WEDGE WATCH

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Adding Fuel to the Fire?

"Every generation laughs at the old fashions, but follows religiously the new."
–Henry David Thoreau

First Quarter 2007 Financial Statistics

DJIA: 12354.35

S&P 500: 1420.86

90-Day T-Bill: 5.03%

30-Yr. T-Bond: 4.84%

In the poignant but light-hearted 2005 film "The World's Fastest Indian," 63-year old Burt Munro, a kind-hearted eccentric, self-taught mechanical genius and aspiring motorcycle land-speed record holder, experiences severe chest pain one morning at his home (a one room cinderblock garage/house in the picturesque town of Invercargill, New Zealand). Several hours later, at the hospital, a doctor hands Burt a bottle of pills as she informs him that he has experienced angina, instructing him to take one of the pills if he has another attack. Carefully sitting up in his bed, the ever curious Burt myopically peers inside the bottle, asking "what are these?" She replies: "trinitrate pills, better known as nitroglycerin." "Oh yeah, the stuff that blows things up" he chuckles with a wry smile and subtle twinkle in his eye. Several scenes later, preparing to fulfill a life-long dream of racing his 43-year-old Indian Scout motorcycle (circa 1920) across Utah's famed *Bonneville Salt Flats,* the ever resourceful Burt is shown casually and openly dropping one of the nitroglycerin tablets into the gas tank, a humorous attempt to supercharge the engine's thrust (all the while surrounded by dozens of ardent competitors, sporting the latest high octane technology, eager to prove him and his motorcycle tired old relics). What they didn't know, however, was that over the prior 15 years or so Burt had devoted sixteen hours a day, seven days a week to carefully crafting and modifying engine parts, often by hand, in singular pursuit of the secret to *optimum speed*. Given such tireless devotion, he must have figured a little "rocket fuel," in the form of a single nitroglycerin tablet, couldn't hurt and might just be what the doctor ordered (both for him and his bike).

Amidst the topsy-turvy world of money management, investors, too, are in relentless pursuit of the often elusive, but still highly coveted, "competitive edge." In recent years, the "edge" or "rocket fuel" of choice, for those of the institutional ilk, has come predominantly in the form of *hedge funds, private equity and real estate*. In terms of the hedge fund industry, the *long/short* variety has garnered the highest percentage of money flows (approximately one-third of hedge fund assets reportedly reside in this category), premised on the prospect of superior "risk-adjusted" returns. Although we won't attempt to dispel that notion here, we will endeavor to "peel back the onion" to see what's beneath the surface of the *long/short* marketplace today and to assess whether its structural underpinnings appear favorable for investors. With that in mind, and via the help of *Michael Goldstein*, one of Wall Street's most insightful quantitative strategists, and his outstanding team at *Empirical Research Partners*, **let's explore a relatively glaring dichotomy that has evolved over the past few years across the institutional marketplace.**

It's been said *leverage* is a "double-edged sword," cutting both ways, depending on the circumstances. Several years ago, following the debt-financed, technology-fueled capital spending binge of the late 1990s, public companies did an abrupt "about face" and began to aggressively deleverage their balance sheets, slashing capital spending and driving cash balances materially higher. To the contrary, at

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about the same time, institutional investors "began embracing *leverage* like never before." In fact, according to *Empirical Research,* "in 2006 the majority of dollars placed by pension consultants (approximately 60%) were directed into the levered categories *(private equity, real estate and hedge funds)* that together make up only a tenth or so of the defined benefit industry's asset base." All in, according to *Morgan Stanley*, hedge funds and private equity funds generated record inflows last year. More specifically, equity-based hedge funds garnered $63 billion of new money and, for the second year in a row, U.S. private equity funds attracted $90 billion (the effective aggregate figure would exceed $360 billion applying conservative leverage assumptions). In fact, according to *Pensions & Investments,* **"institutional investors moved three times more money into alternatives last year than the average for the previous five years."**

