Austrian Investment Monthly

St Onge Research July, 2015

We got a bit of excitement coming into month-end, with Greece playing chicken with their creditors and, separately, the Chinese market blowing off its recent parabolic rise. Both gave the markets a scare, with volatility (VIX) soaring, but still historically moderate, at levels seen as recently as end-2014.

Economically, neither Greece nor China will have systemic effects on US markets and, by extension, the rest of the world that follows the US cycle. Domestic US indicators agree we're still safely in mature boom.

Despite the economic calm, we're temporarily shifting market outlook to "cautious" for the month of July. This is simply because markets have not yet discovered exactly the fallout from the Greek and, to a lesser extent, Chinese dramas. When things are uncertain, it's prudent to dial down risk – investors never need to swing at every pitch.

This month's news section is a damage assessment on Greece, and the theory section takes a break from the headlines to look at that ultimate "smart" money indicator, hedge funds. We'll wrap up with this month's AIM List, always including performance updates.

What Goes Down with Greece?

Worst-Case Scenario on Europe's Latest Basketcase?

Coming to month's end, Greece's swashbuckling leaders are hogging the financial headlines once again. In the February AIM we

Market Outlook: Cautious

June was a bumpy ride. The S&P lost about 2 percent, bringing it close to flat for the year.

Europe, of course, fared much worse, while even gold dropped for the month. Gold's muted reaction to Greece suggests deflation expectations are creeping in. US bond yields were net up for the month, with Fed speculation outweighing Greece.

Economic prospects in the US and its trading partners remain solid despite the credit drama in Europe and the margin crisis in China.

Having said, markets will take some time to digest, and direction depends on policy choices in Athens and Brussels, along with Beijing's monetary stance.

covered the US recession implications of a Greek default. In a nutshell, they are minor. Greece itself is economically insignificant.

Of course, the story doesn't end there. Greece isn't important for all the Fords or iPads that Greeks buy. It's important because of how Greek debt is integrated into financial markets.

The main concern with Greece, fundamentally, is that bugbear from our last financial crisis, "counter-party risk."

In a nutshell, our financial system is increasingly dominated by a web of interlocking assets. Your bond collateralizes my margin loans invested in her equity backing their bonds. A "counter-party" is the entity on the other side of a given trade. The problem is that if my bond dives, the whole daisy-chain of guarantees crumble – the counter-parties fall like dominoes.

These layered assets are often complex on purpose, indeed. For both tax reasons, but also in order to avoid the risk police in financial regulators. This means that officials often have only a vague idea of how much risk there is in the system. Hence bank "stress tests," and hence the efforts to game them.

This means the main question in Greece over the coming months isn't going to be Greece's economic well-being – Greece's GDP itself is significantly smaller than the State of Missouri and even less integrated with the outside world.

Instead, the main question is going to be how much of this systemic risk is in the system. In theory, European banks and regulators have had four years to insulate themselves from Greece. In practice, there is a big reason they may not have actually managed this: bailouts. One of the more dangerous precedents set in the 2008 Financial Crisis was that of "too big to fail." The idea that, if your outfit can just cause enough chaos, the government will parachute in and print what it takes, courtesy of the taxpayers, to bail you out.

So there is probably a fair amount of unhedged risk running around the world's web of assets. Which, on its own, is a concern.

Of course, against this we want to balance the original source of the risk itself – those bailouts. The fact that bailouts, at this point, are so politically appealing means that, even if there is a lot of risk in the system, governments have a much easier time of cancelling out that risk than last time around.

So, ironically, the very reason that we might expect some Greek risk to remain, despite years of warning, is the same reason that we might expect the change of a financial collapse to be very mild.

What to look for in the coming months? For the near term all we're looking at is default. Greece isn't leaving the European Union anytime soon; Britain, Denmark, Sweden all have their own currencies while remaining EU members in excellent standing.

We're not even talking a Grexit – Greek exit from the Euro. Not yet, anyway.

Indeed, all that's on the immediate horizon so far is a default. Which, to put it in perspective, is not very exciting. Government defaults all the time, even in rich countries. In the US, state defaults are news yearly, and every year about about 5 municipalities default, according to Moody's. Indeed, in 2009 the State of California defaulted, issuing IOU's to creditors. California is far more systemically important than Greece, with four times the population and eight times the GDP. It's the largest state in the largest economy on earth, with over $400 billion in debt, even more than Greece. Long-term impact even of the California default? Nothing.

