The Greenwich Roundtable Quarterly™

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EXPLORING NEW FRONTIERS OF INVESTING

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Avoiding Mistakes In Alternative Investments

"Avoiding Mistakes" in hedge funds and private investments is the focus of the latest white paper, issued this fall, in the Greenwich Roundtable's series on Best Practices in Alternative Investments

Although sophisticated investors use alternative assets to obtain attractive risk-returns opportunities, many investors have been the victims of a hedge fund that has suddenly self-destructed, causing investors large losses. The purpose of this paper is to help investors avoid these mistakes through effective due diligence and manager monitoring.

The paper includes 22 case studies of hedge funds that have failed, highlighting how investors could have identified warning signs and thereby minimized the likelihood of their being caught in such an accident.

The paper also provides an overview of disappointments in venture capital, buyout funds, and real estate funds, highlighting the importance of initial due diligence and the need for investors to concentrate on areas where a paucity of capital is presenting exceptional opportunities.

"This piece takes an original and more practical approach than found in media reports as it moves beyond the headlines to examine warning signs of potential trouble in funds, yellow and red flags that investors need to consider in their due diligence and monitoring processes," said Mark Silverstein, chairman of the Roundtable's Education Committee.

"Our intent is to focus on what limited partners should be looking for and what actions they can take to limit the risks of failure," Silverstein added. "Many of these warning signals are subtle, not all funds with warnings are bad funds. Often it's the combination of warnings that is most telling.

"This piece is written in a clinical form, avoiding sensationalism. Similar to safety guidance in other industries, our goal is for this white paper to be used by limited partners to reduce their accident rates. Unfortunately, this issue is timeless. While one may expect investors and managers to learn from past mistakes, the market is organic, with history often repeating itself."

The Greenwich Roundtable series of Best Practices in Alternative Investments white papers have most recently covered Portfolio Construction, Due Diligence, and Managing Complexity.

A Board Retreat was held on July 12th at the Campfire Club of America in Chappaqua, NY. Trustees & Education Committee members enjoyed a round of sporting clays and lunch. Back Row(L-R): Rian Dartnell, Sami Robbana, Steve McMenamin, Ken Shewer, Doug Perkins, Ed Barksdale, Ray Gustin, Trevor Barnett, & Mark Silverstein. Front Row: Ingrid Delson, Adam Randall, Brian Feurtado, & Connie Sledge.

Best Practices Training

Over the past ten years, the Education Committee has pioneered original research on Best Practices for Limited Partners. Now, the Education Committee and the External Affairs Committee are joining forces to bring Best Practices to life. When Due Diligence was first published in 2003 it was unique and the investment world was changing fast. Portfolio Construction, Managing Complexity, and Avoiding Mistakes also were seminal works leading the industry.

The Education Committee has tirelessly collected the best examples of how investors practiced their craft. Often we were compelled to look into other industries to see how they approached these problems. Today the pace of changes has slowed down. Now we have more time to share our findings and bring these works to life for other investors. This is an important part of our mission.

Best Practices training is available for your staff, your investment committee or your association. Best Practices training is available as a workshop that's divided into modules. Each module can be held as a stand-alone session or combined to fit the needs of the attendees. Workshops are conducted by Education and External Affairs Committee members. Please call or write if you'd like to sponsor a Best Practices workshop. Adam@greenwichroundtable.org or 203.625.4505.

Refer a New Member

Members are the Roundtable's greatest asset. The Greenwich Roundtable is the gold standard for education in alternatives. We encourage you to nominate candidates for Membership that would be a good addition to our tight-knit group. Your referrals are the key for us to reach a wider audience of sophisticated investors. If joining the Roundtable can add value to any limited partner, please refer them to Adam at Adam@greenwichroundtable.org. We'll familiarize prospective candidates with our mission and invite them to experience a symposium for a practical evaluation of the benefits of Membership