In the specific case of hedge funds, our primary focus here, *leverage* comes in the form of selling securities short. More specifically, according to *Empirical Research*, "the value of common shares and ETF's being shorted by hedge funds is now nearly $500 billion, up almost $300 billion, or two-and-half times, since the beginning of 2002" (a direct by-product of the "alternatives" money-flow parade). This increased exposure has been proactively layered on "even as the market's loss pool shrunk by four-fifths" (more on this later). In addition, "small-cap shorts are up five-fold over the same time frame, with roughly a trillion dollars of leverage embedded across the hedge fund industry alone (approximately half of which is related to shorting stocks)." Although we would not be shocked to see the "alternatives" bonanza reverse or dissipate materially in coming years, **"a 2006 survey, sponsored by J.P. Morgan Asset Management, suggests that more dollars will be steered in this direction at the primary expense of traditional long-only equity managers."**

What is driving this pronounced shift toward alternative investments? There are likely multiple factors at play; however, it's probably safe to assume that performance and diversification are prime motivators. For example, in the case of the typical college endowment, well-intentioned trustees are now attempting to replicate the outsized decade-plus investment returns produced by the largest endowments such as *Yale and Harvard*. These two high-profile institutions, in tandem with a handful of their Ivy League peers, amongst others, were *very early adopters* of alternative investments, unlike the average college endowment. As a result, they had the "pick of the litter" during the early '90's in a relatively *nascent* and *uncrowded* market that, at the time, was ripe with plentiful opportunities possessing the all-important **margin of safety** so favored by Ben Graham and Warren Buffett.

The backdrop today, however, is anything but *nascent* and *uncrowded*. To the contrary, **alternative investing is now the undisputed favorite of institutional investors** (it seems nearly everybody's doing it), the premise being that *leverage*, in the form of *long/short* hedge funds, *private equity* and *real estate*, can be both performance-enhancing and volatility-reducing from a portfolio perspective. Consider this important caveat however - **what was once professed to be overly risky, and largely dismissed as a result, is now perceived as entirely prudent and worth pursuing (often with gusto), despite lower return potential than ever before.**

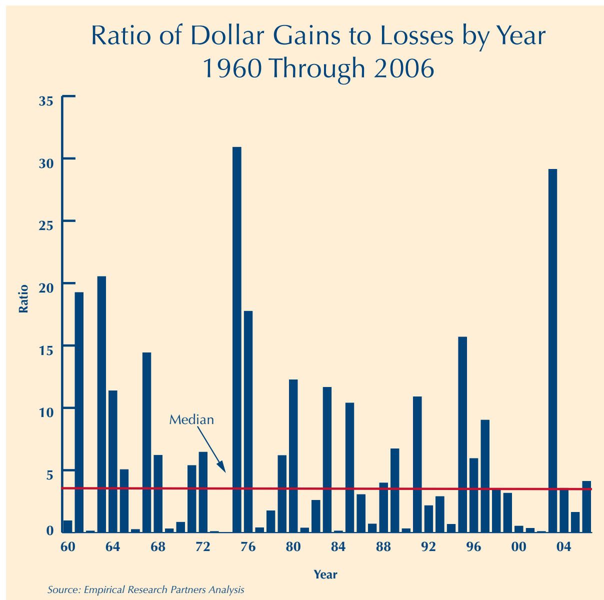
If imitation is truly the sincerest form of flattery, then the *long/short* hedge fund community must have reached full blush by now as the once relatively "hide-bound" mutual fund industry, heretofore "on the outside looking in," is now joining the levered fray with a vengeance (if you can't beat 'em, join 'em). Attracted by the enormous growth in the hedge fund market over the past five years (hedge fund assets have grown from $600 billion to approximately $1.4 trillion), it is not surprising that the fund companies have begun striking back, crafting hedged hybrids, such as 130/30 *long/short* funds (the latest "hot dot"), in a belated reach for their "piece of the pie." *The theory being, according to Empirical Research, that "there is a large, underexploited pool of losing stocks that represent not only low-cost financing but a significant source of profits as well."* **Close scrutiny of this premise, however, should elicit appreciable pause.**

