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## AMG WINTER 2011 COMMENTARY

### Some Thoughts on Risk and Uncertainty

*“Risk comes from not knowing what you’re doing.”*

- Warren Buffet

The events of the past few years clearly reveal which investment managers understand the economic concepts of risk and uncertainty, and which do not. Those who do understand, manage risk, accept uncertainty, control volatility and appreciate that markets are both multi-factor and multi-duration. Those who don’t understand manage a lot less client money than they did a few years ago.

Part of the problem I think lies with journalists who refer to “risk” and “uncertainty” interchangeably when referencing market volatility or sharp asset price declines. This has led to a general acceptance by most investors - professional and recreational alike - that they are the same thing. They are not.

It’s fundamental to investment management that one understands how risk and uncertainty are radically distinct concepts. Risk, in an economic sense, refers to situations with *unknown, but measurable, outcomes*, while uncertainty refers to situations with *unknown and immeasurable outcomes*.

An example from horse racing can help to clarify this distinction. In racing, uncertainty is always present because the winner of any given future race cannot be known, but risk is only present if we have made a wager on the outcome. Risk implies the existence of probabilities (the odds of any specific horse winning) and the occurrence of a quantified gain or loss (the outcome of the wager based on each probability).

The nature of the relationship is such that you can have uncertainty without risk, but there is no risk without uncertainty. Put another way, uncertainty is universal, but risk is specific. This is immensely significant, because ***you can only hedge against those losses that can be separated and quantified in advance.***

It’s true that high levels of uncertainty roil markets, but uncertainty is not a controllable variable; it is something that must simply be accepted. We monitor it as one of the input factors in our macro model, but we can’t manage it like we seek to do with risk. The reason that we teach “*markets abhor uncertainty*” instead of “*markets abhor risk*” is precisely because the relative structure of risk allows it to be discretely hedged away.

As investors we have all made a wager that the values of our portfolios will be higher in the future than they are today. Accepting uncertainty is part of this deal, but accepting risk doesn’t have to be. Risk is a tool that good money managers utilize with great effectiveness to grow client capital. By understanding what risk is and how it allows us to hedge, we gain a valuable advantage towards winning that bet.



## **Why Was 2011 Such a Bad Year for Active Managers?**

*Data Courtesy of Bianco Research*

By many measures, 2011 was one of the worst years for active money managers in history. Consider the following:

- The HRFX Equity Hedge index, which tracks all open equity-based hedge funds on a global basis, underperformed the S&P500 by 21.2% in 2011, its worst ever relative performance (by a very wide margin).
- There are roughly 4,100 US-based equity mutual funds that invest in large cap stocks. Only 17% beat the benchmark last year, the lowest since 1997.
- According to J.P. Morgan, 433 equity mutual funds in the US use the Russell 1000 Growth index as their benchmark. Amazingly 70% underperformed the benchmark by more than 2.5%, while 39% underperformed by more than 5.0%. Only 3% beat the benchmark, one of the worst performances in history.

In the face of these astounding numbers, the natural assumption is to believe that this underperformance is primarily due to bad market calls. However, given the widespread nature of the poor results, this is not necessarily the case.

According to the sentiment surveys published by research group ISI, managers were not overly bullish at the market peaks or overly bearish at troughs. In fact, on average they adjusted portfolio exposure fairly well during the year's volatility. Where they fell afoul was in their failure to manage the correlation risks that arise from global central bank interventions.

Correlations in 2011 were even higher than in the 2008-09 period. Consider that since its launch in 1957 the S&P500 index has never had a single day where all 500 stocks moved in tandem (all up, or all down), but it has had 40 days where over 490 stocks moved together. Of those 40 days, 28 of them (70%) have occurred since the emergence of the European debt crisis in early 2010. These high correlations extend beyond just stocks, though. Correlations among global stocks, currencies, fixed income and commodities reached extreme levels a number of times during the year.

What's causing the high correlations? Simply put, it's a result of repeated capital market interventions by central bankers and other government agencies. Central bank money printing operations have been hitting new highs, and their huge bailouts of both industry and state lead to inefficient allocation of capital. It's also well documented that government intervention shortens economic cycles and increases market volatility. As long as markets remain centrally planned, interconnected risk will remain elevated and global returns will be driven by stress levels in the European banking system.