Trading Strategies and the Monetization of Sentiment

January 19, 2012 • UNDERWRITTEN BY HEDGESERV

Greetings from the Greenwich Roundtable. Our topic, *Trading Strategies and the Monetization of Sentiment* is an examination on ways to make money from markets that have abandoned fundamentals. It's also a continuation of our look into the CTA strategies with Ken Shewer and what makes them tick. Our speakers are all deeply seasoned practitioners. David Gorton's strategy develops its trading signals from technical, price and volume indicators. Pepe Quintana's strategy gets its signals from fundamental inputs. And Gary Gerstein practices the time honored craft of making long-long term discretionary decisions from fundamental factors. Ken Shewer organized and moderated today's session as only someone with 35 years experience in this space could. km@kenmar.com

David Gorton

David Gorton
BHDG Systematic Trading

Sentiment has always played a central role in trading. Price action tells everything. In 1923, Edwin Lefèvre wrote about placing and withdrawing orders to test sentiment and to lure other investors into the market. Trend following is a strategy that captures cycles of sentiment. Since 2008 the market has been driven by the "risk-on, risk-off" mentality. Although sentiment can be described as ephemeral it is more the willingness to take risk. This risk appetite is guided by the assessment of macro-economic uncertainty. If the economy is stalling the risk appetite will be more volatile. In practice prices are driven by residual factors that have no fundamental basis. These residuals are hard to predict and difficult to understand. Most indicators that try to quantify residuals are coincidental or lagging and difficult to forecast. The good news is that these residuals tend to persist. Behavioral stories tell of human actions that culminate in herding around equilibrium. Trend following is one strategy that captures herding and monetizes sentiment. Trend following is also a hedge against fundamental strategies. Successful trend following requires you to get in early and get out as soon as possible. However, Lefèvre said 'capturing the first eighth and the last eighth can be the most expensive eighths you'll ever trade.' The heart of the matter lies in predicting the probability that prices will continue in the same direction. This probability must be updated frequently. We must be prepared to trade when the probability changes. This continuous approach to analyzing and trading is critical. Fixed stop losses eat up profits and fixed time horizons are inappropriate. The best trend is increasing or decreasing prices against the backdrop of low volatility. Parabolic price action is a warning sign. Bond prices behave differently than stock prices. Commodity prices are more vulnerable to supply shocks than to demand shocks. Silver in 2011 had an unjustifiable trend. Sentiment played a big role in the bubble. Reading the blogs was a classic example of herd behavior. Position sizing was critical. As volatility increased our positions were shrinking. Keynes once said 'it would be foolish to attach importance to matters that are uncertain'. Trend following is intrinsically self-correcting. Positions must shrink as trends exhaust themselves.

Thus risk management is endogenous to the strategy. Good trend following employs aspects of contrarianism. Trend following captures market movements that are hard to explain with fundamentals or risk premiums. Some movements are difficult to trade and proper diversification is critical. There are limitations to the strategy when regulation or the underlying environment changes significantly. A strong risk management committee is very important here.
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Pepe Quintana

Pepe Quintana
Bayesian Efficient Asset Management

The premise today is that markets have divorced from fundamentals. Can trending strategies monetize sentiment? Perhaps…yes and no. Consider these three points. First, that markets have detached from fundamentals is nothing new. Bubbles have been formed since trading began but fundamentals always return. Otherwise the whole system breaks down. The basis has changed. There are more frequent cycles and the pace is faster. When markets are divorced the fundamental strategy will lose money. You make money when reconciliation comes. If you keep the same exposure throughout this cycle you will break even and take risk for nothing. Managing that risk will allow you to adjust your exposure to reflect the opportunities available. Increasing your exposure when fundamentals come back assumes that you're able to detect that. Sometimes your gut tells you that the more you lose the more convinced you become that fundamentals come back. This is a dilemma you've got to resolve. Second, there is not one or the other. You can apply fundamentals but profit from misguided sentiment. Stocks dropped after S&P downgraded US debt in August. Fundamentals were in synch. But markets became terrified and ran to safety. The bonds should've been sold but they were bought because they were a safe haven. Things are changing. Static models don't work. You've got to adapt. Third, there are different fundamental strategies where generalizations about fundamentals don't accurately represent the opportunity set. There are systematic or discretionary strategies using fundamentals. I prefer systematic. There are rule based or model based strategies. I favor model based ones. You can explore different parts of the fundamentals. You can explore the absolute directional movements or explore the relative opportunities within a movement. Just because the market is not reacting to a majority of fundamental factors doesn't mean it has discarded all fundamentals. Generalizations are not helpful here. Keep an eye on correlations. Stochastics are helpful in detecting shifts in correlations. Good portfolio construction and diversification should include both fundamental and systematic strategies. Good risk management helps you to rebalance your portfolio between both to its highest utility. Systematic strategies are like maps. They are not a complete description of the territory. The territory is always changing and the maps need to be updated to be useful. The key is to be up-to-date, to have an open mind and to be willing to learn about changes in the environment. Sometimes our trading increases to adapt to the speed of change in the markets.
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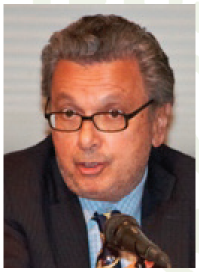