"Too much of a good thing" is often too much of a good thing and in the case of *long/short* hedge funds today, this might very well hold true. In addition to growing capacity imbalances in these non-traditional vehicles (we'll discuss this in a little more detail later) the backdrop for hedged portfolios has been anything but positive in recent years (though the recent turmoil and return of volatility in the equity markets certainly offers a glimmer of hope to much beleaguered bears). Stocks have been on a relatively steady march higher since the Iraq-related market lows of October 2002, making shorts, on average, a "loser's game." Last year was an excellent case-in-point, with dedicated "short-sellers, in particular, experiencing acute pain (losses ranged from 2.5 % to 6.5 %, depending on the source of performance statistics used). Over that same time frame, *long-short* equity hedge funds materially outperformed their short-only brethren, though they came up decidedly shy versus key indices (+11.5% to +14.5% versus +21% for the MSCI World Index and +16% for the S&P 500)." Obviously, bull markets are rarely the friend of the short-seller (and history definitively shows that equities have an upward bias over time). However, it is the structural supply/demand underpinning, *given the dramatic increase in popularity of such strategies*, that may be more instructive regarding future return potential for these products.

At first blush, "the concept behind short-selling appears generally sound." In fact, according to *Empirical Research*, "over the long run the odds of finding a stock that produces a negative total return was 42 out of 100 (based on the statistics from the past 40 years). Big losers, the primary target of short-sellers, defined by total returns of -20% or less, comprise a quarter of the total population. However, while declining stocks are numerous, the dollar pool of losses they've generated is smaller, on average equating to only 7% of the market's capitalization, with big losers accounting for the majority of that total. *What makes the short-selling game even harder than these numbers imply, however, is the clustering of opportunities in just a handful of years."* For example, "the median chance of finding a big loser in a given year is well below the mean, at 21% compared to a mean of 25%. For large-cap stocks," the odds are even less favorable, "with the median at just 10% and the mean only slightly better at 16%. Dollar losses are even more concentrated, with 60% of them occurring in only 10% of all years." These "eye-opening" percentages help bolster the case that **"time is the enemy of the short-seller."**

Speaking of time, "timing" is obviously a critical component of the successful investing equation, especially as it relates to shorting stocks. For example, according to *Empirical Research*, **"the years 2000 through 2002 presented the most shorting opportunities since 1973-74 and before that 1937, but only thereafter did the capital devoted to this bearish/hedged strategy expand by 2.5-fold.** As implied earlier, those inflows were quite late, the losses created by declining stocks in the first three years of the new millennium were almost $10 trillion, over four times the total of the last four years and more than double that of the entire decade of the 1990s." So, all in, *"the odds for short-sellers have historically been quite unfavorable*, with $3.50-$4.00 of gains per dollar of loss in any given year (see **Chart 1**), and $10.00 of gains per dollar loss in a third of those years. Restricting the analysis to the tails, and only counting the big winners and losers (i.e., +/- 20%), the ratio, again, is decidedly unfavorable (at over 4:1)."

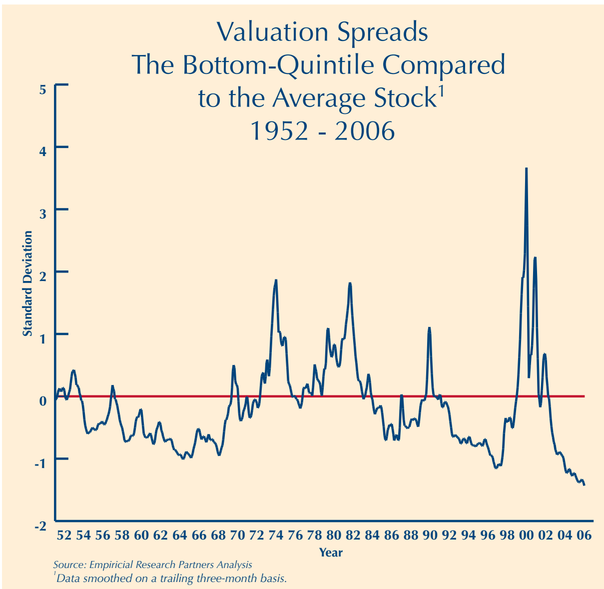
Chart 1



"If there has been an irony to this tale, it is that everyone turned maximum bullish on hedged products exactly at the time when hedging was not needed."
–Henry McVey,
Chief U.S. Investment Strategist - Morgan Stanley

