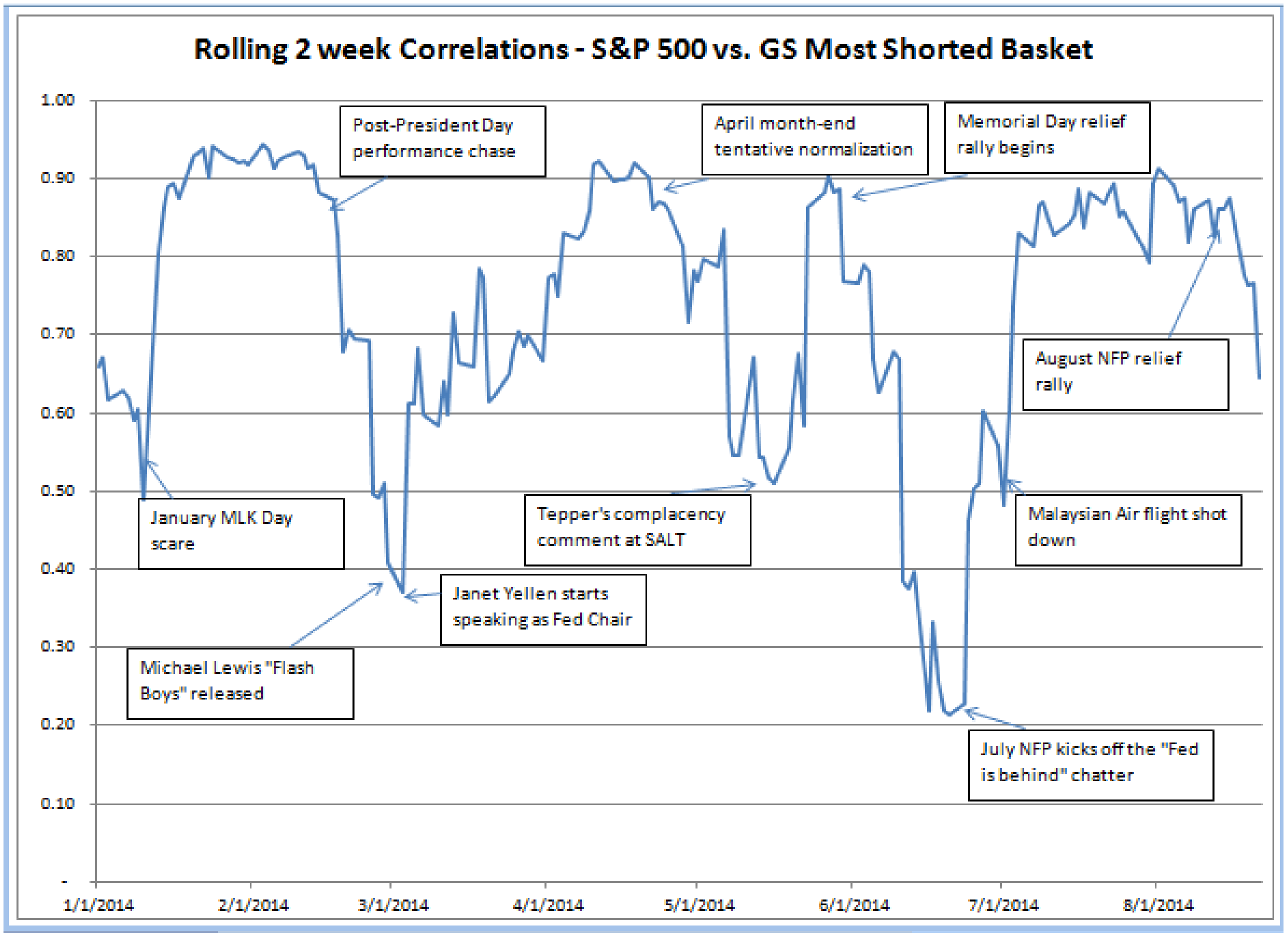
JULY MONTHLY INVESTMENT COMMENTARY

"No structure, even an artificial one, enjoys the process of entropy. It is the ultimate fate of everything, and everything resists it." – Philip K. Dick[1]

THINGS ARE NOT ALWAYS WHAT THEY SEEM

Imagine a children's game of musical chairs. At the beginning, when all of the children are playing, the game moves fairly continuously. But, as the game plays out and children are eliminated from competition, it becomes more strategic. Even at a young age, children intuitively speed up and slow down as they warily eye the diminishing number of remaining seats until there are only two children and one seat left. The child behind the chair will speed up; the child in front of the chair will slow down, both of them with one eye on the teacher until the inevitable end of the game.