Gary Gerstein

Gary Gerstein
Red Oak Commodity Advisors

Recently we abandoned our abacus and moved to the HP12c. The race is not always to the swift nor the battle to the strong but it's the way to bet it. There are other factors that affect price that can't be explained and go bump in the night. The bottom of the market is the point of maximum negative sentiment. The converse is also true. A corollary to that premise is that the lower something goes in price the more likely it is becoming attractive. The higher something goes in price is more likely it is becoming less attractive. This is true in the world of commodities. Declining price reduces supply, increases demand and sets forth powerful forces to reverse that decline. Sentiment is a euphemism for consensus. Consensus is a normal distribution under a bell curve. The only place where you consistently lose is the middle, at the zero bound, where the majority of the bets are placed. If you consistently bet the consensus you are guaranteed to lose. This explains the poor performance of money management, hedge funds, and CTAs. As industries they do not add alpha. The only way to win is to place positions away from the center. The closer you go to the tails the more likely you are to win big and lose big. If you can win you won't need to win that often. Fundamental traders can't predict the future. Our predictions are analyses of probabilities. First you need to understand that you don't know. Sentiment changes more frequently than reality. Reality changes slowly and secularly. Sentiment changes hourly. Over time you want to bet on the fundamentals. One factor we know is the world's central banks have added $6 trillion to liquidity. This money will need to find a home and when it does it will have an unprecedented effect on prices. Inflation is not always measured by the CPI. It's in housing, commodities and other areas. The developing world is growing geometrically in population and economic importance. There's an enormous amount of sovereign debt out there. The central banks will try to inflate this debt away. Taxes and austerity won't get it under control. The money management industry has always been backward looking. That product the clients most want to purchase should be the product they should have least. Clients say 'don't lose money and don't embarrass me'. This creates a negative bias to the marketplace. Initially we'll see an increase in all asset prices except bonds. After that equities will fight competition from rising interest rates. Longer term I'd rather be in agricultural than industrial commodities. Don't underestimate the power that liquidity will have to propel equity and commodity prices. Increase your chance of success by not trading. Trading costs are significant. High turnover CTA's have a 7-8 percent hurdle to break even which is the principle reason eighty percent of them disappear. Second, bias your positions to long backwardation and short contango. You can add 2% and get paid to wait. Third, Gerstein's Law, don't talk to clients about your positions. It inhibits the manager to make instinctual decisions and it dissipates whatever advantage may exist. Next, you make money in option markets by betting on things you anticipate, things you don't know. You won't make money on things you do know. Things you know are already in the price. Gerstein's Law II, for each investment professional you add to your firm you reduce the compound rate of return by 10 basis points. Finally, we look for markets where we can earn 50 – 150% ROR and positively carry a position for 3 to 5 years. Our favorite positions are long natural gas, long lumber, short sugar, short JGB and long Dow futures. ggerstein@redoakcommodityadvisors.com

Please join me in expressing our gratitude to Jim Kelly, Bob Aaron and the gang at HedgeServ who generously provided the underwriting for today's symposium. raaron@hedgeserv.com