Valuation, of course, plays decisively into the equation for short-sellers as well. Recent work by *Empirical Research* highlights this by showing that "at the end of 2000 (the year the dot.com froth peaked), the expected return *disadvantage* of the most expensive stocks was over three standard deviations above the norm, or -14% a year (see **Chart 2**). Subsequently, over the next two years, that seemingly preposterous expectation proved to be very much on the mark, with those stocks trailing the market by over 50 percentage points. *Today, the market is at the other extreme, however, with the spread about 1.5 standard deviations below the mean.* **As a result, it is far from obvious what is expensive, making it even tougher for those searching out compelling shorts."**

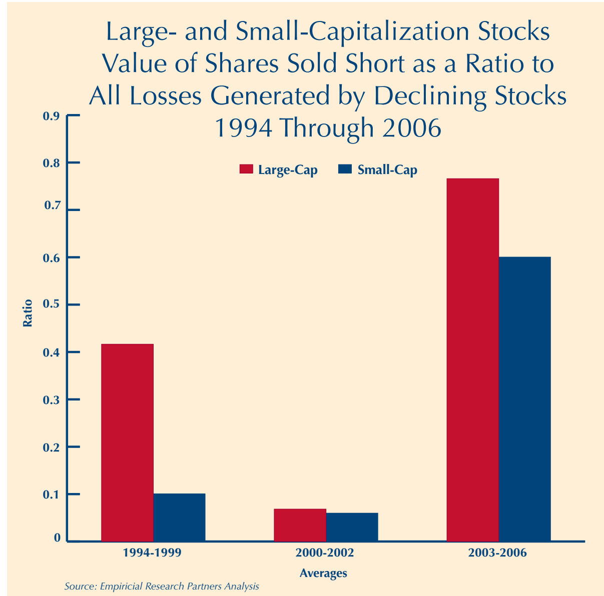
Chart 2



Professional shorting strategies are not a new phenomenon, having been around since the launch of the first hedge fund nearly 60 years ago. Presumably, given such a relatively extended tenure, there is a place, from an institutional perspective, for such tactical approaches (though they should only be pursued, in our opinion, by those possessing the *requisite edge*, ample expertise to discern when opportunities are genuinely compelling). However, as we've highlighted, history shows that the odds do not appear to favor perma-bears or even tactical pessimists the great majority of the time. A few additional statistics and observations, again courtesy of *Empirical Research*, highlight the increasingly problematic supply/demand backdrop for shorts:

Chart 3, which relates the dollar value of short interest to the amount of all losses, is quite instructive. "In 1994 through 1999 (a time when the bulls held sway), there were 26 cents of short interest per dollar of loss. In 2000 through 2002 (the carnage years for stocks following the bursting of the internet bubble), that ratio had fallen to just 6 cents to a dollar (the dedicated short sellers, and there weren't many left standing

Chart 3



then, had the party all to themselves). However, *in the last few years and in 2006 specifically, a surge of institutional interest drove short capital to a whopping 70% of aggregate losses, nearly three times the multiple seen in the 1990's.* For small-cap stocks the rise was an astonishing six-fold. Looked at another way, and assuming that short-sellers are primarily focused on catching the big losers, the numbers are even more striking. In the 1990s, the ratio of short value-to-big losers was 36 cents to a dollar, while in 2006 it was five times that at $1.80 to $1. **In the short-selling industry, it's hard to know exactly what qualifies as a capacity problem or supply imbalance, however, the current backdrop is beginning to appear rather suspect in that regard."**

According to Michael Goldstein, founder of *Empirical Research* and a long-tenured Wall Street veteran, "hedge funds were traditionally expected to bring skills in tactical asset allocation to the table. However, *short selling is a difficult game most of the time and exposure should vary with the opportunity set* (we couldn't agree more). As one might presume, popularity and expected returns tend to be inversely related. Despite that, what's happened in recent years is that shorting has come to be viewed as a *continuing source* of alpha as managers are thought to be able to use research and insight *to win both ways all the time.* While that may hold true for a very select group of practitioners" with highly disciplined, well-conceived approaches, "it seems doubtful it could be the case for a pool of $500 billion, in sharp ascent no less."

