Carousing in Columbus, Ohio

I spent a most enjoyable day in Columbus, OH at the invitation of the local CFA Society. I should extend my thanks to Tim Steitz, Senior Investment Officer – Equities at the School Employees Retirement System of Ohio for organizing such a well attended event, and also Travis Upton, current President of the CFA Society of Columbus and Director of Portfolio Management at The Joseph Group. I talked about my upcoming book, The Hedge Fund Mirage, and hopefully offered some insights to investors growing their hedge fund portfolios. I also had several interesting discussions with investors about the alternatives to fixed income given government manipulated bond markets and the Tyranny of Low Rates.

I am finding that many investors are most interested in discussing less conventional strategies to generate income given the poor return outlook in bonds. Master Limited Partnerships (MLPs) and our Hedged Dividend Capture Strategy were both of interest to a number of people.

Force-feeding Capital to European Banks

There can be little doubt that the European sovereign debt crisis has finally drawn the full attention of Europe's leaders. After following events from a more than discrete distance, it is starting to look as if a consensus is evolving around three principles:

1) Greater write-down of Greek debt

2) More realistic stress tests of Europe's banks with a view to requiring them to reach 9-10% equity capital to risk-weighted assets over a fairly short period of time

3) Using the EFSF as a guarantor of first loss on sovereign debt, in effect increasing its firepower to €2 trillion or more.

The European Banking Authority's (EBA) last stress tests identified only €2.5 billion in capital shortfall for the entire region, a ludicrously low figure that lost them great credibility. Mike Cembalest, JPMorgan's Private Bank CIO, memorably commented that the number was so low he thought the results were being released by country alphabetically starting with Andorra. At the same time the IMF's estimate of the needed additional capital was €100-200 billion.

However, there is a problem with forcing banks to raise additional capital. They may instead decide to shrink their balance sheets instead, a prospect noted in the FT today. Issuing equity at 0.5 X book value is scarcely an attractive proposition and selling assets must be a realistic alternative. But that could well lead to a sharp slowdown in lending, further hampering the EU region's efforts to avoid (or emerge from) recession.

George Soros floats an interesting suggestion that governments should first unconditionally guarantee their banks to stabilize them, following up with recapitalization later when their share prices have presumably recovered.

While it's positive that constructive solutions are now receiving consideration, holders of risky assets can still benefit from being short the Euro. The € continues to be the focal point of the global slowdown. We are long ProShares UltraShort Euro (EUO) as a hedge against other types of long equity risk in our hedge fund. The risk of a complete disaster is receding, but the solutions don't look to be positive for

European growth.

Disclosure: Author is long EUO

Paulson's Paradox

My upcoming book The Hedge Fund Mirage explains how investors have not done nearly as well as the hedge fund managers to whom they have entrusted their capital. However, a handful of managers have genuinely created enormous wealth for their clients as well as themselves. Rick Sopher from Edmond de Rothschild Group did some research on this topic on which the FT reported last year. Among the genuinely value added managers was John Paulson, whose rare insight into the sub-prime bubble netted his clients and himself many billions. John Paulson was credited in the article with generating $33BN for investors.

So it is with genuine sorrow that I have observed reports of John Paulson’s very tough year, culminating with warnings that as much as 25% of his assets may depart by year-end. In my book I had noted Paulson’s strongly profitable performance by way of illustrating that there are some very talented managers who have truly added value to their clients. Regrettably, John Paulson is slipping from this pedestal.

The Tyranny of Low Rates

Ultra low interest rates may be the Fed's best bet at preventing the economy from sliding into another recession, but for savers they represent a stealthy attack on the real value of savings. Money market funds barely pay anything at all, and even ten year high grade corporate bonds only yield 4%. After taxes that leaves very little real yield (i.e. after inflation) and no compensation for the risk of rising rates or any increase in default risk. In fact it would only take a 0.5% increase in long term rates to cause a sufficient capital loss in ten year bonds to wipe out a year's worth of income. The fact that the Fed combined their announcement of Operation "Twist", (buying long term bonds and selling shorter maturities) with an expression of concern over the U.S. economy was enough to trigger another round of risk aversion and a flight into the very bonds the Fed is trying to make unattractive.

The tyranny of low rates is the regime facing fixed income investors everywhere. High grade bonds have returned around 6% per annum over the past decade and have done that much just through the first nine months of 2011. But with yields at 4%, it's pretty clear that the only way to repeat past performance is for yields to drop even further than they are now. A 1% drop in bond yields would cause around a 9% jump in prices, but the economic environment required to drive yields so low is unlikely to be friendly to many types of corporate risk.