After the Fall: Picking up the Mortgage Pieces

June 21, 2012 • UNDERWRITTEN BY HEDGESERV

Greetings from the Greenwich Roundtable. Our topic, *After the Fall: Picking up the Mortgage Pieces*, is a continuation of Ted Seides' original session in May of 2007 that was titled Mortgages: End of the Beginning or Beginning of the End? We all know now that it was the end of the beginning. But today we hear why it's the beginning of the end. Brian Feurtado moderated today's session. He runs the private investor practice at BlackRock and is a Trustee of the Roundtable. Brian rightly observed that investors should expect returns from mortgage strategies nowadays in 6-12 percent range. bfeurtado@blackrock.com

Josh Birnbaum

Josh Birnbaum
Tilden Park Capital Management

Four years ago Hank Paulson was begging for $700 million to act as the lender of last resort. Today there is broad investor support for mortgage securities. Mortgage strategies have still underperformed other asset classes. The residential mortgage backed securities (RMBS) market is still trading at big discounts. Valuations must consider what kind of economic scenarios are priced into these bonds? Home prices are down 10% as a baseline. Under stress more than half of these bonds could fall another 25%. This disconnection does not reflect the housing market. Housing has seen too many false dawns. However housing appreciation in the last quarter has been constructive. Housing is not out of the woods yet. Supply has been constrained. Unwilling or unable to sell their homes 20-30% of borrowers are still upside down and keep their homes off the market. Foreclosure backlogs of current or future defaults have created a huge shadow supply that has not hit the market yet. How do we value this? On the balance sheet, the left side is the houses and the right side is the households. Housing supply exceeds household demand by 2 %. Given the rate of construction and household formation it will take 2-4 years to absorb the overhang. This is manageable. Ratios of home prices to household incomes are at 30 year lows. Valuations are running at a 5-10% discount if we ignore the bubble years. Mortgage market rates are at all-time lows. However credit availability is at multi-decade lows. Overall if we further examine types of mortgages, underwriting standards, and down-payments required, the impact on the mortgage market is accommodative. Housing is cheap. In some markets there is a good shot at upside appreciation. Barring an unforeseen catastrophe, the probability of a housing double-dip is low. RMBS bonds are attractive. They're still pricing-in an Armageddon. Our analysis shows housing is on-the-mend. The risks that worry me are the risks that can't be measured, the risks that can't be diversified or hedged away and the risks that are too expensive to hedge. We try to map these kinds of risks, keep an eye on them and keep an eye on the exits. The health of the economy, housing, employment, and borrower behavior are general economic risks that we watch closely. What if an exogenous event happens? We stress bonds with our Lehman Bros. scenario where borrowers fail to perform. If the event is hedge-able, it's straightforward. The role of the mortgage servicer is another risk. They can modify loans, and other terms that can impact bond holders. Analyzing and managing servicer risk is a big opportunity. If you know what you're doing and you're able to put boundaries around the servicers…you've got an edge. Servicer risk is partially hedge-able. Sometimes you can diversify away from it. Unlike 2008, today investors can take comfort that the government is less likely to intervene in the housing market. The government is more concerned with Agency bonds with programs like HARP. Credit fundamentals must be weighed against market technicals. We try to anticipate the behavior of other market participants, especially the new players. The next financial crisis could be worse than the last, although it's unlikely be led by the housing sector. The timing of the next crisis is uncertain. No one knows how long they can kick the can down the road. One outlook is that we muddle along in a low-growth, constrained economy where central banks stimulate and grow the balance sheet. Another darker view is where central banks cannot influence events any longer. This market is not trading at absolute lows but there are still plenty of money-good bonds still available. jbirnbaum@tildenparkcapital.com