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A quote attributed to *Yogi Berra*, baseball's inimitable sage, eloquently sums it up: *"In theory, there is no difference between theory and practice. In practice there is."* Maybe, just maybe, it's time institutional fiduciaries revisit the time-tested, **old-fashioned "alternatives."** No "rocket fuel" required there. Good luck (and don't forget to watch "The World's Fastest Indian." It's well worth the time).

Index	03/31/07 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	12354.35	-0.9%	-0.9%
S&P 500	1420.86	0.2	0.2
Value Line Composite	471.55	3.0	3.0
American Exchange Comp.	2174.90	5.8	5.8
NASDAQ Composite	2421.64	0.3	0.3

**Does not include dividend income.*

Fixed Income

Liquidity: A Fluid Concept

Financial market participants habitually reference the term "liquidity." However, it is one of those terms that if you asked the user for a definition, they may well struggle to give you a satisfying answer. Indeed, depending on the context of its use, the definition of liquidity can be, well, "fluid." In fact, as we shall see, it is a term easier to define by market conditions that are experiencing its presence, or *absence*.

At a recent meeting of the Institute of International Bankers, Fed Governor Kevin M. Warsh delivered a speech entitled "Market Liquidity: Definitions and Implications." In the speech, he points out that the traditional definition of liquidity relates more to a trading notion. That is, liquidity "...reflects the ability to transact quickly without exerting a material effect on prices." He further points out that optimal liquidity can only be achieved when there are many buyers and sellers who have both the ability, *and the willingness,* to trade.

Based on this elemental notion, Warsh then highlights an underlying assumption that is absolutely crucial to a liquid market (the presence of liquidity) - even though buyers and sellers expect different outcomes, these *possible* outcomes are at least subject to measure. "Liquidity exists when investors are confident in their ability to transact and where risks are quantifiable." And of course, from here it is just a short walk to correlate liquidity with the level of risk premiums- "...high liquidity is generally accompanied by low risk premiums. Investors' confidence in risk measures is greater when the perceived quantity and variance of risks are low."

Warsh completes the notion with the proposition, "Liquidity is confidence." However, his proposition comes with a reminder that "…If unmoored from fundamentals, confidence can give way to complacency, complacency can undermine market discipline and liquidity can falter unexpectedly."

In the final part of the speech, Warsh discusses the challenges for policymakers in the current climate of strong and stable economic performance, financial market innovation, and sturdy legal infrastructures - all key factors that have enhanced liquidity (confidence) in recent years. Further, he makes several important

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points that seem to confirm current market conditions and, in fact, **rebuke concerns about whether liquidity and confidence are too abundant.**

First, he implicitly endorses the idea of the "Greenspan put," or rather now the "Bernanke put" - "...While we cannot - and often should not - prevent all shocks or predict how they will reverberate through the financial system, we can attempt to create conditions that would lead investors to most quickly rebuild their confidence."

In terms of the **yield curve**, he argues that the current negative slope, rather than pointing to future economic weakness, **may be reflecting increased confidence in continued stability of economic output and inflation,** or at least lessened future variability in those measures. If this is the case, then term premiums (compensation for lending over longer time periods) would shrink. And with respect to **credit spreads** and **volatility** measures, he acknowledges that both are relatively low, though not unprecedented in history.

In the past several issues of *WEDGE Watch*, we have tried to highlight the impact that abundant global liquidity has had on a variety of market facets, including credit spreads, low volatility measures and the yield curve. We have also cautioned that confidence may have given way to complacency in some markets.

In that regard, it can now be said with a high degree of certainty that complacency (and let's be honest, greed) entered parts of the **mortgage finance markets,** and that liquidity faltered quite rapidly once poor lending decisions began to show up in the form of outsized delinquency rates for subprime mortgages. The stunning collapse of a number of subprime lenders is a clear real-world example of Warsh's admonition of confidence becoming "…unmoored from fundamentals." Liquidity vanished as the range of possible outcomes (all to the downside!) widened substantially.

Suspecting that more areas of the credit markets have become unmoored from fundatmentals and that liquidity can falter rapidly, we remain comfortable with higher than average credit quality in client portfolios, **particularly given the small yield sacrifice involved.**

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