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Taking a Global View in 2007

When it comes to your investments, if you're not already taking a global view of risk and return, the question is, why aren't you, and when will you? Simply having investments distributed around the globe doesn't qualify, by the way – not any more so than does a European bank qualify as a global bank by simply owning shares in banks in North America and Asia. If we can engage in a little word play here, we'd say that investing globally is not the same as being a global investor, the latter of which takes far more advantage of the investment opportunities available on the global playing field.

As we have thought about what's important for investors to be focused on in 2007, three key themes stood out from all the rest. First, it has become increasingly difficult, we believe, for investors to treat assets in different markets as though they exist in isolation. The basis for return and the sources of risk are increasingly dependent upon much more than local market conditions. Second, the important trend amongst institutional investors towards applying fewer constraints is one that now gives global product a significant advantage relative to investment products with more limited scope. Without the reduction in investment constraints, global product isn't necessarily better than a portfolio of various domestic and international products run in separate buckets. Third, on a separate, but tangentially related note, as investors have increased the aggressiveness of their investments in response to the low global market volatility conditions today, investors need to be keenly aware of the nature of the risk that they are taking, and to be prepared with a response should normal volatility rapidly re-enter the market.

Global Integration

It is conceivable that the most important milestone reached most recently was achieved by the emerging markets whose GDP – as noted by the Economist – exceeded just marginally 50% of world GDP (when measured using purchasing power parity implied exchange rates rather than the generally depressed exchange rates associated with emerging markets today). Not only have emerging markets become a large part of the global economy, they are no longer as dependent upon the developed world as they used to be. It used to be the case that for emerging markets, trade was conducted primarily with developed markets. Today, nearly half of their trade takes place with other emerging markets. Not only is the US economy no longer the growth engine of the world, but the developed economies generally are no longer the sole growth engine for emerging markets.

Such examples of change should come as no surprise to anyone. This and other examples merely mark how far we have come on this path

towards a more global economy. We've seen similar evidence in the labor markets. Whereas previously, labor was a global commodity principally only in the area of manufacturing, we have seen global commoditization taking place in that part of the labor force where information and knowledge concerning its use are the chief inputs. More and more examples of firms with global revenue streams arise every year, and mergers and acquisitions cross international borders seemingly on a routine basis now. Even activist investing on a global basis has been rapidly on the rise via private equity funds, particularly in 2006.

Let's be clear about what these changes mean, however. One needs to differentiate between the notion of global integration and the notion of global convergence, or global homogenization. We at First Quadrant live in the greater Los Angeles region, a city, like several cities around the world, known as a "melting pot." The term says a lot about what people expect from so-called "globalization." Differences are expected

to be melted down, leaving a more mediocre, or compromised amalgamation of what had previously been rich and distinct cultures. Yet take the cuisine in Los Angeles, for example. If you want authentic Mexican, East Indian, Iranian, Thai, Vietnamese, Italian, French, or you-name-it cuisine, you can find it preserved here. What you also find are fine examples of how the best of these cuisines can be fused, making for offerings that are often just as appealing as what is found on the menu of the separate, original cuisines. (True, along with every good example of a fusion is a poor example of compromise.)

The economic landscape, at least so far, looks quite similar. Economic interactions are largely between economies *with significant differences*. These differences are found in standards of living, labor laws, property rights, monetary policy, exchange rate management, infrastructure, taxation, degrees of ethnic friction, degrees of protectionism, and degrees of difficulty in simply doing business. Differences are plentiful. And, perhaps, as with fusion cuisine, there are those best global firms that have managed to draw the best from management, talent and manufacturing processes around the world to assemble truly world class organizations. We see First Quadrant as such a fusion, particularly when it comes to our global sourcing of human capital.

Under such circumstances, what is an investor to do? Should one resist the increasingly fluid nature of the world and carve the world back into fixed, distinct pieces according to country, region or sector and distribute assets accordingly, or should one engage in *fluid opportunity seeking across this diverse set of opportunities*? The logic of the former escapes us. The logic that supports the latter seems clear.

Foremost on investors' minds in recent years has been the difficulty of finding rich opportunities for high quality investment return. Not coincidentally, at the same time, there's been a widening recognition that a relaxation of investment constraints may ameliorate this situation. Reducing investment constraints allows for two kinds of enhancement of the return. First, it allows for better opportunities for return to be pursued and captured if and when they appear outside of the more constrained opportunity set. Second, it allows for greater breadth of opportunities to enter the portfolio which should, therefore, improve the quality of the return, i.e.,

to improve the risk adjusted return, through wider diversification of the active risk.