Donald Brownstein

Donald Brownstein
Structured Portfolio Management

Macro economics is a lot of talk about how markets should work rather than the way they really work. We view the mortgage market as providing an elaborate tool kit to take positions and construct our portfolios. Our SSH portfolio focuses on the non-agency sector. Fifteen years ago the non-agency sector did not mean sub-prime or Alt A (riskier than prime, less risky than sub-prime) mortgages. They were loans on homes with high credit quality. When prepayments were exercised the homeowner could pay-off the loan without prepayment penalty. This was a free option for the homeowner. That option allowed people to refinance when interest rates fell. Non-agency loans prepaid very differently than agency (Fannie-Mae, Freddie-Mac) loans. Non-agency loan prepayments were more difficult to predict. Non-agency borrowers exercised their option less. This phenomenon defied economic theory and we developed some deep insights into the structure of the mortgage market. We hedged our risk with IO (interest only) securities which were short positions on the prepayment option. These insights were prosperous for our limited partners (Does the Citizens United decision recognize LP's as people? Audience laughter). In 2007 we offered a fund that shorted the sub-prime sector. Our timing was perfect because the lawyers delayed the documents. Otherwise we would've been early. The consequences of the sub-prime collapse were revealed when we discovered that the Alt A sector had grown from 3% to 25% of all mortgages. We predicted that there would be a spike in interest rate volatility. This forecast unfolded as a result of the financial panic. The mortgage market is huge and it affects everything. Today we think there is a change underway in the US housing market. I was born in 1944. Things changed after World War II. Cities like Chicago and Detroit enjoyed population booms as people migrated from the South. As migration continued cities began forming in the West. Before that people in cities rented their homes. Rental was the preferred mode of occupancy. In rural America people owned their homes and their farms. After WWII rural America population declined and cities grew. Cities grew outward into the suburbs. Levittown Long Island started the low cost ownership trend. The American dream became ownership in the suburbs. In 2006 housing prices began to descend after a sixty years of continuous increases. The surprise of 2006 was the supply of houses exceeded demand. We ran out of people who could afford to buy houses. Today there are 4.5 million homes without an owner-occupant. Owner occupancy has dropped from 70% to 65%. It could fall to 55%. How will these homes be rented? A market will emerge for lease-backed securities that will package the overhang. $3 trillion in home equity from 15 million houses must be picked up. The capital markets are the only obvious solution. Capital markets rely on securitization. The recovery of the housing market will be solved by securitization. It's the last big part of America that hasn't been corporatized. don@spmllc.com


Greg Lippmann

Greg Lippmann
LibreMax Capital

We buy securities, not loans. We care about macro events and how they affect the prices of our bonds. The pace of mortgage bond selling from European banks will increase. The supply will push prices down in the short term. We also buy securitized receivables especially when banks are non-economic sellers. Aged inventories and balance sheet constraints force these sales. We make economic decisions purely on risk-reward and we're eager to pounce. Thus we trade our portfolio more actively. We trade not only mortgages but across collateral types. We hedge against risks of servicer behavior or governmental interference such as the robo-signing scandal or the moral call to give principle forgiveness. The mortgage market is huge but opaque. There's no price clearinghouse. There's a wide range of opinions on price. The key is data and models. The expenses are extensive. The barriers are high. Few participants can accurately analyze these markets. There's a lot of alpha to be mined here. Sub-prime is most interesting. Across the nation lower-end homes went down disproportionately more than the higher-end. Now they're up 5-10% while the higher-end is still coming down. Half of the sub-prime borrowers, depending on the specific pool, have been underwater for 2 years, they're trapped and they're still paying. We believe this market has stabilized. If the housing market falls again we believe the prime borrower will default at a greater rate than the sub-prime. Prime pools are not poised to recover as fast as sub-prime. Sub-prime is priced more attractively. Lease-backed securities are the future. Buying-to-rent will be a big business. The most exciting area is in the lower-end. Buying-to-rent is putting a floor on prices. Buyers don't care about the view. They just care about the economics, the rental yield. When a market is forced to clear, its economic value is revealed. When you're allowed to kick the can, like Europe, the market won't clear. The prime mortgage market has seen few defaults. You can buy the low-end in bulk and manage them with scale. The US economy seems to be getting weaker while the housing indicators seem to be getting better. Mortgages are fantastic risk-adjusted investments. The strain on the banks leads to opportunity in mortgages. Truly liquid mortgage long-short strategies may enjoy a golden period of opportunity in the next few years. In the short run, the banks are selling. In the long run, they're not issuing these securities any longer. glippmann@libremax.com

