

FQ Perspective

by Max Darnell

Three experienced climbers wake in their tents at dawn and begin to plan the day's ascent. Two of them go outside to check conditions, and begin to talk about the day ahead.

After miserable weather the day before, the first one smiles at the sky and says to the other, "The clouds are clearing, and the wind is dying down. I think we're going to have a clear day ahead of us. I say we take the western-most route up today. I know it's more precarious, but it's faster, and with the good weather we can leave behind some of our heaviest bad-weather gear and travel more lightly."

The second climber takes in the conditions, thinks about what the first climber has said, and responds, "Hmm. I don't think so. I think this is nothing more than a brief respite from the storm. Even though the wind is lighter this morning, it still has the deep chill of yesterday's storm, and those clouds still look heavy with moisture. I've seen conditions change quickly for the worse on mountains like this one over and over again, and the last thing I want to do is get caught out in another storm without protection. Let's take the eastern-most route which will give us better protection from the storm when it comes, and where the path is easier for carrying the extra gear."

At this point the third climber emerges from his tent, taking in the morning's conditions. "I've been looking over the map again this morning, guys. Here's what I think we should do," he says, pointing at the map he brought with him. "If we head up this route here, we can carry our storm gear with us to this point here. That will give us time to see how the conditions are evolving. If the conditions have worsened, we can connect with the eastern trail, taking all our gear with us in case it gets really bad. If, on the other hand, this morning's improved conditions hold, we can leave our storm gear, connect

with the western-most trail, and yet be within a short distance from it if the weather sours later in the day."



We're in an environment today where the conditions can, and likely will, change quickly for better or worse and back again. Fortunately, our approach to investing depends far less on our subjective ability to forecast this year's weather, and depends much more instead on our ability to respond to objective changes in observable conditions. The point is that our approach to investing bears more resemblance to the third climber in the illustration above. We're all about adapting as conditions change. Most of the time we're able to follow our models which, themselves, are triggered off of changing conditions. Following our models is wise because in all but the most extreme conditions, our models have tended to be right when our subjective views disagree.

Extreme conditions have caused us to override our models recently, sometimes successfully, sometimes not. In mid-January of 2008, we took action to restrict our active asset class strategy from taking a large overweight on stocks. That worked well, of course, but we remained too conservative in our view and continued to override our models desire to take equity risk in early 2009, and that hurt. The good news is that our tactical asset allocation strategy (Global Tactical Asset Allocation) added value in both years, and our new conditional strategic asset allocation strategy (Essential Beta) kept up nicely with it's comparison benchmarks over the period in which it has been running (which was most of 2009). We had some difficulties elsewhere – in volatility arbitrage and in equities, but those difficulties aren't related to asset allocation, the subject we're addressing here.

It is under extreme conditions that our subjective views tend to be more reliable, although as 2009 shows, we



aren't always right. But when our subjective views are wrong, we mostly risk missed opportunity. We don't increase risk through our subjective views. We use subjective views to neutralize risk when we think extreme conditions have made our models less reliable.

Are we in extreme conditions today, or have conditions returned to normal? No, and no. From our perspective, there is no such thing as "normal" if by "normal" we mean either "constant," or "unprecedented." There is no "new normal," and no "old normal." Market conditions are remarkably varied and ever changing even when not extreme. For us, extreme conditions are created by extraordinary imbalances or potential breakdowns in the market or market mechanism.

In January of 2008 we decided to override our asset class model because an extraordinary informational imbalance caused us to define conditions as "extreme." It was clear to most investors at that time that an unusual level of undisclosed information lie buried in securitized bundles of mortgage backed securities, on financial institutions' balance sheets, and in SIV's (structured investment vehicles). Positive information about public companies is rarely hidden, so when information is obscured, it's usually because there's something amiss. We thought the conditions were sufficiently extraordinary that our asset class model would be less reliable in 2008, and it was.

Today we find much to be concerned with, but we see nothing extreme that stands outside the purview of our models. The massive injection of liquidity does appear extreme from our perspective, but, in the main, the facts surrounding this injection are publicly available and should be reflected in market prices. As a separate and long-term issue, we continue to be concerned about the fact that this massive liquidity injection has been used globally to dampen the impact of the credit crisis when it was excess liquidity itself that played an important enabling role in creating the credit crisis. As we've said before, central banks are throwing gas on the fire in an attempt to put it out. Perhaps central banks will show themselves to be quite adept at withdrawing liquidity at just the right time, and we hope they will be, but there's much at risk if they don't.

