

PRINCIPLES

An Investment Newsletter

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Hedge Funds: The Antidote to Low Market Returns?

The consensus outlook among institutional investors is for modest returns in conventional equity and bond strategies over coming years. This seems reasonable in light of current equity valuations, dividend levels and historical earnings growth rates.

CBIS has suggested that participants reduce overall investment expectations, and we have focused our efforts on minimizing trading costs, fees and other sources of friction that lower returns. However, many investors feel driven to seek higher returns from alternative sources in order to meet their long-term objectives — thus the popularity of alternative investments (encompassing strategies such as venture capital and private equity partnerships, commodities and managed futures, real estate and timber, energy partnerships, hedge funds and hedge fund-of-funds).

Alternative investments encompass a broad array of often complex products. With attentive program analysis and oversight, as well as attention to the timing of entry into selective programs, attractive returns far above those of the public markets (i.e., traditional stocks and bonds) are possible.

However, a problem all too evident today is that of investors clamoring for alternative product based on attractive historical returns, the low correlation of those returns to stocks and bonds, and the strong psychological motivation of wanting to partici-



FRANK HAINES, *Chief Investment Officer*

pate in such compelling results. This is a disturbing situation, as such decisions are often based on past and not prospective performance. Moreover, the complexity and lack of transparency of many alternative investment programs does not permit a complete understanding of the reasons for their performance results. The vast array of alternative strategies is too comprehensive to tackle in one article, so we will focus here on the hedge fund category. The following are some of the problems with current performance expectations for hedge fund investments.

■ Many of the catalysts that supported historically strong returns are no longer present. Hedge funds utilize many components of the public markets — stocks, bonds, and cash securities. Just as bonds and stocks have

benefited handsomely from over 20 years of a secular bull market driven by the decline of inflation and long term interest rates from the double digit levels of the early 1980s, so have hedge fund strategies. Strategies with a long equity bias or duration exposure, and those based on a tightening of credit spreads, a convergence of global bond yields and/or currency compression with the emergence of the Euro, have benefited hedge fund managers as much as managers of traditional equity programs.

However, credit spreads are now historically tight, global bond yields have converged, mortgage spreads are tight, the outlook for equities is modest and the long-term decline in interest rates appears to be over — these sources of hedge fund returns have withered away. Of course, this reduces opportunities for conventional stock and bond managers as well, however their returns depend more on equity market action (beta) and their costs are far less onerous.

■ Accommodative Federal Reserve policy has ended. The carry trade has been very popular since the Fed began

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easing interest rates in 1999 to save the banking sector in the wake of the Long Term Capital blow-up (essentially, this entails borrowing in the overnight market for low cost and investing in short maturity bonds to pick up additional yield, which can be magnified through leverage). As long as the Fed signaled its intention to keep rates very low, this was an easy way for hedge funds to compound returns. But the change in Fed approach this past summer to a policy of tightening rather than easing removes this source of easy money. This change in interest rate direction also increases the cost of leverage, a significant source of return in many hedge strategies. As the yield curve flattens, many bond strategies and leveraged trades become less attractive.

■ **Too much money.** The hedge fund industry has reached a size never before contemplated — over 7,000 funds with a trillion dollars in capital (before leverage). The reason for the growth is simple: hedge fund managers can get fabulously rich very quickly. The hedge fund business, however, has traditionally been a cyclical one. Established during the 1950s, it has gone through two previous boom and bust cycles. The first coincided with the late 1960s bull market, and collapsed with the market downturns of 1969-70 and 1973-74 as too many of the funds were not sufficiently hedged.

The second wave of growth occurred in the late 1980s with the advent of global macro hedge managers such as Julian Robertson and George Soros, who expanded the diversity of fund strategies and developed strategies more capable of absorbing large asset flows. But results deteriorated with asset growth as too many new managers chased the same themes and investment opportunities, and many of the larger funds closed or faded from prominence. All this time the hedge industry focused

on the high net worth investor and endowments and foundations; the product was never designed for mass investing.

It is often said that the financial markets are large enough to encompass multitudes of different hedge fund managers. But these managers tend to congregate around the same basic investment approaches, and some of the compression of P/E multiples and the lack of significant undervalued opportunities in the equity markets, as noted by CBIS' equity managers, is most likely an indication of hedge fund activity on the margin.

Why does every generation have to relearn the lesson that money is made by making the uncomfortable choices, not by following the crowd?

Our bond managers comment on the rich pricing of mortgages, lower quality corporate bonds, emerging market debt and junk bonds, reflecting demand driven more by speculation than by investment for the longer term. However, today's low volatility will correct with some unexpected shock, and while some hedge managers may lock in their gains many will get caught by the resultant price dislocations and liquidity failures.

In the current cycle it seems that everyone wants to commit to hedge funds. Broker dealers are starting fund-of-funds, public pensions are committing billions, retail mutual funds are configuring approaches for

the modest retail investor, etc. But hedge investing is not a scalable business — it works well when modest funds pursue reasonable opportunities. In any alternative asset, whenever too much money chases opportunities, returns become diluted and, as Gresham's law states about money, bad managers will drive out good managers. That has become evident with some of the more successful hedge managers closing to new business, distributing capital back to investors, or leaving the business as Robertson, Steinhardt and George Soros recently did.

■ **The experience factor.** The tech bubble of the late 1990s was enabled in part by a new generation of sell-side and buy-side analysts and portfolio managers with little investment industry experience, who had experienced only one model of equity results and outlook. Most were not in the investment business during the last major market downturn, in October of 1987, much less during last sustained severe bear market, in 1973-74.