After almost five and a half years of a bull market, it is beginning to feel like the final stages of a game of musical chairs with the complex adaptive system (about which we have written previously) becoming more skittish. For hedged players, this has been an extraordinarily difficult year, belied by the apparent stability of the uptrend in long-only indices such as the S&P 500, as correlations have been unstable.



Reference: Point Frederick Capital, Bloomberg, Goldman Sachs[2]

[1] GoodReads Quotes About Chaos, http://www.goodreads.com/quotes/tag/chaos?page=2

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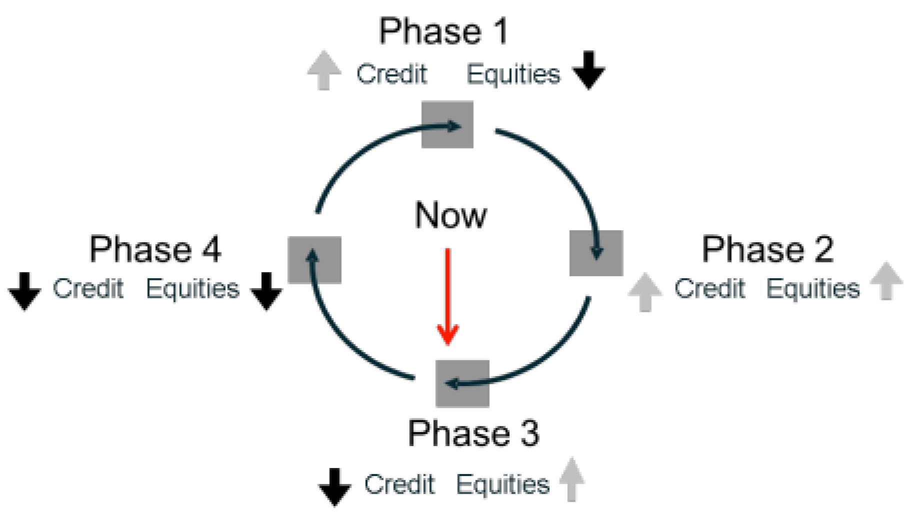
This is not, as the tired cliché oft-repeated goes, a "stock pickers' market."

What has led to such profound dislocations in correlation that has made life so difficult for hedged portfolios? And, should this tendency persist, what is the best way to deal with it?

Well, one natural response might be to suggest that we are closer to the end than the beginning by looking at the history of market cycles. Recent moves in high yield outflows might suggest that we are entering a new phase of the market cycle, here posited by Citi's Global Strategy Team:

Figure 2. Credit/Equity Cycle: Heading Into Phase 3



Source: Citi Research

Reference: Citi, FT.com[3]

In this framework, everything comes down to what you believe about where we are in the credit cycle and whether credit spreads will start rising from their extremely tight levels. Again, here is Citi as quoted in the FT:

> "Instead, a QE-induced search for yield has brought capital into corporate bond markets and kept spreads falling. The traditional relationship between leverage and credit spreads has broken down (Figure 9). Instead of becoming a headwind for global equities, credit spreads have remained a tailwind. QE has prolonged phase 2 of the equity/credit cycle.
>
> "But that may change. More recently, US HY bond inflows have turned into outflows and spreads have widened accordingly. It is still early days and the sell-off has largely been contained to US HY, but perhaps the prospect of QE withdrawal (in the US at least)

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[2] Goldman Sachs Most Short Rolling Index ("GSCBMSAL Index" on Bloomberg)
[3] David Keohane, "The Leverage Clock Tolls For Thee," FT Alphaville, August 15, 2014 http://ftalphaville.ft.com/2014/08/15/1931182/the-leverage-clock-tolls-for-thee/