We remain concerned about the fact that the credit extension remains anemic. Individual banks are lending less while the scale of banking overall has shrunk both by assets and by leverage, i.e., lending has shrunk for both reasons. Securitization activity, while not dead, is barely breathing, in particular outside the spaces controlled by the public sector. We mustn't forget that prior to the crisis, nearly 60% of mortgages and credit-card debt were funded through

securitization, as were roughly 90% of auto loans. The so-called shadow banking system was significant and has neither been restored nor replaced. In earlier academic work, Bernanke had identified continued credit stinginess as prolonging the Great Depression once the monetary base and bank reserves had been repaired. We appear to be mired in the same problem today.

The "good news" about the economy and corporate profits has yet to become truly good news. We're pleased, of course, to see that unemployment may be improving (although it must be acknowledged that unemployment data is very, very noisy today – as evidenced by the sheer scale of the gap between "normal unemployment" and "extraordinary unemployment"). However, today's US unemployment rate of 10% is not good news, nor is a shift from 10.2% to 10.0% when no new jobs are actually created. A more complete measure of unemployment, designated U-6 unemployment, counts everyone in the US who wants a full time job but doesn't have one because (a) they are looking but are not finding, (b) have quit looking due to having become discouraged by the job market, or (c) are working part time when they'd prefer to be working full time. U-6 unemployment is currently above 17%. We don't have a long enough history to compare this level with prior recessions, but suffice it to say, that's a lot of underemployment. Add that many workers have taken salary cuts, that double digit unemployment is found today in many countries around the world, and the fact that corporate profits in the S&P 500, for example, have been improved through cost reduction rather than revenue expansion, and the picture of the economy remains ugly.

In addition, the housing market in countries such as the US continues to be at risk. Home mortgage performance in the US continues to weaken and many expect we won't see an end to worsening in this debt sector until mid-2010. Estimates of US home mortgages in late-stage delinquency fall above 4 million, and over 15 million home mortgages are estimated to be in a net-negative equity position. These homeowners along with those who have already lost their homes are not going to help the economy begin growing again through aggressive consumption. They'll be rebuilding their savings instead.

There are other debt sectors to be worried about as well. Commercial real estate has been given a great deal of focus of late. Rising vacancy rates for commercial office space and significant write-offs for commercial construction loans have been running high. Sovereign debt as a percentage of GDP has grown substantially in many countries, and we have all read recently about the specific countries and regions where this is most concerning. One should



pay close attention to the potential ripple effects across the banking industry should any major spread widening or defaults occur.

Finally, regulation or government intervention could turn out to be a concern if a punitive, rather than constructive orientation results in counterproductive regulatory measures. Good can come from improved transparency, centralized clearing, and from imposing limits or controls on leverage for government backed entities. But bad may come from regulation that seeks to punish and/or satisfy merely political ends. Punitive pay caps (price controls never work as intended) are one current example. Raising the cost of equity transactions for those who trade stocks quickly and frequently would be counterproductive, whereas insuring that their orders are published without delay to insure an equal playing field would be constructive. Limiting the ability of “speculators” to transact in the commodities markets, as a final example, is likely to increase the cost for commercial participants to obtain the hedges they need since they depend on the speculators to take the other side of their trade. We’re hopeful that sensible, objective decisions will be made where regulation is concerned.

Our view at First Quadrant is hopeful, but guarded. It is human nature to be creative, productive, and move forward in the face of adversity. If today, like the climbers at the beginning of our commentary, we were climbing uphill through the snow, then we’d be leaving much deeper footprints in the snow than usual for we are carrying a much heavier burden up that hill today than we have at most times in the past. That doesn’t mean we won’t succeed in reaching the peak. It simply means that the going is much more difficult right now, and that there is more risk of us being delayed, or worse, suffering significant setbacks. In today’s markets and economy, we have less room for error, as our resources are more strained trying to cope with the burdens we’re already carrying.

Our core belief about the path forward for the market and the economy, therefore, is less about direction and more about risk. We face more risk today than we typically do. Our markets and our economy are more vulnerable today. This means we live in a fatter-tailed world, and this means the value of being tactical and opportunistic is higher than it normally is.

What we are seeking to do for our clients is to navigate our way forward through these risks and these changing conditions. It is, for example, less important whether we can gauge today where the S&P 500 will be at the end of 2010 than it is that we know how to respond if risk either continues to moderate or begins to rise again instead, for example, and to know how to respond if either inflation and interest rates begin to rise or if both remain low and stable instead. Our Essential Beta product is designed to help clients navigate strategically on a conditional basis to changes in the environment, while our tactical overlay products and our equity products are designed to help our clients navigate tactically and opportunistically to such changes. In the spirit of knowing when to carry bad weather gear, we are exploring with our equity clients the use of index options for opportunistically hedging their benchmark risk, recognizing that there are good times in which, and good prices at which insurance is attractive, and other times and other prices which should discourage us from buying insurance.

We’ve been studying the map carefully, and we’re prepared to respond to whatever way the day unfolds.