So default itself is not a big deal, economically.

What is worth watching is three things. First, an escalation from default to Euro exit. This is a possibility, especially given Greek PM Tsipras' unpredictability. It magnifies the counter-party risks, as Euro-denominated assets because less valuable.

Second is the willingness of Eurozone governments, and the European Central Bank to feed liquidity into markets (a form of ongoing "bailout"). Generous support dulls the risks, even if it does gradually impoverish citizens.

Third, we want to keep an eye on bank stocks in Europe and elsewhere. Greek debt has seeped worldwide, including Japan, the US, and China, and those governments may be less willing to bail-out Euro-speculators than are the Europeans.

Finally, how could it all come to tears? We're about to discover exactly how much stress was squeezed out of the system, and we're about to discover how ready governments are to bail out the remaining gamblers. If central bankers have been asleep at their post, there'll still be a lot of risk coursing through the European financial system. If so, the ECB has its bailout and plunge protection work cut out. And if it screws this up, or gets hobbled by fiscally prudent voters back home, we could ultimately see Lehman-style financial crisis in Europe in the medium-term.

Keeping Track of that "Smart" Money

How Much Crystal is in Hedge Funds' Balls?

Every month intrepid financial journalists

Name	Securities Held	Qtr End Equities	QoQ Increase	Metro Region	Portfolio Top 10%	Top Holding
Citadel Advisors LLC	3,432	$55,196	11.4%	Chicago/IL Metro	7.4	United Technologies Corporation
D. E. Shaw & Co. LP	2,462	$53,545	6.2%	New York City/NY Metro	14.0	Phillips 66
AQR Capital Management LLC	4,209	$52,567	27.6%	New York City/NY Metro	8.6	Apple Inc.
Millennium Management LLC	3,196	$44,623	25.1%	New York City/NY Metro	6.0	NextEra Energy, Inc.
Renaissance Technologies LLC	2,934	$42,481	12.4%	New York City/NY Metro	11.4	Colgate-Palmolive Company
Adage Capital Management LP	709	$42,102	1.9%	Boston/MA Metro	14.2	Apple Inc.
Icahn Associates Corp.	27	$34,612	0.4%	New York City/NY Metro	87.5	Icahn Enterprises L.P.
Brookfield Asset Management PIC Canada LP	28	$31,183	#N/A	Toronto/Ontario Metro	98.5	BROOKFIELD PROPERTY LP EXCH UNITS
Lone Pine Capital LLC	48	$26,253	(5.5%)	New York City/NY Metro	47.3	MasterCard Incorporated Class A
OZ Management LP	340	$24,394	12.8%	New York City/NY Metro	29.1	Allergan, Inc.
Viking Global Investors LP	63	$24,304	(5.3%)	New York City/NY Metro	47.9	Valeant Pharmaceuticals International, Inc.
Paulson & Co., Inc.	81	$24,087	(11.7%)	New York City/NY Metro	52.3	Shire PLC
Orbis Investment Management Ltd.	232	$23,796	(0.1%)	Hamilton/Bermuda Metro	33.0	NetEase, Inc. Sponsored ADR
Kayne Anderson Capital Advisors LP	145	$21,061	(6.7%)	Los Angeles/CA Metro	61.7	PLAINS AAP LP UNIT
Glenview Capital Management LLC	77	$20,727	4.0%	New York City/NY Metro	37.3	Thermo Fisher Scientific Inc.
ValueAct Capital Management LP	14	$17,967	20.6%	San Francisco/CA Metro	88.5	Valeant Pharmaceuticals International, Inc.
Two Sigma Investments LLC	2,106	$17,641	(16.7%)	New York City/NY Metro	9.1	Medtronic Plc
Pershing Square Capital Management LP	9	$17,638	16.5%	New York City/NY Metro	100.0	Allergan, Inc.
Lansdowne Partners (UK) LLP	99	$16,880	11.9%	London/UK Metro	59.1	Comcast Corporation Class A
Bridgewater Associates LP	336	$13,032	0.9%	New York City/NY Metro	88.9	Vanguard FTSE Emerging Markets ETF
Gotham Asset Management LLC	936	$12,638	19.7%	New York City/NY Metro	7.2	Gilead Sciences, Inc.
Gateway Investment Advisers LLC	858	$12,437	(5.1%)	Cincinnati/OH Metro	18.2	Apple Inc.