> will re-establish the old relationship between leverage and spreads. If this is the case, then it seems that the delayed move from Phase 2 to Phase 3 of the credit/cycle may be starting."[4]

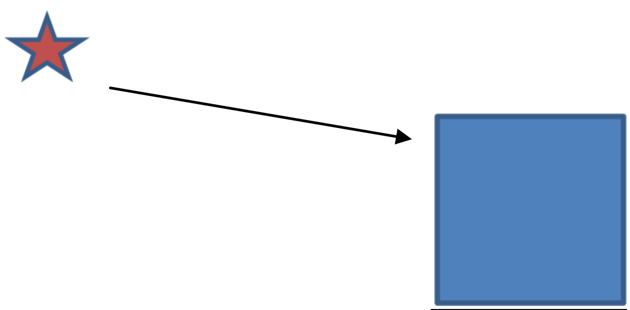
Certainly there are some brilliant investors who are beginning to position for a rollover in the market:

> "'You definitely are seeing managers reduce risk levels,' said Robert Duggan, managing director at fund-of-funds investor Skybridge Capital, which manages $11.2 billion in assets. 'It has been in the last four to six weeks that you've seen a bit of a sentiment shift. "Cautious" or "more defensive" are clearly things you hear when you speak with managers."[5]

Fear and loathing about the remaining longevity of the bull market in risk does not explain what we have been calling the "non-stationarity" of the US equity market, however.

Let us assume that there is some underlying distribution to all the securities in the tradable universe that describes their returns profile individually and in relation to one another. When this universal variance-covariance matrix is stable, that is to say when the expected returns for individual securities, when the variance of individual securities, and when the correlations between individual securities are all fairly constant through time, then we would describe the distribution as "stationary."

A stationary distribution is investable, particularly for hedged value-oriented and special situations investors, in that it highlights securities that are mispriced unsustainably. Let the blue box in the crude graphic below represent the stationary distribution and the star represent the mispriced security.



An investor can take a hedged position by investing long or short in the mispriced security and establishing an offsetting position in something not mispriced in order to play the normalization of the pricing relationship, with this normalization driven by some fundamental catalyst presumably.

If, however, the distribution is not stationary and its characteristics fluctuate irregularly, then investing with a hedged portfolio can be very difficult. The mispricing can become exaggerated, or the security that had been deemed previously to be "not mispriced' can itself become mispriced, in this schema. Consider the distribution shifting from blue to red to yellow, as below.

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[4] David Keohane, op. cit.
[5] Laurence Fletcher, "Nervous Hedge Funds Turn Defensive On Concerns Over Asset Prices," Wall Street Journal, August 20, 2014 http://online.wsj.com/articles/nervous-hedge-funds-turn-defensive-on-concerns-over-asset-prices-1408549333?KEYWORDS=hedge+funds+defensive

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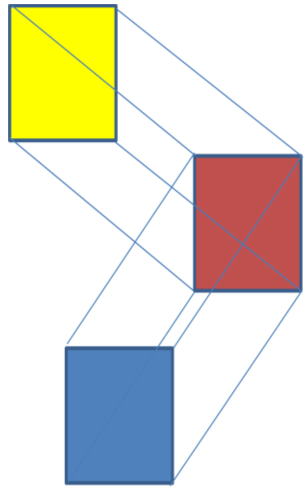

I have come across another theory that might do more to explain the turmoil underneath the broader indices, why it started, and what it means for risk going forward. It is a theory called the "Fractal Markets Hypothesis" and I give full credit to BCA Research for having brought it to my attention.[6]

It is defined in plain language in a research note written by Bank of England researchers:

> "In particular, we revisits [sic] the 'Fractal Market Hypothesis' (FMH), a theory of market behaviour proposed by Peters (1991). This conjectures that the dynamic of market prices – in particular its self-similarity – might be caused by the interactions of agents with different time horizons and differing interpretations of information."[7]

A normal market is made up of investors running the gamut from very short-term traders to pension funds with decades-long perspectives. Not only do investors differ in terms of their temporal framework, but investors may react to and interpret the same information differently, shaped by their distinct preferences. In normal times, these players can all co-exist profitably because of the self-similarity of markets. Charts of price action for the same security when looked at with different scaling of the time axis look remarkably similar. It is this so-called "self-similarity" which suggests a fractal approach to markets.

