-term policy allocations may not serve institutions as well going forward as they have in the past for just this reason. As larger allocations are committed to relatively illiquid venture capital, leveraged buyout, real asset, and hedge fund partnerships, institutions may not have the liquidity to shift assets and garnish strong future returns should equity and bond markets fall to more attractively valued levels.

Manager Incentives

When serving as an agent, managers know clients can withdraw their capital at any liquidity date. Many managers are loathe to hold cash when facing an unattractive opportunity set, fearing that short-term underperformance relative to peers will lead to asset withdrawals. Moreover, the need for managers to justify their existence creates pressure to put money to work: why is a client paying fees for a manager to sit on cash? Given the high fees earned by alternative asset managers, the dilemma is only exacerbated.

When market valuations are frothy, managers face a difficult choice: risk the impairment of investor capital by purchasing aggressively priced assets or risk their business by sitting on the sidelines. In an example of the principal/agent dilemma, many managers choose poorly compensated investment risk over personal business risk. As Keynes reminds us, worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

Convergence of Hedge Funds and Private Equity

Hedge funds managers are now participating in the domain formerly cordoned off for private equity managers. This trend may be motivated in part by the possibility that some

hedge funds have grown too big for their britches and therefore are compelled to buy entire companies rather than fractional shares of companies. Many hedge fund managers moving into private equity contend they can purchase companies today more attractively in private markets than in public markets.

The word "today" seems glossed over by those with a mandate to play the public markets who are in fact investing in private assets. Hedge fund managers are knowingly accepting illiquidity when conducting private transactions. If successful with the private investment, hedge fund managers may earn high returns that justify the effort despite foregoing the option to change their mind. But should middling results on the private equity investment or a dip in prices offered by Mr. Market "tomorrow" cause public securities to offer higher prospective rates of return than private investments, these managers will not be able to sell their illiquid investments to create the liquidity to buy. These managers could face a vicious cycle, where underperformance relative to peers leads to fund withdrawals, in turn increasing the remaining portfolio allocation to illiquid assets and further reducing the liquidity to take advantage of new investment ideas.

Credit Markets

In the credit markets, the rampant production of credit derivatives has decoupled credit pricing from fundamentals. As described by Michael Lewitt of Harch Capital Management Inc.,

> In today's credit markets, trading and pricing are driven by mathematical models and have virtually nothing to do with fundamental credit considerations…the art of credit analysis is likely to suffer now as it is delegated to a sideshow compared to quantitative modeling that increasingly dominates today's credit culture…
>
> Speaking from experience, this trend away from credit fundamentals will only work as long as the underlying credits are performing and meeting their obligations. Once the default rate starts ticking up, the ivory tower world of financial models will undoubtedly go the same way as the one that caused the financial markets so much pain in 1998…the markets work in theory, but they really don't work in practice.[***]

Credit spreads on everything from junk bonds to emerging market debt have traded at historically tight levels for three years. These instruments are priced for perfection, at a time when the default rate on U.S. corporate debt stands at a paltry 1.1%. The greatest risk may lie in the junior tranches of CDOs (collateralized debt obligations), which are leveraged plays on credit predicated on few if any defaults in a portfolio. As much as we would like to believe in Goldilocks being the only character in the fable describing the U.S. economy, we shouldn't forget that the three bears eventually came home and scared off the trespasser.

<u>All is Not Lost – Opportunities Remain</u>

Cash Ain't Trash

[***] Reprinted with permission from Michael Lewitt, *The HCM Market Letter*, June 12, 2006. Page 3.

In strong market environments, the cliché "cash is trash" is commonly uttered by relative performance junkies who realize that the yield on uninvested cash may be (or more likely, has been) a drag on returns. In a low return environment, savvy investors can choose to exchange poorly compensated risks for cash they can use for future opportunities. Those investors with adequate, highly liquid reserves will be the most nimble in seizing the most attractive prospects of tomorrow. Moreover, investors holding cash will not be saddled with a psychological burden from having reversed a wrong decision after a market correction, potentially fostering a hesitation to pull the trigger at the most opportune time. By embracing the uncomfortable position of overtly accepting short-term underperformance of long-term return objectives, these investors stand the best chance of reaching their goals over a full cycle. Behavioral, career, and client pressures prevent just about everyone from taking this stance, so it is likely to remain an opportunity for the few who can stand alone.

The Exception, Not the Rule

The majority of investors for whom cash is not a realistic option do have other strategies to consider. Alternative asset classes possess a wide dispersion of returns across participants. Whereas public equity and bond markets tend to have relatively narrow bands separating first and third quartile performers, managers of alternative assets have demonstrated a much broader spectrum of results. Astute manager selection will continue to provide investors with a chance to meet their objectives, regardless of what happens in more liquid markets and in aggregate across alternative asset classes.

Easier said than done. For example, although hedge funds are reported to be 8,000 in number, our internal research estimates that over 80% of all hedge fund assets are managed by the largest 250 among them. Like large cap stocks in a cap-weighted index of U.S. equities, these large hedge funds effectively are the market for the asset class. An institution seeking to outperform must either select winners among this group or invest in higher performers outside of it. If employing the first option, allocators find that many of the large funds with the best track records are closed for new investment, leaving a sub-optimal choice among the rest. On the other hand, few institutions have the resources to separate the wheat from the chaff amidst the much larger and less efficient pool of smaller managers. There are no easy solutions to outperform in any asset class; hedge funds are no exception.

Opportunistic Hedging

Hedging is a form of insurance that is usually a cost center, but profitable when a portfolio needs it most. As most hedging strategies – such as short-selling or long volatility – have negative expected returns over time, few institutions with long time-horizons consider hedging a useful component of a policy portfolio. Even fewer managers dedicate their career to generating alpha against a headwind of beta. Short sellers have earned some flashy headlines in the press, but only a handful have stayed in business.

In order to earn incremental returns while waiting for a high-return world to resurface, investors should tactically introduce hedging strategies to their portfolio. ETFs present a

growing array of granular methods to hedge undesired beta. With credit spreads at historically tight levels, shorting low-grade bonds is one of the most attractive risk-rewards in the market. Cash also does the trick, gaining in appeal with each hike in rates by the Fed.

The Consensus Proves Wrong

One of my favorite hedge fund managers is fond of saying “the markets will cause the most pain, to most of the participants, most of the time.” The consensus may be right in the short run, because the consensus *makes* the short run, but their time eventually runs out. Change is inevitable. In other words, the consensus is ultimately wrong. I suppose it is possible that the low return consensus might prove incorrect and we will all end up richer as a result, but I wouldn’t bet on it.

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NOTE: We apologize for the mess of the last two pages on our issue of August 1. That was scratch work and design for the issue itself and did not belong in the mailing.

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