There are alternatives. Investors should seriously consider reducing their conventional fixed income allocations. In any event, most balanced accounts will be below target on equities and above target on bonds following the sharp sell of in global stocks during the 3rd quarter. Rebalancing is generating bond sellers and stock buyers. But while this may push long term rates up a bit, the Fed is unlikely to contemplate raising short term rates until at least 2013.

As a substitute for bonds, we have three suggestions. Master Limited Partnerships (MLPs) pay distributions of around 6% and are likely to grow those distributions at 4-5% over the next year. It's enlightening to read through the public filings. One of our holdings in Magellan Midstream Partners (MMP). The tariff increases on pipelines that cross state lines are controlled by the Federal Energy Regulatory Commission (FERC) and annual rate hikes are linked to the PPI-FG (Produce Price Index for Finished Goods). Regular price increases linked to inflation are part of the reason MLPs can grow their distributions so steadily. MMP for example hiked prices on its pipeline network that runs down the center of the U.S. from Minnesota to Texas by 6.9% in July. MMP also provides an interesting way to benefit from the growing use of domestic natural gas in the U.S. since they continue to expand in areas rich with shale gas.

Barrons regularly writes about MLPs – a recent article highlighted the attraction of the sector.

Another place of refuge from low interest rates is a combination of cash and stocks. It needn't be as reckless as it sounds. The math can be quite compelling. Using ten year treasury notes which currently yield around 2% as an example: a taxable investor's $100 investment would grow to $113 after ten years. The same $100 could be allocated 80/20 between riskless three month treasury bills and large cap stocks. Putting only $20 into 2% dividend yielding stocks combined with a very modest 4% growth in dividends would also result in $113 of value in ten years. But this includes some very cautious assumptions – dividends ougfht to grow faster than 4%. They've grown at 5% over the past 50 years and companies are paying out a smaller share of their profits than in the past because it's more tax efficient to buy back stock or reinvest back in their businesses. And the $80 in treasury bills in this example may not pay any interest today but holding cash preserves flexibility to invest later when the future appears clearer or interest rates are higher. We've been discussing this strategy with clients. In effect the unusually high equity risk premium, the difference between the earnings yield on stocks and the interest rate on treasury securities, is making this possible as investors afraid of a repeat of 2008 seek safety in bonds.

Finally, it can be attractive to own a diversified portfolio of dividend paying stocks hedged with a short position in the S&P500. Stable earnings typically allow steady dividends, and such companies often have less volatility in their businesses and their stock prices than the market as a whole. $100 invested in dividend paying stocks can be made market neutral with around a $50 short position in an ETF such as SPY, hedging against short term price fluctuations but still allowing the investor to earn dividends and participate in dividend growth.

The Fed is making fixed income an unattractive hiding place. Prudent alternatives exist that offer the prospect of higher income with acceptable levels of risk.

High Frequency Trading's Social Utility

The New York Times reported yesterday that regulators around the world are examining High Frequency Trading (HFT) with a view to curbing its influence over short term market moves. The use of computer algorithms to execute short term trading strategies has resulted in physical proximity to stock exchanges being valuable so as to reduce latency in the transmission of orders. In other words, reducing the time that electronic pulses take to reach their destination can have a meaningful impact on results.

There is an assumption among stock market regulators generally that increased volume is a good thing. Higher volume causes increased liquidity and, so the argument goes, lowers the cost of transacting for everybody. It’s generally not an unreasonable view, and the corollary is that the cheaper is it so trade, the better off are both the savers who put money in the market and the companies who acquire those savings through equity issuance. In fact, for all the focus on short term swings in the market it’s as well to remember that its ultimate purpose is to channel capital from savers to where it can be usefully invested in productive ways. That is the point, after all, of a stock market and at its most fundamental every related activity ought to be geared to promoting that outcome.

Regulators don’t currently expose every new trading strategy or activity to that litmus test. Perhaps that’s as well. But HFT does seem to be about as far away from channeling savings to useful places as it’s possible to be. The New York Times article mentioned above goes on to note how firms routinely post thousands of orders at a time, only to cancel many of them a split second later. Firms have been fined for trying to manipulate the market through the sudden appearance and disappearance of large orders. HFT was blamed by some for the “flash crash” on May 6, 2010.