> "When a day-trader experiences a price move that they judge to be of sufficient severity to cause them to sell, a longer-term investor may step in and buy from them, thereby preventing significant price falls. The long-term investor may be willing to do so because, from their perspective, the day-trader's n-sigma event is not unusual (unless, of course, n is very large); judged by the longer-term distribution of returns, it is closer to the mean."[8]

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[6] Dhaval Joshi et al., "Fractal Dimensions And Market Turning Points," BCA Research, July 24, 2014

[7] Nicola Anderson and Joseph Noss, "The Fractal Market Hypothesis and its implications for the stability of financial markets," Bank of England writing for Vox, September 3, 2013 http://www.voxeu.org/article/fractal-market-hypothesis-implications-financial-market-stability

[8] Anderson and Noss, op. cit.

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Here is where we get to the possible explanation for the breakdown in stationarity.

> "It follows that financial markets can become prone to instability when this fractal structure is broken. Such a breakage could occur when investors with a longer horizon either stop participating in the market, or become short-term investors.
>
> "…
>
> "The original explanation offered by Peters (1991) has an exogenous event causing the short-term investors to sell and the consequent fall in prices causing long-term investors to doubt the validity of the information on which they base their behavior … A more subtle and endogenous explanation explored by Haldane (2011), because long-term investors view the market less regularly than short-term players, they come to doubt the veracity of the information given by prices in a market where other investors view prices more frequently."[9]

There are (at least) two possible implications for the collapse in time horizons across the investor spectrum: reduced liquidity and fatter tails.

> "In either case, the removal of longer-term investors from the market, or reductions in their trading horizon, causes liquidity to evaporate as there is no longer heterogeneity of investor valuations."[10]

And here is the Bank of England's Andrew Haldane summarizing the fractal markets hypothesis implications for fat tails:

> "Cramming ever-larger volumes of strategic, adaptive trading into ever-smaller time intervals would, following Mandelbrot, tend to increase abnormalities in prices when measured in clock time. It will make for fatter, more persistent tails at ever-higher frequencies. That is what we appear, increasingly, to find in financial market prices in practice, whether in volatility and correlation or in fat tails and persistence."[11]

The following table from the BCA note compares the Fractal Markets Hypothesis to the Efficient Markets Hypothesis:[12]

BOX 1

The Efficient Market Hypothesis (EMH) Versus The Fractal Market Hypothesis (FMH)

EMH	FMH
Return distribution is Normal (Gaussian)	Return distribution is non-Normal (non-Gaussian)
Stationary process (mean of distribution doesn't change)	Non-stationary process (mean of distribution does change)
Returns have no memory (no trends)	Returns have memory (trends)
No repeating patterns at any scale	Many repeating patterns at all scales
Continuously stable at all scales	Possible instabilities at any scale

[9] Anderson and Voss, op. cit.
[10] Anderson and Voss, op. cit.
[11] Andrew G. Haldane, "The Race To Zero," Speech at the International Economic Association Sixteenth World Congress, Beijing, July 8, 2011 http://www.bis.org/review/r110720a.pdf
[12] Joshi et al., op. cit.

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Anecdotal evidence points to diminished liquidity in the bond market:

> "Tony Rodriguez, co-head of fixed income at Nuveen Asset Management, has been in the bond market since 1986. He says the ability to buy and sell bonds has become more challenging. In the past, 'if average liquidity was a 5 on a scale of 1 to 10, today's markets might be something like 3 or 3 ½,' he says."[13]

And high frequency trading volumes may have fallen structurally after the release of Michael Lewis' book, "Flash Boys":

> "The sharp drop in stock-trading volumes in recent months has further pushed investors toward more-traditional methods of swapping shares. In the second quarter, trading volumes fell to their lowest level in seven years, according to data from Credit Suisse. With volumes so low, even small trades processed electronically run a risk of moving a stock's price, traders say."[14]