An important, and for some, controversial, source of breadth comes from including top-down, or macro, decisions in the portfolio. Some investors remain wary of making such decisions. It is our belief that this wariness stems from having experienced what for many investors is a toxic combination of (a) making concentrated bets that (b) have long-term investment horizons attached. At least a year ago, for example, investors would have started to think that the long run-up in the price of value stocks over growth in the US was due for reversal based upon long-term relative valuation (value was bordering on being expensive relative to growth – there's a normal spread there that shows mean-reversion tendencies). That would have been a painful investment decision to follow in concentrated fashion, even if, as we think, the logic is sound long-term. A similar expectation has been held about the long rally in small cap stocks relative to large in the US. For long-term valuation reasons, many investors started to fret about a decline in the US dollar some number of years ago.

None of these decisions should be taken in concentrated fashion, nor should long-term expectations be the only guide to deciding when to act upon them. In simple terms, macro tilts should, like all other investment risks, take place in well diversified portfolios, and the tilts should be managed by taking account of the current market and economic conditions that may or may not serve as catalysts for a correction to any long-term valuation. These principles are applied everyday by those who are specialists in the area of macro investing. We, for example, have been generating high quality risk adjusted returns with well diversified portfolios consisting of nothing but macro tilts. It can be done if done right.

Not to be missed is the fact that taking macro tilts will add breadth to portfolios that include more constrained decisions. Global portfolios where risk and return are managed from a global perspective rather than within a series of individual country, region or sector silos are by definition better positioned to take advantage of a reduction in the investment constraints for the obvious reason that they are free to take advantage of opportunities that cross borders. What is not always fully ap-

preciated is the fact that this *needs* to occur. This brings us to the second observation that we'd make about the increasing level of economic interaction across borders. While this interaction lies between entities that remain substantially different, those differences are narrowing in certain respects, particularly in the sense that they are increasingly subject to risks and risk factors outside of their local environment.

While we can't be too explicit in a publication as widely distributed as this one about the specifics, suffice it to say that we've been managing money since 1994 with broad recognition that, for example, such things as the interest rate environment in Japan affects prospects for stocks in the US, and that changes in the sterling/dollar exchange rate will affect the value of euro bonds on the Continent. The point is that what drives prospects for return within markets is increasingly influenced by what takes place outside of those markets. As the years have passed since 1994, these principles have become increasingly important, and that had an important impact upon the shape that our new global equity platform took (launched in 2006). For example, the amount of risk we optimally allocate to exploiting relative value in Australia at any point in time, or the optimal risk allocated to earning a liquidity premium in Hong Kong, will both tend to depend upon the nature and magnitude of the opportunities we find in countries as far away as Spain.

Just pause for a moment and consider what the big issues are currently. Today our focus has shifted from concerns about domestic liquidity conditions, and instead is focused on the fact that the globe is awash with excess liquidity. While we are each possibly more focused on our own local real estate markets, we're aware of the fact that real estate has reached uncomfortable heights in many regions of the globe, and we're concerned about what a global retrenchment in real estate prices might mean to consumption globally and, therefore, for the global economy. While the US is planning to build a fence between ourselves and our important neighbor to the south of us, immigration issues and, in its more violent form, ethnic conflict is a worldwide problem today bearing more common threads than not. Income disparity and the social, economic and political tension that it creates has become a global phenomenon derived from somewhat common causes. And who around the globe

isn't concerned about the strong dollar, and size of the US trade deficit?

Commodities, the most global component of trade, have grown sharply in both value and scarcity, and are driving international activities of various types, from the Chinese seeking to secure foreign supply of their anticipated future demand, to the Russians less constructively using commodities as a tool for achieving their political ends. Chavez has been using his new found national wealth to pursue his own more personal political agenda and ideals. His activities are sponsored by, and in some cases directly involve commodities (e.g., his activities in Manhattan). Without question, market sensitivity to conditions in the commodities markets has been high throughout the world.

We could continue, but the point should be clear: managing assets in today's world from a purely domestic perspective ignores the realities of today's investment landscape. Our answer to this has been to provide global product that takes advantage of the opportunities that may be captured by fluidly crossing country, region and sector boundaries. Both our global macro and our global equity work do just this, and, we think, are important components of what our clients should be investing in going forward.

A Word About Risk

Worldwide and across asset classes, market volatility has generally been quite low. Across the developed world, relative returns of markets (e.g., the return on Japanese equities vs. the return on UK equities) have delivered volatilities less than 50% of what is normal. This is true of both equities and bonds. Currency risk has held up better than most, running at 80% of what is normal. Within the US equity market, we continue to see remarkably low levels of relative return volatility (how stocks perform relative to each other). Relative return volatility in the Russell 1000 universe, for example, has been running at 75% its normal level, the lowest level we've ever seen for the Russell 1000.

