



'Absolute' Returns Are Not Necessarily Absolute and They Need Not Be Or Muzzling The Bear and Exploiting The Bull

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Do Absolute Return funds produce returns that are independent of the markets? Should we expect return profiles to be about the same in bull, bear or sluggish environments? Many people think so. For example an article about Harvard and Yale endowments in the September 2007 issue of **Smart Money** magazine ("A League of Their Own") defines the category this way:

"Absolute return consists of assets that are expected to perform well in good and bad markets and aren't correlated to broad market averages."

The article goes on to say that:

"Most hedge funds fall into this category, including so-called long/short funds (which try to profit from both rising and falling markets), merger arbitrage and distressed securities."

Even a casual glance at the data reveals that this is not the case. The table on the following page compares HFR Index returns for some major strategies for the bear market period of 2000-2002, against the bull market period Jan 2003 through June 2007. The Hedged Equity, Event-Driven, Distressed and (disturbingly) Macro categories clearly perform much better in the bull market. Some of the other strategies do appear to be essentially invariant, but the returns are *low*, most notably – and disappointingly – in the Market Neutral category. Convertible Arbitrage seems to be counter-cyclical, which would ordinarily be appealing, but in fact the strategy exhibited marked instability over the period. The aggregate, represented by the Fund-Weighted Composite, appears to be heavily cyclical.

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Performance of Selected HFR Strategy Indices in Bull and Bear Markets		
	2000-2002	2003-2007
Convertible Arbitrage	12.3%	5.7%
Distressed	7.0%	17.6%
Equity Hedged	1.4%	13.0%
Equity Market Neutral	7.3%	5.5%
Event Driven	4.7%	15.8%
Fixed Income Relative Value	6.1%	7.1%
Global Marco	5.4%	10.3%
Merger Arbitrage	6.3%	8.4%
Fund-Weighted Composite	2.7%	13.0%
S&P 500	-14.6%	14.7%
US T-Bill	3.9%	2.8%

When one considers the true nature of the strategies, the cyclical bias should not be surprising. Shorting securities is difficult and hedging is costly. One would therefore expect the preponderance of strategies to be “long-biased”, and for the market-neutral strategies to post either lower or more erratic returns. This, by and large, is what we observe.

Another pro-cyclical bias in absolute return strategies is more subtle, more insidious. That is the tendency for “convergence” strategies – which include most “value” and arbitrage strategies, to *diverge* and post losses during unexpectedly volatile periods. This can be devastating for those strategies that are highly leveraged. It can be especially devastating for a portfolio of diverse strategies, normally uncorrelated, which suddenly move together in the wrong direction. That is what we saw this past August. While such periods tend to be infrequent, they are also unpredictable and their impact can be large – one ignores them at one’s peril. The main point here is that these periods are not cyclically neutral. They do not normally accompany bull markets.

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Implications for Absolute Return Portfolios

Just because the majority of strategies are not independent of the markets does not mean that structured portfolios, such as those employed by Liberty Gateway, cannot be. There is no need to replicate the structure of the industry. Should not one limit choices to those strategies which are truly independent of the markets? One often hears an additional compelling argument for true market-uncorrelated portfolios: "Why should we pay those fees for beta (the market component of return), which one can have for extremely low fees via index funds?" Only alpha – the market-independent component – could ever merit 2% management and 20% incentive.

Other things being equal, the "pure alpha" argument is compelling. Whether other things are in fact equal depends on the opportunity set available. Here is the opportunity set we see: market-independent funds include some asset-backed lending, some trading, various market-neutral equity and some arbitrage. While we value such strategies and strive to include them in Liberty Gateway portfolios, it is taking things too far to limit portfolios to *only* these strategies - much too far. Such portfolios are, variously, too conservative, too erratic, too illiquid or inadequately diversified. Meanwhile one is forced to pass over a large array of investment talent merely because the "alpha" is accompanied by some "beta". We do not see how this could be optimal. Our main point here is that such a restriction is simply not necessary.