Highfields Capital Management LP	76	$12,404	(8.1%)	Boston/MA Metro	51.7	DIRECTV
Two Sigma Advisers LLC	1,993	$12,238	2.6%	New York City/NY Metro	10.6	Google Inc. Class A
Gardner Russo & Gardner LLC	110	$11,563	5.7%	Philadelphia/PA Metro	71.3	Nestle S.A. Sponsored ADR
Coatue Management LLC	56	$11,550	15.0%	New York City/NY Metro	59.9	Apple Inc.
Third Point LLC	42	$11,481	31.5%	New York City/NY Metro	61.9	Amgen Inc.
Elliott Management Corp.	70	$10,776	12.3%	New York City/NY Metro	73.2	Kabel Deutschland Holding AG
Cevian Capital AB	13	$10,557	1.0%	Stockholm/Sweden Metro	93.1	Danske Bank A/S
York Capital Management Global Advisors LLC	161	$10,156	11.2%	New York City/NY Metro	36.5	American Airlines Group, Inc.
Carlson Capital LP	304	$10,052	6.9%	Dallas/Ft Worth TX Metro	14.9	KeyCorp
Discovery Capital Management LLC	114	$9,895	0.4%	New York City/NY Metro	40.0	Apple Inc.
Fir Tree, Inc.	91	$9,604	11.0%	New York City/NY Metro	41.7	CDK Global Inc
Senator Investment Group LP	58	$9,377	1.3%	New York City/NY Metro	37.2	Actavis Plc
Winton Capital Management Ltd.	773	$9,206	(37.6%)	London/UK Metro	9.0	Edwards Lifesciences Corporation
Tiger Global Management LLC	69	$9,145	12.8%	New York City/NY Metro	52.1	MasterCard Incorporated Class A
GLG Partners LP	807	$9,056	73.3%	London/UK Metro	27.0	Asahi Glass Co., Ltd.
Trian Fund Management LP	11	$9,014	11.9%	New York City/NY Metro	100.0	E. I. du Pont de Nemours and Company
JANA Partners LLC	22	$8,861	(22.2%)	New York City/NY Metro	74.4	Walgreens Boots Alliance Inc
Blue Ridge Capital LLC (New York)	49	$8,761	(0.4%)	New York City/NY Metro	41.7	Charter Communications, Inc. Class A
Marketfield Asset Management LLC	74	$8,685	(42.8%)	New York City/NY Metro	26.9	Financial Select Sector SPDR Fund
Egerton Capital (UK) LLP	61	$8,659	1.7%	London/UK Metro	52.4	Southwest Airlines Co.
Baker Bros. Advisors LP	129	$8,572	22.9%	New York City/NY Metro	75.0	Pharmacyclics, Inc.
Numeric Investors LLC	860	$8,459	12.8%	Boston/MA Metro	21.6	Apple Inc.
Balyasny Asset Management LP	443	$8,456	6.6%	Chicago/IL Metro	14.5	Baker Hughes Incorporated
Greenlight Capital, Inc.	48	$8,441	11.9%	New York City/NY Metro	56.8	Apple Inc.
Soroban Capital Partners LLC	21	$8,400	26.5%	New York City/NY Metro	78.9	Williams Companies, Inc.
Corvex Management LP	30	$8,170	16.4%	New York City/NY Metro	77.5	Williams Companies, Inc.

gather the top hedge fund holdings into lists. People read this stuff because, presumably, this tells us what the "smart" money is doing. After all, everybody knows hedge fund managers are smart -- they don't give Bugatti's and Tuscan villas to the dumb kids.

More about this whole IQ thing in a moment, but for now let's ask, just for fun, what is the ultimate "smart money" up to?

> "During the quarter, the funds added exposure in aggregate in eight of the ten sectors, with the largest increase in the Energy sector... The only two sectors in which the 50 hedge funds decreased exposure in aggregate were the Utilities and Telecom Services sectors."

Let's pull that apart. Utilities and telecoms are the two least-sensitive "safe haven" sectors, and energy is among the most. In other words, hedge funds in aggregate are pulling money out of safe sectors, and rotating it into cycle-sensitive sectors. Especially that super-cycle industry, energy.

Well, they're a little late to the party here. As in lemmings running faster as they near the cliff: this boom's been on for over six years now, and just now they've decided to liquidate their safety and put chips on the table? This is, roughly, taking off your pants and putting the lampshade on your head when the party's already winding down. It was good fun awhile ago, now it's just silly.