## **Portfolio Recap - 2011 Q4**

We remained well hedged through the much of the year's final months. Bluntly put, we could afford to be skeptical of the various "solutions" put forth by European politicians because we weren't faced with the career risk of being down 20% YTD at the end of September. This positioning did hurt our absolute returns as we failed to



participate in October's hope-fuelled risk asset rebound, but our research suggested the probability of a further correlation crash remained high, so we stayed on the sidelines.

The income side of client portfolios was relatively unchanged in the 4<sup>th</sup> quarter. We eliminated our allocation to US corporate bonds as volatility rose and risk aversion saw high yield credits sell off. When bonds become a *source* of portfolio volatility, it's time for review. Canadian preferred shares and corporate bonds did their jobs by trending slightly higher within their expected ranges. The biggest "missed" trade of the year for us is rarely a bond trade, but this year it was. Our 0% weighting to long-dated government bonds, particularly US treasuries, cost us a lot of relative performance versus some balanced benchmarks we track. Some classes of long bonds returned upwards of 30% in the second half of the year. But to be fair, I can't think of a single strategist who anticipated that a sovereign downgrade on US debt would lead to the lowest long-term US interest rates since the 1950s.

Gross equity exposure in client portfolios remained relatively constant, but we were busy on the hedging side. At various points in the period we had anywhere from 20% to 80% of our gross equity exposure hedged with a combination of inverse ETFs, and in some cases, put options. In Canada, our long equity investments remained focused on lower beta, higher yield sectors of the market - Banks, REITs, Pipelines and Telecoms. In the US we looked for growth in the Consumer, Info Tech and HealthCare sectors. The execution of our equity hedging program in the second half of the year wasn't always perfectly timed or sized, but it got results. According to the Globe and Mail, the average equity fund in Canada returned -10.9% in 2011, while our equity portfolios, after accounting for hedge profits, fell less than 1.0% on average.

As mentioned in previous letters, we've become much more interested – and active – in utilizing select currency and commodity investments to generate returns. This quarter saw us buy back at \$1,600 the gold exposure we'd sold in September at \$1,900, and take a sizeable short position in the Euro at an exchange rate of €1.00/\$1.42 (short Euro, long US dollar). Earlier in the year we also booked substantial gains in long US dollar and short oil positions during the heights of the summer debt crisis. Although these profitable investments were offset by some losses taken in silver and agriculture, our commodity and currency trading was the most profitable area of management in 2011.

Our alternative strategies mandates were a big disappointment this year. Although we owned good managers who generally beat equity benchmarks, they consistently fell short of our expectations – not just during the crisis, but throughout the year. As a result we fired two of them. Pending further review we may make new allocations to these, or other, alternative investments. I still believe that we want to have exposure to the particular skills and talents that the very best of these managers possess. The one manager that we did keep this year, we did so because of their specialty in mergers & acquisitions, an area that I think will see a lot of activity in 2012 as cash-rich corporations look to acquire, rather than build growth.

### **Current Positioning & Looking Ahead to 2012**

Typically, we manage client portfolios to take advantage of what we see as the key emerging (or continuing) themes for investment returns. In July of last year we made the right call when we reversed our earlier expectations for accelerating growth in the



second half of the year. As we all know now, growth slowing turned out to be the most important call of the year, and by proactively turning our investment focus to risk management (hedging) at the macro level, we saved clients lots of money.

Like last year when we got bearish early, we are also getting bullish early in 2012. Between mid December and early January we closed all of our equity hedge positions and began reallocating some capital into higher-beta growth sectors. We still maintain, on balance, a relatively conservative portfolio but believe that in at least the early part of the year, risk-reward favors the upside.

Much of our market-level research is focused on the US markets because we can extrapolate, through interest rates, fund flows and trade relationships, how what happens in the US is transmitted out to other parts of the world. It then follows that if we get the most important elements of the US economy – the dollar, growth, inflation – right, we will get a lot of other things right as well.

Let's start with the dollar. By now it's pretty clear that Ben Bernanke and the US Federal Reserve are in a box with respect to further quantitative easing / monetary stimulus. The last round led to peaks in oil and food prices that crushed growth globally and started the Arab Spring. Anchored at ZIRP and under heavy fire from Washington for its prior easing, the Fed has passed responsibility for any additional stimulus to Congress, absent another true crisis. Meanwhile, the European Central Bank has increased its balance sheet by a trillion dollars (40%) during the past 6 months via open market purchase of PIIGS sovereign bonds and various asset repurchase programs to bolster Europe's financial system.