A less draconian approach is warranted. We consider sensitivity to market movements – "beta" – as a force to be tamed and kept within bounds, not squelched. A more reasoned approach is to construct a highly diversified portfolio which in the aggregate aims for an expected return of **Alpha + (Beta X 0.25)**. Here we use the S&P 500 return as our beta proxy. (This is a simplification, as the returns of the underlying strategies are potentially affected by numerous equity and credit markets, but the main point is unaffected.) For the purpose of this discussion, we assumed a reasonable alpha target of 0.9% per month, or just over 11% annually. Although this figure is significantly below what one sees in historical simulations, we recognize that it is, in practice, on the ambitious side. As for **Beta X 0.25**, it is derived from historical data, from "due diligence" observations and from collective information on the various strategies. One auxiliary benefit of extensive manager diversification is that the inevitable measurement errors on the individual managers tend to canceled out in the aggregate.

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For simulation purposes, 2xs portfolio leverage is employed. The expected return is therefore doubled, and a funding cost subtracted. It should be noted that the beta factor is now **0.50**. The following table displays return expectations for various S&P movements. Funding costs are assumed to be 8%, somewhat higher than the present level.

Sensitivity of Targeted Returns to Changes in the Market (S&P 500)					
Change In S&P 500	Alpha Target	Return	Leverage Return	Funding Cost	Gross Total Return
-20%	11.3%	6.3%	12.6%	8.0%	4.6%
-15%	11.3%	7.6%	15.1%	8.0%	7.1%
-10%	11.3%	8.8%	17.6%	8.0%	9.6%
-5%	11.3%	10.1%	20.1%	8.0%	12.1%
0%	11.3%	11.3%	22.6%	8.0%	14.6%
5%	11.3%	12.6%	25.1%	8.0%	17.1%
10%	11.3%	13.8%	27.6%	8.0%	19.6%
15%	11.3%	15.1%	30.1%	8.0%	22.1%
20%	11.3%	16.3%	32.6%	8.0%	24.6%
25%	11.3%	17.6%	35.1%	8.0%	27.1%
30%	11.3%	18.8%	37.6%	8.0%	29.6%
35%	11.3%	20.1%	40.1%	8.0%	32.1%

Target returns since 2000

Things become more interesting when we look at returns over a market cycle. The table on the following page shows expected returns of the simulated portfolio, on the above assumptions, from 2000 to the present. The prime rate (= upper bound) is used as the funding cost. The tabulations were calculated monthly but displayed annually. Returns are shown both gross and net of industry standard fund of hedge fund fees (1% mgt, 10% incentive, 0.5% expense). Not surprisingly, the beta factor proves to be a serious headwind during the bear market of 2000-2002, keeping the simulated portfolio returns in single digits. It becomes a tailwind thereafter. For the entire period the annualized gross returns for the simulated portfolio is 17.6%, with corresponding net returns of 14.2%, compared to S&P returns of 1.7%.

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Liberty Gateway Investment Management Commentary

	S&P 500		Base Portfolio		Portfolio @ 2xs Leverage (Gross)	
	Return	VAMI	Return	VAMI	Return	VAMI
		\$1,000		\$1,000		\$1,000
2000	-9.1%	\$909	9.0%	\$1,090	8.3%	\$1,083
2001	11.9%	\$801	8.3%	\$1,181	9.0%	\$1,180
2002	22.1%	\$624	5.1%	\$1,241	5.2%	\$1,241
2003	28.7%	\$803	18.7%	\$1,473	35.0%	\$1,675
2004	10.9%	\$890	14.3%	\$1,684	25.0%	\$2,095
2005	4.9%	\$934	12.7%	\$1,899	19.5%	\$2,504
2006	15.8%	\$1,082	15.5%	\$2,193	23.2%	\$3,085
2007	5.2%	\$1,138	8.8%	\$2,387	12.1%	\$3,459
Annualized		1.7%		12.0%		17.6%