This brings us to that "smart" bit. Are hedge funds actually any good at investing?

Historically, hedge funds range somewhere between terrible and laughable at managing money. That hedge funds survive must keep the efficient-markets crowd up at night, all those Bugatti's earned by losing client money.

Just how bad? The funds, of course, are evasive. Fortuntaely, British bank Barclay's keeps track of hedge-fund returns. Notably, Barclay's stresses they have nothing to do whatsoever with those hedge funds. A smart caveat, it turns out.

Let's run through the numbers. Barclay's compare S&P total returns, "total" meaning they include dividends. They compare this to net returns to investors in Barclay's Hedge Funds Index (HFI). The total returns don't include trading costs, though a buy-and-hold would make these near-zero.

Year	S&P 500 Total Returns	Barclay's HFI Index Returns
2011	2.1%	-5.5%
2012	16.0%	8.3%
2013	32.4%	11.1%
2014	13.7%	2.9%

Simply adding up the numbers tells us that, over that four-year period, S&P would give you a 78% return. While hedge funds would give you a 17%. This is, to put it mildly, atrocious.

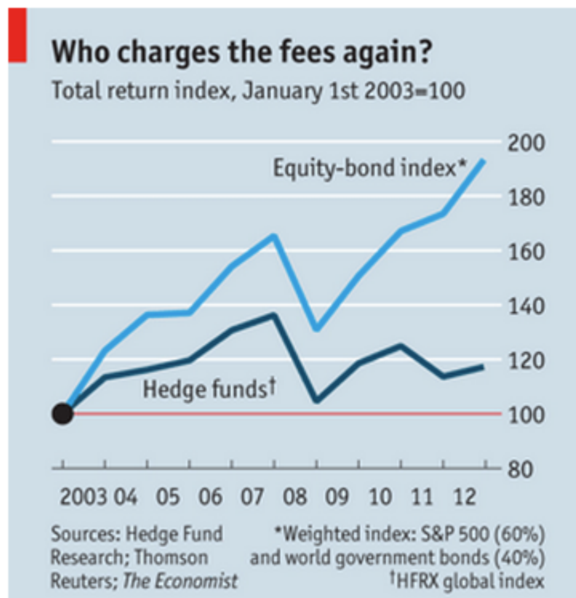
To put it in perspective, you'd have lost, in relative terms, nearly a third of your nest-egg. You'd have, say, $117,000 when simple buy-and-holding the market would've given you $178,000. A third in just four years.

Run, don't walk.

What about the longer-term? Perhaps hedgies just had a bad couple of years? Surely those Bugatti's mean something.

Well, hedge funds probably do know something. About marketing, anyway.

Here's a long chart, from the Economist magazine. Running back to the post-dot-com rebound in 2003. The Economist is comparing compare hedge funds to a 60/40 mix of the S&P and government bonds. In other words, the Economist is taking hedge funds at their word, comparing them to a common passive hedging strategy.



Not only does the mixed portfolio beat the hedge funds, but the hedgies didn't even protect you in 2008 -- they plunged at near-identical losses.

If hedge funds can't even hedge, why bother?

Indeed. In a recent article, The Economist noted that, stung by their lousy returns, hedge-funds are rebranding as "low volatility" vehicles.

This is rather rich. No longer shall hedge funds claim to be the "market-beating wedge" of your portfolio. Now they're going to be your insurance. Presumably so they can mine those trillions locked away in pensions, endowments, institutions.

The cute twist here is that slow & steady is a very cheap investment strategy. As in almost free. You could buy, say, a blend of corporate and government long bonds, which any half-decent broker will fix you up with nice and cheap, and just keep them for decades. Heck, you could even play the market, popping it all into SPY at, again, nearly zero fees.

So why on earth would anybody pay hedge funds' outrageous fees, typically something like half of your growth in fees alone -- 2-and-20 on 5% returns is precisely half in fees. You may as well light half your stack on fire while you're filling out your investment objective forms.

Investing in hedge funds is, essentially, renting a Ferrari to pull up a stump in the yard. It's expensive. It's unnecessary. And, frankly, it's not very good at the job.

Truth is hedge funds, as an industry, failed. They failed spectacularly at their one job -- beat the market.

Bottom line? If you're investing in public markets, it's not worth even bothering with the high-priced outfits.