The result of these divergent policies has been a 10% rise in the trade weighted US dollar since last September 1<sup>st</sup>. During this time we've seen a marked deceleration in food and commodity price inflation, and a sustainable drop in leading indicators for unemployment result in rebounding consumer confidence. For those who believe the US needs to pursue weak dollar policies to be successful, remember that 70% of the US economy is consumption and that as a developed nation America should expect to always be a *net importer* of goods. A strong dollar boosts consumption because it deflates inflation and makes consumption cheaper for Americans. The weak dollar has done nothing to help either employment or exports in recent years.

Consider that of the last 8 US Presidents only 2 have followed strong dollar policies – Reagan and Clinton. Reagan created 18 million jobs from 1980 to 1988, and brought the unemployment rate from over 11% to under 5.5% when he left office. Clinton inherited an unemployment rate of 8%, created 22 million jobs during his tenure and left office with unemployment at 4%. The job creation records of the "weak-dollar" Presidents since the 1960s have been dismal.

Next up is growth. For all of the reasons I mentioned above, we actually have a favorable outlook on US economic growth in 2012. The consensus view was late to come down in 2011 and is looking at the wrong factors today. This will lead them to underestimate growth in the short to intermediate term. Most economists are still bringing their US growth forecasts for 2012 down, from 2.25% to 1.75% for instance, when they should actually be bringing them up from 1.5% to 2.25%. These depressed consensus estimates now provide room for upside surprise.

The high frequency leading and concurrent indicators are suggesting that the bottom, if not already in, is near. And not just for the US, but also for Asia and Europe as well. Sequentially, with inflation slowing and PMIs turning up from contraction



levels there is growing room to restart another cycle of accommodative monetary policy. Growth slowing is no longer a fresh opinion. But identifying that growth slowing at a slower rate is a leading indicator for growth accelerating, is.

Overall we are seeing a vastly different environment from the one we saw 3 months ago from an uncertainty / correlation / volatility perspective and we have added some higher beta exposure to take advantage of what we see as generally rising markets for growth investments in the coming months. We still continue to favor yield producing assets at the core of the portfolio, but think that clients will be able to benefit from exposure to sectors such as technology and emerging markets (Hong Kong, Singapore, Brazil) during this current market phase.

With respect to the tail risks that we're looking to potentially benefit from or hedge against in 2012, a few stand out to chat about here. The first is with respect to Gold and commodities in general. The short term correlations between the US dollar, Gold and other commodities have become strongly negative (-0.67 for Gold, -0.73 for the CRB index), after having been only moderately so for much of last year. At low levels of long commodity exposure we can weather a drift higher in the US dollar, but should we anticipate a parabolic strengthening we'd look to hedge or sell our current exposure in these areas, potentially even going short.

The second tail risk that we've been spending a lot of time researching lives at the long end of the US treasury curve. The working thesis here is that as a strong dollar moderates inflation expectation and encourages upside revisions to real growth, we could see a backing off from long treasuries, sending prices lower and yields higher. Over the last week the US 10 and 30 year bonds have moved through their zones of support and appear to be headed lower. A sustained flight from Treasuries could deliver big profits to positions on the short side.

The third opportunity that we think we're ahead of the consensus curve on is with respect to debt stresses in Japan. With 31% of its outstanding debt stock (US\$3 trillion) due to be rolled over this year and a record high 49% of all government expenditures coming from new debt issuance we see some significant headwinds for the Japanese market in 2012. Currently, both Fitch and Standard & Poor's have a negative outlook on Japan's long term sovereign debt and research suggests that the Japanese financial sector could be in line for between \$80-\$100 billion in necessary recapitalizations should Japan be downgraded to an A+ rating. CDS spreads for Japanese debt have been widening out recently, especially versus other Asian nations. Recall that stock markets in the PIIGS countries sold off between 35% and 75% as sovereign debt stresses gripped those economies. Shorting the Nikkei 225 could be the trade of the year. For more on Japan, see the "Kyle Bass" post on our website in the "Commentary" section.

As always, our deepest thanks for your continued support and trust. Best wishes for a happy and prosperous 2012.

Cheers,



  
**Andrew Shortreid, CFA**

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