So ask yourself if the world would miss High Frequency Trading if it just disappeared from the landscape. Who would care, other than the traders themselves and (presumably) the providers of the trading capital they use. Would stock market returns be lower? Would the cost of raising equity capital be higher? It’s doubtful.

The Principal Agent Problem in Private Equity

Peter Morris has written an interesting article noting the principal-agent problem as it relates to investors in private equity. Peter spent 25 years working in financial services and is the author of a report written for the Center for the Study of Financial Innovation (CSFI) called Private Equity, Public Loss? Peter and others have pointed out the disparity between low returns earned by private equity investors and the ample compensation earned by the managers of those investments. The principal-agent problem Peter notes is not unique to private equity of course, but he makes a good case for much greater transparency around results for such investors and challenges the notion that “sophisticated” investors are well equipped to make well informed decisions in this arena. Investors in hedge funds have suffered through similarly poor results as Peter also notes, and he kindly refers to a book I have written called The Hedge Fund Mirage which explores this issue.

There are interesting public policy issues surrounding this entire area, in that public pension funds are increasingly allocating capital to alternative investment strategies in the hopes of reaching the 7-8% return targets they need to meet their obligations. Ultimately, a failure to meet those goals will have consequences for taxpayers throughout the developed world as workers retire if pension plan returns fail to met expectations.

Why Comstock Resources Has Fallen Too Far

In sorting through the wreckage of the past quarter's bear market, I've spent some time reviewing Comstock Resources (CRK). We own CRK – we liked it at $30 a share truth be told, although we did have the good sense to lighten up the position at those heady levels. CRK is a natural gas E&P name drilling for shale gas mainly in East and South Texas and North Louisiana. We've long liked natural gas as a replacement for coal in fuelling America's power plans. It is cheap, abundant, clean(er) and here, in the U.S. But the very abundance of natural gas has depressed its price for some years now and forced the E&P companies exploiting it to operate at successively lower costs. CRK qualifies, in that it has estimated extraction costs of around $1.26 per MCF (thousand cubic feet) although that continues to fall. It also has manageable debt. They operate in a similar area to Petrohawk, which was acquired earlier this year by BHP Billiton. We think CRK may ultimately be acquired, although today's market environment offers much less immediate prospect of that given the difficulty of financing acquisitions.

Meanwhile, CRK's stock price recently sank as low as $14 (and even now has only rebounded to just over $16). At current prices you can buy the entire company for less than $800 million. Assuming they can realize $1.25 per MCF on the proved reserves of 1.05 TCFE (trillion cubic feet equivalent), and after adjusting for debt net of cash the company is trading for approximately the value of its proved reserves alone. This doesn't account for their reserve potential which could be 3-5 times as much again. CRK's problem is that the market always worried they won't have enough cashflow to fund their drilling program and as a result will need to come to the market for additional equity , and this along with the disappearance of any imminent takeover explain the precipitous drop in the stock. The company believes they will fund all their capex needs from internally generated cashflow, and they expect to spend $610 million on capex (i.e. drilling new wells) in 2011 for which they don't expect to tap the equity market. In addition they have $400 MM in unused credit through their bank revolver.

I've met Roland Burns and chatted with him several times over the past year. We think this stock offers an attractive risk/return at current prices, and will be looking for opportunities to add to our position.

Disclosure: Author is Long CRK

How UBS mismanaged its way to a profit

The good news from UBS today is that they expect to post a modest profit for the third quarter. This is in spite of losing $2.3 billion through the unauthorized trading of Kweku Adoboli. On top of that, the woefully inadequate risk oversight that Mr. Adoboli so painfully exposed has forced UBS to hasten the shrinking of their investment bank, incurring restructuring charges. However, in spite of these twin blows to their results, UBS expects to include a $1.5 billion Swiss franc profit from widening credit spreads on their debt. That's right, because the company's self-inflicted wound has soured investors on the bank's prospects and therefore raised the yield on their debt, in the topsy-turvy world of accounting this is counted towards their profit. The green eye-shade logic is that because UBS owes money (on the bonds they've issued) the lower price for the bonds implies the value of what UBS owes has gone down. It's the same as if the investors in those bonds just decided to forgive 5% of the face value.

Of course, UBS still owes the same amount of money, and borrowing just became more expensive for them. But the Looking Glass world of liability accounting regards this differently. So when UBS announces a profit for the third quarter, remember that it came about through the market's recognition of their weak risk management structure.