Nobody can tell you for certain what has been suppressing volatility levels. There are a number of hypotheses to consider. This may be a perfectly "normal" low in the volatility cycle. "Normal" in the sense that volatility cycles are never the same: they

differ in amplitude (how low or how high volatility gets relative to what's normal) and frequency (how long the peaks or troughs last before normal volatility levels are seen again). This cycle looks deep and long, but it's not obvious that it's beyond what might be expected. In short, there's reason to think that nothing has changed and that volatility will revert back to more middling levels in due course.

It's possible that volatility levels are lower as a result of a greater diversity of investors in the marketplace today. Take the US equity market, for example. Ten years ago trading in the marketplace was dominated by traditional equity investors who, in mass, have a relatively homogeneous approach to investing. If all investors respond to new information in relatively similar fashion, this would be expected to magnify market movements. With a greater diversity of investors involved, volatility may be dampened instead.

There are a number of other explanations being offered which we're sure you know, so we won't take you through all of them. Our own expectation is that volatilities will behave as they always have, and will come to rise well above current levels once again. Whether the average volatility may have fallen structurally at the margin or not doesn't matter as much given that we assume we're well below either the past or the future normal levels.

If we're right in assuming that today's low volatility levels are, indeed, merely passing through a normal cyclical trough – admittedly one that may have greater amplitude and lower frequency than most prior troughs – then there's a risk that many investors either under-appreciate, discount or ignore altogether the tail risk that they've taken on. In response to the low volatility environment, portfolio positions have been variously magnified, concentrated, or otherwise adjusted to increase the risk, and therefore, potential return, associated with them in this low volatility environment.

As volatility passes through peaks and troughs in its cycles between high and low levels, the magnitude of the *typical* daily price move rises and falls by definition. The magnitude of an *unusual* or *outlier* price move does not, however, rise and fall in a corresponding fashion. As far as we can tell from the few outliers there are to observe (outliers, by definition, occur infrequently), there's no relation-

ship between the size of market shocks and the volatility level observed just before the market shock.

This means that if market risk is running at half of normal market risk levels, and portfolio positions are doubled to avoid delivering only half the normal level of risk and return, then the size of any outliers that may occur are likely to be twice the size of what would be normally expected. We are not saying this is good or bad: this is a matter of balancing one risk against another, e.g., balancing the risk of under delivering on the return goal versus the risk of delivering larger than normal outliers. We just want to make sure this matter is clear to investors, and, as we've invited our clients to do on previous occasions, to engage with us in making sure we're balancing your own risks and objectives in a fashion appropriate to your risk tolerance and return objectives. We would encourage you to have this conversation with all of your managers.

What Can We Do For You?

It seems that changes everywhere bode well for the skill set that we have to offer our clients. Our skills in producing standalone alpha – ported or not – have become increasingly important to investors as this decade has progressed. Initially the increase in interest in alpha as a source of return was motivated by a falling equity market. More recently, and particularly as we look to the near future, that interest in our alpha production skills is increasingly motivated by the growing interest in liability driven investing and the need that that creates for sources of return that are independent of liability exposures. There is no question that most investors who turn towards liability driven investment profiles will need to increase the role of alpha in their portfolios – assuming they can find sufficient sources of alpha production.

The continuing trend towards reductions in investment constraints also raises significantly the value of the skills we have to offer. Allowance for greater symmetry around the benchmark has meant that we have been able to deliver increasingly better quality returns in our global macro work by shifting from long-only to long-short approaches, and is allowing us to deliver better quality returns in our equity work though the use of so-called extended, or 130/30-type mandates. We began running global

130/30 equities in September of last year, and we have won our first domestic US 130/30 equity program which should start early this year.

Reductions in investment constraints have furthermore meant that we are able to more effectively allocate risk, both tactically and strategically within both our global macro and global equity products. Risk shouldn't be allocated on a fixed basis – capitalization based or otherwise – in global products. It should be opportunity-based. No individual equity market or region, for example, provides the same potential level of alpha at all times – relative or absolute. Relative opportunities shift from country to country, region to region, and sector to sector as conditions change.

Most importantly, and central to our comments on the pages here, our long experience thinking globally and investing based upon global influences upon asset classes, markets, and individual assets is becoming increasingly valuable as it becomes increasingly important to think globally about risk and return.

Finally, we can work with our clients to, at a minimum, make sure that they are aware that risk is not what it may seem when viewed from the naïve perspective of a simple risk calculator. The tools we use in this industry to measure risk should not be taken as the last word. In their typical use, they place too much weight on recent performance to tell us anything meaningful about outlier risk, and they can not be looked to to tell us about risks not yet experienced. We must think beyond what these tools can tell us. Better, we can work with our clients to insure that we manage their assets in the manner that best aligns with their unique risk and return objectives.

We look forward to a fine 2007, and to those who are our clients, we thank you for the confidence you have placed in us as we push forward to deliver on your investment goals and needs.



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