Chances are they've got no expertise, they can't do a thing for you, but they'll happily charge you for the privilege of looking busy with your money.

And, if you do stumble into one of these "what's the smart money doing" hedge-fund trackers, grab a cup, sit back and enjoy the peek under the hood of just about the dumbest money out there.

AIM List, May 2015

Each month's AIM List is twenty stocks or ETF's that we believe are likely to rise.

A new list is chosen each month, and recommended use is to switch them out for the following month's picks – this is what back-tests best. Of course, to increase tax efficiency or reduce trading costs you would hold for longer periods, at the risk of sacrificing returns relative to montly hold.

Each month's list is constructed as follows:

Step 1 is choosing market direction. Here we decide where we are in the business cycle itself. This is important because in booms you want stocks that have a recent history of soaring, and in busts you want a recent history of plunging. Either way, you're letting momentum take its lead from the cycle-stage. For this you'll use indicators, interpreted to separate noise from signal. The AIM newsletter's articles are intended to help with this stage.

Step 2 is generating the universe to choose from. Once you've decided boom or bust, simply screen by momentum over 3 months and 1 year. In booms screen for 100 or so stocks that have performed well over both periods, and in busts screen for 100 or so that have done worst. Motley Fool CAPS Screener is an excellent free screener. To reduce risk I like keeping about $3 billion in market capitalization and above $5 in price, but season to taste.

Step 3 is to cull by fundamentals. Look through profits, revenue, dividends and cash flow to identify "red flag" firms that seem poorly run. You're looking for smooth growth in results, and dividend cuts or cash drops indicate trouble. Too-fast growth can be as concerning as too-slow growth: you want low drama here.
Be merciless: there's no reason to ever swing at a bad pitch. This is, after all, why we started with a list of 100 – so we can throw away 80%. Yahoo! Finance is an excellent free tool for fundamentals research.

Step 4 is to cull the list so it's diversified by industry. This is to avoid getting caught in industry-specific regulatory or political events. In particular, you don't want too much biotech, finance, or tech, since these industries are sensitive to firm-specific news.

Now you've got a business cycle matched list of stocks with smooth momentum, little drama or red flags, and decent diversification. You're all set.

Using these techniques, you'll tend to beat the market in normal times -- times of continuing boom or continuing bust -- and underperform during inflections. This is by design. Because it's relatively rare that the market inflects from boom-to-bust or bust-to-boom, statistically one should assume continuity. Outperformance in normal times should more than cancel underperformance during inflections, simply because inflections are rare – about thrice per decade.

Please remember that the AIM List is intended to fluctuate more than the market. Expect higher volatilities with higher highs and lower lows. When the market is up, the List will tend to be up more. When the market is down, the List will tend to be down more. Although historical returns' risk profile is excellent, with monthly standard deviations significantly lower than the S&P, please regard the list as a great place for speculative capital, and the wrong place for the kids' college fund.

Historical AIM List returns:

Between June 1 and June 30, 2015 the List outperformed the S&P by a half-percent, down 1.5% versus the S&P's 2.0% decline. This was a pleasant surprise, since the List it designed to underperform in down-markets.

The List has returned 13.7% since its September, 2014 inception. This compares with 8.2% for SPY over the period. This is an annualized rate of 19% for the List versus annualized 11% for SPY.

Year-to-date 2015 the List has returned 5.7% versus 1.1% for SPY. This is an annualized return of 12% for the List versus 2% for SPY.

On a $150,000 portfolio, since inception the List has returned annualized excess profits before trading costs of approximately $10,300 over the benchmark SPY. As always, past outperformance is no guarantee of future performance.

Here is the AIM List for July, 2015:

AET	Aetna Inc
AOS	A O Smith Corp
CI	Cigna Corp
CLVS	Clovis Oncology Inc
DATA	Tableau Software Inc
DST	DST Systems, Inc.
DXCM	DexCom Inc
EA	Electronic Arts Inc
EPAM	EPAM Systems Inc
GIII	G-III Apparel Group Ltd
GILD	Gilead Sciences Inc
GPN	Global Payments Inc
HOLX	Hologic Inc
HZNP	Horizon Pharma PLC
IMAX	Imax Corp
PANW	Palo Alto Networks Inc
SKX	Skechers USA Inc
STRZA	Starz
WWAV	The Whitewave Foods Company
ZBRA	Zebra Technologies Corp