

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Well, we finally got a sharp correction on equity markets last week, something that was long overdue. However, it looked very much like just another pause to refresh. Risk appetite is high and investors are willing to overlook the negative factors and focus on the positives.

This isn't irrational behaviour, just a matter of basking in the sunshine and ignoring the clouds gathering on the horizon. For market participants, it is not particularly wise to fight the current momentum - - paraphrasing Keynes: the market can maintain an upward momentum longer than you can remain solvent. So bears are likely to go on being squeezed until the trend runs its course.

There is a lot of vested interest among fund managers to see this market go up and, hopefully, end the year on a high note. It may not happen exactly that way, if one of the risk factors pops up. But they would sure like to give it a try, and that's the way most folks are betting.

Hedge funds, in particular, have had a rough year. The returns of hedge-fund indices have been outdistanced by the broad market both this year and last, and by a good margin. This is a reversal of their healthy out-performance in 2001 and 2002, when markets were doing miserably.

Be it noted that these are absolute return funds where the managers generally have a free hand in terms of the strategy they can adopt. As a rule, they are not benchmarked to market indices but are expected to beat them handily because they are subject to so few constraints.

Unfortunately, the track record of the good years hasn't carried over to recent times. There are, of course, bright stars in the universe, but the general picture doesn't impress, particularly since performance tends to be overstated in any case. Measurement problems have always been an issue in the task of assessing hedge-fund performance. Most studies have found that returns are biased upwards and risk is underestimated.

The industry has become quite crowded as both supply and demand have increased. On the demand side, there is considerable interest among investors, of all categories, in alternative investments. As for supply, juicy fees have attracted a large number of start-ups.

A major problem is that some of the old strategies aren't working very well. Inefficiencies have disappeared in many areas, as more practitioners have crammed in - - trying to replicate the same methods. Successful managers need to be creative and flexible, switching from losing to winning strategies.

One of the biggest lessons in trading and investment is that cycles change, and what worked yesterday may no longer work today. This sounds trivially true but, surprisingly, it is neither well-understood nor effectively practiced by many investors, including professionals.

Another thing to remember is that there isn't a sharp dividing line between hedge funds and their orthodox brethren. Some managers in the former category use fairly standard techniques that are straight out of orthodoxy. More recently, some long-short funds have switched into being directional long.

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Money is still flowing into hedge funds at a healthy pace and investor expectations are high. Fees are scaled to the degree of out-performance and managers have a strong incentive to do well this year. Many orthodox funds have also struggled to perform well against their benchmarks. The first nine months of the year have been tough and the upswing in the last four weeks has come as a great relief. For long-only managers there is much motivation to keep the fire burning.

Bond yields are still low enough to make stocks look attractive. However, there are a number of factors that are currently being ignored but will make their presence felt as we enter 2005. Investors may have to face up to earnings uncertainty and softer economic growth. In addition, currency volatility and geopolitical insecurity are lurking in the background.

Europe

With the dollar slipping against major European currencies and oil prices still toppy, stock markets have been feeling the pinch. However, as we have said before, valuations are fairly attractive, compared with bonds, and relative to global stock markets. Local retail investors are generally sellers but others are in a buying mood, such as private equity and firms buying back their own stock.

Asia/Pacific

The dollar's slide against the yen finally forced Japanese authorities to step up their rhetoric about intervention. This may give foreign-exchange traders reason to pause because policy makers are beginning to feel some pain. Japan's domestic demand situation is iffy and economic growth performance now hangs largely on the competitiveness of exporters.

Bonds

Consensus expectations are for another hike in the target fed-funds rate in December, and this has supported the yield on the 2-year US Treasury note. At the same time, concerns about inflationary pressures have eased, leading to a flattening of the yield curve. Meanwhile, stronger currencies have resulted in a rally in Eurozone and Japanese government bond prices.

Currencies

Greenspan's comment, last week, about the sustainability of the US's current account deficit stated the obvious. Meanwhile, there does not appear to be a consensus among finance ministers and central bank governors on what to do about the greenback's depreciation. So the foreign exchange market's interpretation is that more dollar weakness is in the offing. But watch out for more intervention talk.

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