Regulatory changes have made the provision of liquidity more difficult for banks. The Volcker rule casts a wide net in its definition of proprietary trading making the holding of inventories problematic, forcing the banks to act as agents and never as principals. Pile onto this new rules for the maintenance of regulatory capital and cash equity trading is a less and less attractive business model. When Europe forces the regulatory divorce of equity research and cash equity trading, then liquidity will be only more problematic. It is hard to tell if these are intended or unintended consequences by those who would set policy, given earlier failed attempts at restricting trading volumes by imposing transactions taxes in Europe.

It is also interesting, if not coincidental, that the destabilization of markets in March coincided with the release and publicity tour for Michael Lewis' book on high frequency trading, "Flash Boys." While regulators were able to deflect prior concerns about insider trading associated with co-location, the attention of the public that Lewis' publicity tour generated, most notably with his "60 Minutes" interview[15] in which he alleged that the stock market was rigged, inspired what my old friends in the Canadian Forces refer to euphemistically as a "sense of urgency" about the problem. Any fiduciary would have a difficult time justifying trading with high frequency traders if it could be avoided after the publication of the book. And high frequency traders themselves, when they were not scrambling to increase their lobbying activities[16], probably throttled back their machines while waiting for the smoke to clear, hoping that the bureaucracy would file these complaints in an obscure circular loop of administrative red tape after a suitable cooling-off period.

> "Former CFTC Commissioner Bart Chilton, who famously blasted high-frequency traders as 'cheetahs' when he was a regulator, has gone to work with a leading high-frequency trading association, the group said Thursday."[17]

We have argued in previous letters that the non-stationarity we have observed since March was leading to waves of risk management trading creating remarkably difficult conditions for hedged investing. When the market has been non-stationary, risk management trades have begotten risk management trades in a cascade of pain. When long-term investors are uncertain they either stop trading or they trade

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[13] Tom Lauricella, "Reduced Liquidity In Bond Markets Concerns Portfolio Managers," Wall Street Journal, August 3, 2014 http://online.wsj.com/articles/reduced-liquidity-in-bond-markets-concerns-portfolio-managers-1407106289?KEYWORDS=trading+liquidity

[14] Dan Strumpf, "Stock Market Keeps Its Faith In Humanity," Wall Street Journal, July 28, 2014 http://online.wsj.com/articles/stock-market-regains-its-faith-in-humanity-1406564845?KEYWORDS=high+frequency+trading+volumes

[15] CBSnews.com, "Michael Lewis Explains His Book 'Flash Boys'," http://www.cbsnews.com/news/michael-lewis-explains-his-book-flash-boys/

[16] Jenny Strasburg and Scott Patterson, "High-Speed Traders Race To Fend Off Regulators," Wall Street Journal, December 27, 2012 http://online.wsj.com/news/articles/SB10001424127887324001104578165842110484364

[17] Eamon Javers, "High-frequency trading critic Chilton joins HFT lobby effort," CNBC.com, http://www.cnbc.com/id/101937327#.

on "overwhelmingly negative short-term market dynamics."[18] And when long-term investors are skeptical of the market microstructure, they minimize trading even further.

If the return on investing in an individual security is determined by a combination of the fundamentals, sentiment, and positioning, it is positioning that has been the dominant factor this year. And the combination of reduced liquidity and this fractal behavior is leading to fatter tails. Long-term investors need to be concerned about persistent fat tail environments because the potential dispersion is so much greater.

So, what are the implications of all of this high level thinking to explain the events of the past five months for hedged investing?

First, we are all short-term traders now. The reduction in liquidity from regulatory and structural changes to markets, combined with the growing bifurcation of asset management into either fully passive ETF investing or super-active hedge fund investing, and the persistence of fat tails makes it exponentially more dangerous to be a long-term trader.

Second, there will be times when it is straightforward to make money as a hedged investor and there will be times when it is extraordinarily difficult to make money as a hedged investor. The successful hedged investor will have to adapt in order to become more nimble in switching between these regimes by reducing exposure aggressively in the difficult times, one cost of which may be premature switching that foregoes investment profits during the straightforward periods from inaccurate assessments of phase shifts.