The Sorry Math of Bonds

The equity risk premium (as defined as the earnings yield on stocks minus the yield on the ten year treasury note) is wide for good reason. 2012 consensus earnings for the S&P 500 of $105, which implies an earnings yield of 9.3% (September 30 S&P 500 at 1131) and a spread over the 1.90% yield on the ten year treasury of 7.4% is wide by any measure. It last reached these levels in 1973, during the Yom Kippur War and the OPEC oil embargo. Today's problems are different and maybe far worse. An assessment probably depends as much on whether one's philosophy of life is optimistic as on how the macro issues will play out. For our part, we are cautiously constructive and maintain equity exposures at neutral, believing that current valuations offer a sufficient discount for the risks.
While respectable cases both for and against equities can be made, the absence of value in bonds seems far less contentious. No doubt for most of those holding this view (like us), they held it at higher yields than these and so far it has not been right. At the risk of being stubborn, lower bond yields simply make it more right than it was. The latest

Federal Reserve plan to shift its purchases of bonds to longer maturities ("Twist") has perversely caused short term rates to drift up somewhat even while the Fed's prospective buying (and coincident negative economic outlook) has driven long term yields down. In fact government bond markets are increasingly manipulated by governments, and therefore look less appealing places to invest. Even without a view on whether inflation in five years will be sharply higher, lending to anybody for ten years at less than 2% doesn't seem much more compelling than holding cash. For the taxable investor assuming a 40% tax rate, 2% pre-tax is 1.2% after tax which over ten year turns $100 into just under $113 (and unless inflation averages no more than 1.2% over the same period guarantees a loss in purchasing power). The economic environment that would make today's buyer of 2% yielding government bonds happy in ten years' time is unlikely to be kind to most types of credit risk. High grade corporate bonds linked as they are to government bonds offer only modestly better prospects. So today's buyer of corporate bonds desires many years of economic misery to contain inflation but not so much so as to damage corporate creditworthiness, a fairly precise forecast that doesn't leave much room for error in either direction.

Virtually all investors have an allocation to fixed income in one form or another. While bonds have not looked cheap for a long time it does seem that today's low yields, distorted as they are by government intervention, demand a robust response from investors. Since public policy is to make the goal impossibly narrow, maybe it's time to take your ball and go home. If an investor shifted $100 out of fixed income and allocated $80 to 0% yielding cash, the remaining $20 invested in risky assets (such as equities) need only grow at 6% p.a. pre-tax to generate the same $113 of ultimate value as in the ten year treasury example above (assuming a 15% tax rate on dividends and capital gains).

To illustrate with some brief Math: since dividend yields are 2%, this only requires 4% of annual growth. 2% dividend yields imply companies are paying out only 2/9ths of profits (as earnings yields are 9%). The remaining 7/9ths that's retained would need to earn a return on equity (ROE) of only 5% to generate the 4% dividend growth noted above (dividend growth = % of earnings retained X ROE; 7/9ths of 5% is approximately 4%). A 5% ROE is around half the current cost of equity implied by the S&P500's 9% earnings yield. To summarize without the Math – being more pessimistic than this probably isn't the winning side of the trade over the long run. In the short run, anything can happen.

The 80/20 Cash/Stock substitute for fixed income doesn't need to jump very high to clear the performance hurdle that's been set. It incorporates some attractive upside, in that dividends may grow faster than 4%. And one day in the far distant future, maybe cash will even sport a yield again as it once did. This strategy also provides the flexibility to invest some of the cash at a later date, perhaps when the economic outlook is clearer and when bonds would presumably have to be sold at a loss.
We don't yet have the requisite Newsweek cover announcing "Why You Should Only Invest in Bonds", but the Math is starting to look compelling. Alternatives to bonds include MLPs (currently offering around 6% tax deferred yields with a solid history of distribution growth); stocks with long histories of reliable dividends; bank debt, and the cash/equities barbell described above.

The Credit Risk in Bank of

America

Many perverse things are happening in financial markets beyond the easily visible carnage in equity markets. Take Bank of America (BAC) for example. Credit insurance for one year through a credit default swap (CDS) costs 4.35% (according to Bloomberg). One year LIBOR is 0.85%. How does Bank of America function in today's money markets, where presumably nobody will lend to them at anything close to prevailing rates when the cost of insurance is five times as much. Presumably the only inflows they are receiving are those small enough to qualify for FDIC insurance (i.e. under $250K).

Author has no position in BAC