Asset Allocation for 2013: Charting the Opportunities, Navigating the Risks

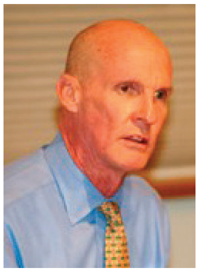
October 18, 2012 • UNDERWRITTEN BY SOLUS

Greetings from the Greenwich Roundtable. Our topic, *Asset Allocation for 2013: Charting the Opportunities, Navigating the Risks* is our annual symposium for the chief investment officer. In this session we take a 30,000 foot approach where we ask the brightest lights in the industry to tell us which strategies to buy and sell. Today's discussion was helpful because our speakers translated the opportunity set from the effect it might have on the portfolio of an endowment, a pension fund or a private investor. Believe it or not, we've never taken an interdisciplinary approach to asset allocation before. The conclusions could best be described as one pool's food is another pool's poison. Ewen Watt is the super smart leader of BlackRock's client think tank. John Powell is the chief executive of Stanford University's innovative endowment. Gerlof de Vrij previously ran a giant pool for a Dutch pension fund and is currently trading a solidly profitable global macro portfolio. Ted Seides moderated this panel by asking how we will make 8 percent next year. ts@protegepartners.com


Ewen Cameron Watt

Ewen Cameron Watt
BlackRock Investment Institute

Risk falls into four categories: growth risk, rates risk, positioning risk, and political risk. Opportunities are linked to collateral, the business cycle, risk-reversal and positioning. In Europe we've swapped systemic risk for growth risk. The European Central Bank is trying to secure capital flows and avoid the grinding outflows from peripheral nations which would require current account adjustments which would make it impossible to stabilize the financial system. The ECB has accomplished those flows. The evidence is the volatility of the spreads between the peripheral nations and the core. Unless the politicians screw up in the next 6 months the US will be the fastest growing G-7 nation in the next 3-5 years. The will provide the opportunity to get on the long path to reduce the fiscal deficit. China's growth is changing. It will decline to 5% by 2020. Most growth will be focused internally. This will have a profound effect on stocks, bonds and commodities. There will be less imported machinery and more imported minerals. Soft commodities will have supply problems. The most unpleasant surprise will be if rate expectations start to rise which will happen sooner than people think. This is linked to collateral. Is there an improving or deteriorating outlook for collateral items? The value of collateral in the US is improving because the housing market is improving. Every spread asset class has negative convexity thanks to the Federal Reserve. And many have extending duration as well. This feels like a policy assumption that money multipliers will not increase. Money multipliers have flattened despite the increase in the money base. Thus the risk in 2013 is an accelerating rate of credit creation where negative convexity assets in the US begin to be sold-off. Europe is still a few years away. The values of collateral in the BRICs are slowly improving. Housing prices in China are rising. Brazil is stabilizing thanks to monetary policy. All are undervalued because investors have been reminded that they have a business cycle. Some investments are standing out. The great income theme from bonds has been successful for its promoters and some investors. But 2013 will see a return to equities, REITS and emerging market debt. EM debt must rise because these countries need to develop their own bond markets. I'd short US treasuries & high yield. The dollar will increase in 1-3 years. Budgets will tighten and current account deficits will be lower. China will export less and US will export more. The maturing European crisis will throw up a lot of opportunity. We're reducing high-yield exposure and replacing it with Italian and Spanish 10 year bonds. Ewen.cameronwatt@blackrock.com