Third, fat tails can occur both on the upside and the downside. The general presumption from a risk management perspective is that one needs to be worried principally (and exclusively) with a fat tail market crash. However, depending on positioning, it may be just as likely that there are scrambles for paper as the fat tail can occur on the upside, as well. The markets for high quality collateral in the aftermath of the financial crisis, or the current market for German bunds, are examples of this mad dash. Knowledge of positioning will become imperative to successful hedged investing. Watch out for rising markets in which volatility for upside calls starts to skew higher, for example. The move higher in August since the release of the payrolls data has been interesting to watch as market participants who sidelined themselves grow more anxious with every fresh high in the index as the end of the month approaches.

Fourth, unhedged investing in long-only vehicles (or, vehicles such as certain types of hedge funds that are only nominally hedged, like many event-driven and distressed funds) have always been "work-until-they-don't" propositions. Given the fat tails world in which we now live, they will now become "**really**-work-until-they-**really**-don't" propositions.

[18] Anderson and Voss, op. cit.

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Long: Alcatel-Lucent

What: Alcatel-Lucent provides Internet Protocol (IP) and cloud networking, and ultra-broadband fixed and wireless access to service providers, enterprise, and institutions worldwide. The Core Networking segment (44% of total revenue) offers intelligent IP service routers, switches, and networking platforms to support IP-based applications and services as well as terrestrial optical products, which enable carriers to manage voice, data, and video traffic patterns. The Access segment (56% of total revenue offers wireless products that enable mobile network operators to offer mobile data capacity; cable, antenna, and tower systems; and fixed access products, which enable service providers to offer ultra-broadband connectivity.

How: The Company sells substantially all of its products and services to the world's largest telecommunications service providers through its direct sales force. ALU's revenue base is reliant on a small number of large customers; Verizon, AT&T, and Sprint represent 33% of total revenue. Although customers are not obligated typically to purchase a fixed amount of product or service over time, the Company does enter into long-term sales agreements with select customers whereby it has agreed to sell products at a fixed price. The Company remains vulnerable to a downturn or delay in spending in the telecommunications industry. ALU operates globally, with concentrations in the US (42% of revenue), Europe (25% of revenue), Asia (17% of revenue), and the rest of the world (16% of revenue).

Why: In the aftermath of the merger with US-based Lucent Technologies in 2006, ALU suffered a major cash burn of E700m per year due to (i) decreased demand for networking equipment following the recession; (ii) competition from Chinese manufacturers which benefited from high growth in Asia; and (iii) a high fixed cost base. In response to these challenges, new management launched an extensive three-year operational restructuring in June 2013 which is designed to reposition ALU from a telecommunications generalist to a specialist with better-aligned management and a strong focus on innovation, specifically in the high-growth areas of IP and cloud networking, and ultra-broadband access. Among other objectives, the turnaround contemplated E1B of fixed cost cash savings from 2013-2015, E1B in cash proceeds from asset sales, and E2B reduction in debt. ALU is just now showing signs of success from its operational turnaround as losses have moderated due to a downsized business, project margin improvement, and lower fixed costs. Thus far, ALU has achieved E478m in cumulative fixed cost savings (versus a target of E1B).

When: The investment horizon is long-term as the full benefit from the restructuring plan will take years to realize. The Company forecasts positive free cash flow by 2015, although this could be accelerated if cost reductions arrive faster than scheduled, or there is a pick-up in global telecom infrastructure spending due to enhanced competition or regulatory pressure.

Red Team Analysis: In the future, we may write that the investment did not work due to slowing/peaking growth in smartphone penetration, mobile data usage, and IP network transformations. Carriers in some of the Company's key regions may choose to focus on their own cash flow generation and may reduce fixed asset investment.