	HFR FW Composite		HFR FW Composite @ 2xs Leverage		Portfolio @ 2xs Leverage (Net)	
	Return	VAMI	Return	VAMI	Return	VAMI
		\$1,000		\$1,000		\$1,000
2000	5.0%	\$1,050	-0.4%	\$996	6.0%	\$1,060
2001	4.6%	\$1,098	1.5%	\$1,011	6.7%	\$1,131
2002	-1.5%	\$1,082	-7.6%	\$934	3.3%	\$1,168
2003	19.5%	\$1,294	36.8%	\$1,278	29.3%	\$1,510
2004	9.0%	\$1,411	13.7%	\$1,453	20.7%	\$1,823
2005	9.3%	\$1,542	12.2%	\$1,630	15.9%	\$2,113
2006	12.9%	\$1,741	17.5%	\$1,915	19.1%	\$2,516
2007	6.8%	\$1,860	7.9%	\$2,067	9.9%	\$2,765
Annualized		8.4%		9.9%		14.2%

Ponder that. Despite a beta factor that most Absolutists would consider high, the portfolio beats the market by a very significant margin. It does so, basically, by "holding the line" during the bear market period, then posting impressive returns when the bull market returns. It makes money when there is money to be made. That is all that is needed to done.

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Benchmarks

It is sometimes claimed that Absolute Return investments should have an absolute, numerical benchmark rather than be compared to a market index. We disagree. Equities are the standard for all other asset classes, which should either show superior returns, or else significant reductions in risk. We do in fact expect absolute return portfolios, on a gross basis, to beat the market, not every month or every quarter, certainly, but every calendar year – excepting only extreme bull markets. We can tolerate some tracking error there.

While a market index such as the S&P 500 or (better, perhaps) MSCI World is one benchmark to look at, it is not the only one. The “target” leveraged portfolio return is - in practice – itself a benchmark, obviously an important one. If it is a legitimate target, we can only expect to beat it 50% of the time. We also compare to the HFRI Fund Weighted Composite Index, adjusted as if it were 2 Xs leveraged, and using the same funding cost. It is well known that such indices contain an upward “survivor” bias, which, in the current benchmark context, is a plus.

Investing for the Long Term

The central challenge of long-term investments is to avoid being caught by severe equity bear markets, while maintaining necessary exposure to the more frequent bull markets. One needs both blades of this scissors. While there is no denying that the long-run returns of equities dwarf those of mutual funds and cash, this is an insufficient basis for structuring a portfolio. Given finite lives and inherent uncertainty, it is not good enough to note the incredible increase in wealth of a hypothetical investor in equities in, say 1926, who has held on to the present through thick and thin. A strategy of “buy and hold” for the very long run, weighting heavily in equities, is simply not suitable for most applications. An intervening bear market can severely damage returns for a decade, maybe an entire generation.

In traditional asset allocation, the alternative is to hold fewer equities, and more bonds and cash. But the long run returns for these asset classes trail those of equities very badly. One pays a heavy price for averting the bear by such methods.

That leaves dynamic asset allocation, or market timing, as an alternative. But to attempt this is to move from the frying pan into the fire. Market timing is notoriously difficult, and we know of no one, professional or otherwise, who has been able to do it with anything close to the necessary precision. One has to time *both* the bear and bull phases, and the penalty for missing either, through drawdowns or foregone returns, is very severe.

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As such, we believe in a in non-market timing strategy that is targeted to achieve the following; MUZZLE THE BEAR – EXPLOIT THE BULL.

To be sure, this method – the achievement of alpha return – is neither simple nor a foregone conclusion. But it is a *superior* bet, we believe, than market timing. Yet it does **not** require independence from markets - only not too much dependence. One does not have to post wonderful returns all the time. It is quite sufficient to make money in the good times, and not to lose much in the bad times. This might be an illustration of Warren Buffett's oft-quoted but enigmatic "Two rules for investing":

Rule #1: Don't Lose Money

Rule #2: Don't Forget Rule #1.

Back to the Future: The 1930's and the Nature of Severe Bear Markets

As a fun exercise we consider how our target return profile, $0.9\% + (\text{Beta} \times 0.25)$, leveraged, would fare during the grand-daddy of all U.S. bear markets, that of the Great Depression, 1929-41. We used Dow Jones data, and confine the numerical analysis to annual. Funding cost is held at an arbitrary level of 5%. (As interest rates were at historical lows for most of the period, this figure is probably on the high side.) Table 4 displays the calculation.