History appears to be repeating itself now in a new generation of hedge fund managers and advocates, often with track records of only a few years and investment experience of a decade or less. While purported to be the investment industry's "best and brightest", they are assessing value and competing with long-only managers who have decades of experience and a true perspective on market cycles and difficult market conditions. We would tend to side with experience, as the financial markets are dominated as much by psychology as by quantitative modeling.

This lack of experience carries over into the performance history of many hedge products. Today's new hedge fund investors are often making decisions based on limited data derived from modest sums under management, and are using hypothetical hedge indices that are seriously sur-

vivor-biased, suffer from illiquid security pricing and resultant volatility reduction, and often correlate to market returns. Perhaps the hedge fund industry's sizeable incentive fees are justified for original thinking, but they seem extreme for market exposures and/or leverage that can be purchased far more cheaply in the public markets and with conventional managers.

■ **The Holy Grail?** Many investors are now looking to hedge funds as an investing holy grail that will help gen-

erate portfolio returns no longer achievable with today's expected stock and bond returns. CBIS, however, recommends that participants lower return expectations, consider a Market Neutral allocation, and enhance added value from traditional stock and bond portfolios by minimizing frictions and risks until investment opportunities again arise — through the revaluation of equities or the widening of credit or mortgage spreads, for example.

Due to the number of managers entering the business there will inevitably will be some hedge funds

that suffer large losses, yet the most likely outcome for most hedge fund investors is that they will gradually grow disenchanted as their return expectations are not met over coming years. It will become apparent that it is only the managers who are getting rich, and not the investors.

The hot money's asset of choice continually changes, whether oil and gas partnerships, LBOs or tech stocks. Why does every generation have to relearn the lesson that money is made by making the uncomfortable choices, not by following the crowd? ■

SRI Success: Gillette Moves to Declassify Board of Directors

In response to a shareholder proposal co-filed by CBIS, The Gillette Company, a global market leader in consumer products, agreed to propose an amendment to its corporate charter that requires the annual election of all directors. Shareholders will vote on this declassification proposal at Gillette's annual meeting in May 2005. Gillette's current classified (also known as "staggered") board structure calls for directors to be elected in classes to staggered three-year terms.

Election of directors is a means of holding directors accountable as representatives of shareholders. Many

investors believe that staggered boards can contribute to the entrenchment of management, help insulate directors and senior executives from the consequences of poor financial performance, and reduce directors' accountability to shareowners. Many prominent institutional investors such as TIAA-CREF, CALPERS, Fidelity, State Street Global Advisors, New York City and State pension funds, and influential proxy voting services such as Institutional Shareholder Services (ISS) support the annual election of directors.

Gillette noted in its announcement

that prior shareholder proposals were one of the factors that led the Board to propose the change. CBIS and Walden Asset Management filed shareholder resolutions for the past two years asking Gillette to declassify its board. Majority votes were registered in 2003 (63%) and 2004 (68%). In 2004, investors frustrated by the lack of responsiveness from Gillette's board to these majority votes registered their concern with 24% withholding votes for the Directors.

We applaud Gillette's willingness to respond to shareholders' wishes for improved corporate governance. ■

CBIS Reduces Balanced Fund Management Fee

CBIS is pleased to announce that the CUIT Balanced Fund's trust management fee will be reduced from 1.00% to 0.80% effective January 1, 2005. Our growth has allowed us to reduce fees while expanding and improving services to participants.

The Fund has produced an admirable record, exceeding its weighted benchmark by over 4%, net of fees, over the past five years on an annualized basis. Traditionally, it has served as an introduction to equity and bond investing for small participants. However, there may also be

numerous larger participants for whom the Fund appropriate.

The Fund has a value equity bias — Dodge & Cox manages two-thirds of the equity allocation in addition to the fixed-income allocation (RhumbLine's S&P 500 index approach has been the other third of equity exposure since April 2002). This makes the Fund suitable for participants with a lower risk tolerance (typical of smaller participants) as well as larger institutions who are less knowledgeable about investing and concerned about downside equity risk. The one-fund struc-

ture is appealing from an administrative viewpoint, and the combination of equity and bond assets in one fund dampens much of the shorter-term market fluctuations inherent in either asset class alone. Another strength is the automatic rebalancing that occurs as CBIS reviews monthly allocations in light of cash flows.

We recommend the Balanced Fund regardless of the size of a participant's assets, and view it as an ideal program for a participant converted from investing only in cash equivalents or all bond investments. ■



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ANNOUNCEMENTS

■ Christmas and New Year's Holiday Schedule

Since Christmas and New Year's Day each fall on a Saturday this year, CBIS will be closed on Friday, December 24 in observation of Christmas, and will close at 1:00 P.M. E.T. on New Year's Eve, Friday, December 31.

■ Gatherings in Rome and Dublin in March 2005

CBIS will host a regional gathering in Rome on Thursday, March 3, 2005, and in Dublin on Monday, March 7, 2005. Invitations for the gatherings will be mailed by the end of the year. If you have any questions regarding invitations or meeting-specific information, please contact the Gathering Coordinator in our New York Office.

Contacting CBIS *Your CBIS Investment Advisor is ready to assist you.*

New York:
90 Park Avenue
29th floor
New York, NY 10016-1301
Tel: 800-592-8890
212-490-0800
Fax: 212-490-6092

Chicago:
1200 Jorie Boulevard
Suite 210
Oak Brook, IL 60523-2262
Tel: 800-321-7194
630-571-2182
Fax: 630-571-2723

San Francisco:
One Embarcadero Center
Suite 500
San Francisco, CA 94111-111
Tel: 800-754-8177
415-623-2080
Fax: 415-623-2070

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