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Long: Siemens AG

What: Siemens AG is a global multi-industrial company. The Company is a leader in the Automation, Power, Healthcare, and Transportation sectors. The Energy division manufactures electricity transmission & distribution equipment, steam and gas turbines, wind infrastructure, and products for the oil and gas industry. The Automation segment comprises motors, drives, discrete automation products, and process automation equipment. Healthcare includes imaging, diagnostics, and healthcare IT and distribution.

How: The Company sells equipment for critical infrastructure needs much of which leads to lucrative long-term service contracts. Siemens works with utilities, oil and gas companies, industrial companies, transportation organizations, and healthcare organizations to fulfill their equipment and service needs. The Company sells these products and services directly to customers. Short cycle products such as motors and drives, and some building automation products are sold through dealers and distributors. The Company invests heavily in research and development, as well as engineering, and it serves top-tier customers in its end markets. Siemens also sells locally developed and manufactured products to serve second-tier regions with more idiosyncratic regional requirements.

Why: Siemens recently unveiled their new strategic plan aimed at lifting profitability. The plan eliminates costs by dismantling the sector divisions and duplicative corporate functions. Newly appointed CEO Joe Kaeser (formerly the CFO) is intent on creating a leaner, more nimble industrial company with an emphasis on investing in areas of high growth, product strength, pricing power, and Siemens technological superiority that will enable greater scale. The Company has identified electrification, automation, and digitization as the themes to exploit into the next decade. Additionally, management continues to restructure operations, targeting E1B in cost savings by 2015.

When: Industry automation orders are showing signs of recovery as manufacturing gains momentum in North America, China, and Western Europe. In terms of the Siemens portfolio, audiology has been singled out as the first business being prepared for its own public equity listing. The healthcare division is being run independently with the first disposition from this business announced several weeks ago. Cerner Corp. is spending $1.3B to purchase Siemens Health Services, the healthcare information technology business within the healthcare division. The Company has taken charges in the transmission segment and Siemens can see the light at the end of the tunnel as a number of troubled projects run off. Siemens is investing in the oil and gas space, especially in new technology and computing to optimize costs for the exploration and production industry.

Red Team Analysis: In the future, we may write that this investment did not work as stimulus efforts waned in China, leading to lower industrial investment. Also, pricing pressure in transmission and distribution may lead to a reduction in the profitability outlook.

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Short: Serco Group plc

What: Serco Group plc operates as a service and outsourcing company serving public and private sector organizations globally. Within the UK and Europe (together 44% of total revenue), Serco offers prison management, military support, rail transportation, education, and environmental services. Within the Americas segment (18% of total revenue), the Company provides technology and management services focused primarily on the US federal and Canadian governments as well as US state and municipal government. The AMEAA segment (21% of total revenue) offers transport, justice, immigration, health, and defense services in Australia, the Middle East, Asia, and Africa. The Global Services segment (17% of total revenue) provides end-to-end business process outsourcing services.

How: Serco typically earns revenue under a long-term service or outsourcing contract issued by a public (federal or state government, municipality, agency, etc.) or private entity. Serco has a contract win rate of approximately 20%.

Why: The Company's reputation suffered a significant blow last year as Serco was found guilty of overcharging taxpayers for electronically monitoring criminals. The scandal not only resulted in a six-month ban on bidding for UK government contracts, but it has had a lasting effect on financial performance due to (i) high management turnover at the project manager level; (ii) a low win rate of 20% compared to that of competitors which ranges from 45-60%; (iii) customer attrition in the UK and Australia; and (iv) profit margin compression due to loss-making contracts. After issuing consecutive profit warnings, the Company announced a GBP 170m equity raise in April 2014 for working capital needs and the pay down of debt. Valuation remains elevated at 16x forward EPS.

When: Short-term value realization will be in the form of ongoing customer attrition and a weak contract pipeline. If performance continues to suffer and management is unable to replenish lost contracts with new wins, Serco may be forced to issue additional equity. There is a growing possibility that the Company may breach its leverage covenant (currently 2.41x vs. covenant test of 3.5x).

Red Team Analysis: In the future, we may write that the investment did not work due to a pickup of new contract awards relating to immigration work in emerging markets (Africa, Middle East, and Asia) and/or the execution of a successful turnaround under the leadership of the Company's new CFO.

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