Target Return Applied to 1930's Data							
	Dow Jones		VAMI	Base Portfolio	VAMI	Base Portfolio	VAMI
1928	354.50		\$1,000	(Gross)	\$1,000	(Net)	\$1,000
1929	300.25	-15.3%	\$847	9.9%	\$1,099	7.6%	\$1,079
1930	164.58	-45.2%	\$464	-5.0%	\$1,045	-6.5%	\$1,006
1931	77.90	-52.7%	\$220	-8.7%	\$953	-10.2%	\$903
1932	60.26	-22.6%	\$170	6.3%	\$1,013	4.8%	\$946
1933	98.67	63.7%	\$278	49.5%	\$1,514	44.3%	\$1,365
1934	104.04	5.4%	\$293	20.3%	\$1,822	16.9%	\$1,596
1935	141.13	38.5%	\$407	36.9%	\$2,494	31.8%	\$2,105
1936	179.90	24.8%	\$507	30.0%	\$2,242	25.7%	\$2,645
1937	120.85	-32.8%	\$341	1.2%	\$3,281	-0.3%	\$2,637
1938	154.30	27.7%	\$435	31.4%	\$4,312	26.9%	\$3,348
1939	149.99	-2.8%	\$423	16.2%	\$5,011	13.2%	\$3,791
1940	131.13	-12.6%	\$370	11.3%	\$5,578	8.8%	\$4,126
1941	110.96	-15.4%	\$313	9.9%	\$6,131	7.6%	\$4,438
Annualized	-8.5%		-68.7%		15.0%		12.1%

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Although the Great Crash of October 1929 draws much historical attention, it was actually more of a technical event, akin to the plunge of October 1987 (unless you were buying on margin). In the wake of the crash the market was down 15.3% for 1929, not great but hardly a catastrophe given the magnitude of the preceding bull market. There was a significant rally in the first few months of 1930. But then came the real downturn, as the market both anticipated and contributed to the Great Depression. As the table shows, a buy-and-hold investor was down 45% for 1930, then lost another 52.7% (!) in the worst of all years, 1931. 1932 saw still more losses. By the end of 1932 the market was down a terrifying 85% from its level at the end of 1928.

What of our simulated portfolio? Against a "headwind" consisting of a furious gale, it could hardly thrive. But it holds the line. On a gross basis the portfolio is about flat for 1929-32, while the net is down by a cumulative 5.6%. It is not clear that our hypothetical investors would be patient with such performance – cash in a mattress would have done better – but at least they could afford to be.

But then comes 1933. Happy days are here again. The market is up 63%. The portfolio, net, is up 44.3%, which puts it in the black for 1929-33. The buy-and-hold guy, if there be such, is not so fortunate. He or she gets the full 63% but remains in a very deep hole. This follows, unfortunately, from the arithmetic of large losses. If you lose 50% you need to make 100% just to make it back to the starting point. If you lose 85% the upside requirement is 566%.

The simulated portfolio is well-positioned to take advantage of the generally bullish conditions of Roosevelt's first term, and to more than hold its own in the renewed bear market which ensued during the years preceding World War II. The full results are dramatic. For 1929-41 the target portfolio, net, is up 12.1 % annually, so that an initial \$1,000 grows to \$4,438. By contrast the Dow Average shrinks by 8.5% per year. \$1,000 invested at the end of December 1928 has withered to ...\$313.

This is an exercise. Obviously we are not declaring victory over bear markets. What we *are* declaring is that the target constitutes a *sufficient condition* to achieve an impressive return in difficult times. It does not have to be invariant to the market. It is as "absolute" as it needs to be.

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The Jones Nobody Could Keep Up With

Absolute return funds, it is commonly claimed, date back to the partnership set up by A.W. Jones in 1949. Jones pioneered the notion of going both long and short equities, and in the process introduced the 20% performance fee - based, it is said, on the practice of Venetian traders, who took 20% of the proceeds from every voyage. Jones called his creation a "hedged fund."

What, exactly, was the Jones strategy? Contrary to myth, it was by no means an absolute return, market-neutral strategy. Jones was interested, first and foremost, in adding leverage to an equity portfolio. His interest in short equity positions was twofold: first, to partially offset the effect of the leverage ("speculative techniques for conservative ends"); second, to make money on the positions (positive short alpha, as we would say today). The Jones portfolio was net long, with the net exposure typically between 50% and 80%.