John Powers

John Powers
Stanford Management Company

Let's talk about our portfolio today and how we may modify it going forward. We're highly illiquid. We're 50% illiquid. We feel the premium is worth the wait. We wake up every day with high equity beta that's embedded with growth, small-cap and venture equity. Our goal is to payout 5.5 %, match inflation and grow the real value of the endowment. We like our portfolio. How do we think about the world and what's our response in the portfolio? I'm not convinced that events over the next year will be linear. Over the next 2-5 years I have high conviction that there will be a series of unpredictable external non-linear shocks. There's a high potential for volatility. There will be risk to the portfolio as well as opportunity if we respond correctly. Our world view is not guided by what's cheap and what's expensive today. Our liquid assets and our borrowing power allow us to move against the crowd and provide nimbleness at the bottom. The biggest portfolio trend is to move away from outsourcing everything and the redemption friction that it creates. We're running a larger portion in-house on a market proxy basis with as little correlation as possible. In our liquid portfolio we're shooting for less equity beta than normal. This gives us T+3 deployable capital in case dislocations occur. We expect low returns and high volatility. Last year was a great year for core real estate, not messy real estate. Last year it was difficult to detect opportunity in the equity markets, especially between the Euro and Non-Euro Zones. We like venture capital because of our close ties into that community. You can't create venture exposure overnight and we respond to quality. We don't like Treasuries. Tail hedging against rising interest rates and inflation seems cheap today. JGB-Treasuries seem like a bubble. Universities are inherently inefficient. The tenure system creates rigidity. Contributions come with strings. Operations have a lot of inflexibility baked-in. This isn't bad because innovation/invention comes with a lot of waste and inefficiency. But the administration tries to reduce inefficiency. Never waste a good crisis. In 2009 the crisis provided the opportunity to cut waste deeply. This took the pressure off the endowment to sell at the bottom. The administration shared the risk with the endowment. We are an episodic tail hedger when pricing is asymmetric and the payoff is huge. The university is unique. We're risk oriented. john.powers@stanford.edu

Gerlof de Vrij

Gerlof de Vrij
Blenehim BV

Earning 8% on a diversified portfolio is difficult. Let's distinguish between the short run and the long term, between a cycle and a regime. We are in a difficult regime. Returns will be cyclical and difficult. A bumper year is possible but it's likely to be followed by a down year. ALM models predict 5% from nominal bonds. If 10 year Treasuries yield 2%, either yields must rise to 5% (and prices drop) or prices rise (and yields fall to zero). 5% will be difficult from the fixed income allocation. Being out of bonds is dangerous because they're negatively correlated to stocks. Over the last century the correlation has been zero. Recently the correlation is negative because we're in a monetary regime where the central bank steps in and drives yields down whenever prices fall. Bonds provide diversification. Bonds no longer provide returns. They're hedging instruments. European institutions are now using bonds to hedge their liabilities. They need to increase bond duration with their liabilities which has driven yields down. This has never happened before. It's created huge dislocations. This is the era of balance-sheet recession. Central banks dropping yields to inject liquidity is not the solution. Reducing debt and structural changes are needed. Current account surpluses exist in countries like China, the GCC, Germany, Switzerland and Netherlands. Deficit countries have negative real interest rates. Investors who need to deliver returns are faced with monetary policies that work against them. This is a financial repression regime. Yields will remain low for a while. Japan has low yields that have created a deflation trap where monetary policy doesn't work anymore. Our low yields have created a liquidity trap. The search for yield has lowered spreads dramatically. This has the potential to create a bubble…tail risk is high. Inflation is unlikely to follow as economic growth is muted. Reflation is more likely. If the US crisis is cyclical, not structural, then the recovery is self-sustaining, yields rise, bonds fall and stocks rise. Stock valuations are fair. US earnings and cash levels are high. Europe is cheaper than the US. Portfolio construction must be dynamic, responding to valuation extremes and driven by fundamentals, not liquidity. Try to make returns rather than take returns, especially in illiquids. Try to embed concepts like fundamental indexation, equal weights, and volatility benchmarks into your liquids to change the behavior of your active beta. Apply the same concepts to fixed income. Valuation really matters, especially in the long run. Oil and gold prices are high. The outlook for Europe is improving. China and its impact on commodities and the emerging markets are uncertain. Do your homework and be a contrarian. Investing in Italian & Spanish bonds may be lonely but they're likely to be a good long term bet. With bond yields so low, getting 8% will put pressure on other assets to deliver.
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We've been running the marathon of discovery for nearly 20 years now. Please join me in praising the steady support from our Underwriter's Council. Their funding affords us creative freedom and their names go largely unnoticed. They've all been selected for their integrity and their reputation. The influence they exert on our programming is less than zero. If you find our mission useful and our content helpful please let them know how much you appreciate their support and then make a contribution of your own.

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Ron Fingerhut
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Michael Fisher
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