How successful was Jones? For a significant period, quite successful indeed. From the Fund's inception (limited partners were admitted in 1952) through 1965-66, the annualized return was greater than 20% per year with only one down year, and that loss was small. In 1966 the Jones Fund was featured in Fortune Magazine in an article entitled "The Jones Nobody Keeps Up With". The writer of the article, Carol Loomis, noted that Jones was out-performing not only the market, but the top-performing mutual funds, and with lower risk (She also removed the "d" from "hedged"). Partly as a result of the article, more than 100 hedge funds were in existence by the late 1960's. The strategies did not necessarily follow Jones. Presumably that 20% performance fee was a major motivator.

But there was a flaw in Jones. He had been a market timer, and never lost interest in the practice. He reserved the right to vary his net leverage. During 1969-70 he essentially removed the short positions, raising the net long position over 100%. The result was disaster. The partnership lost 35% in the bear market of 1969-70, a time that saw the elimination of many other hedge funds, for similar reasons. That experience taught Jones a lesson. He never again had that kind of exposure, and had only one more down year before the partnership converted to fund-of-funds in 1984. His fund was positive during the severe bear market year 1973-74. In all Jones experienced only three down years out of thirty-five, compared to nine for the S&P.

We believe that the Liberty Gateway approach, not market-neutral investing, is in the spirit of Jones. Like him, Liberty Gateway employs leverage, and maintains "net long" positions. We also have certain advantages. Our optimal strategy is far more diversified across strategies than was Jones, who employed multiple portfolio managers but stuck with long/short equity; and our overall exposure is more strictly controlled. And we do not market-time.

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Towards a Superior Approach to Asset Allocation

At this point we should reiterate: the alpha figure used here, 0.9% per month, is a *target*. There is no assurance that this target can be met. There is no assurance of anything. For this reason alone, we certainly do not recommend that our strategy, or any combination of Absolute Return funds, occupy the lion's share of anyone's portfolio.

However, for anyone eligible, Absolute Return products deserve consideration for *inclusion* in a portfolio, and not just as an exotic sliver. The Smart Money article referred to earlier notes that Yale and Harvard, perennial leaders in returns among university endowments, employ a diversified approach to asset allocation in which traditional equities are less than half of the portfolio, and bonds occupy an even smaller slot. Real assets, private equity and absolute return vehicles play a prominent role. The article notes that there are important lessons for individual investors here. While it is not feasible to imitate the actual investments of the Ivy League schools, it is indeed possible to allocate a portfolio in a somewhat similar manner. The article offers interesting suggestions in the real asset and private equity areas. The suggestions in the Absolute Return area are...weaker. We immodestly suggest that Absolute Return is a superior option here.

The *essence* of the Harvard/Yale approach – though the university endowment chiefs do not describe it this way – is the same as that contained in this paper: employ moderate beta, and significant alpha, so as to ride through bear periods and exploit the bull markets. However there is now a third tool at hand: allocations to *markets* which are low-correlated with traditional equities. Details of this approach to asset allocation are far beyond the scope here. However, one aspect, impinging on absolute return investing, should be highlighted. The question is often asked: “How can alternative investments (including absolute return funds) enhance traditional portfolios?”

We believe that the question itself is wrong. It is this approach – designating the traditional investments as “core” and the alternatives as “satellite”, which may have led to over-emphasis on the importance of absolute return vehicles being market-uncorrelated. For the traditional investments then “use up” all of the beta. The superior approach is to look at the traditional / alternative mix *simultaneously*. The modern approach to asset allocation says, in effect, “Ask not how alternative investments can enhance a traditional portfolio. Ask how traditional and alternative investments can be combined to produce the best possible portfolio, at a given level of risk.”

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Founded in 1980, privately owned and managed Liberty Gateway is an advisor that engineers multi-manager hedge fund allocation models with sustainable alpha. These customized models are designed to meet an investor's unique return objectives and risk tolerances. The firm's strength lies in its innovative yet prudent expertise to identify outstanding niche managers coupled with vigorous initial due diligence and ongoing risk management. Its dynamic investment approach can also be accessed through its fund-of-hedge funds.

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