welling@weeden

http://welling.weedenco.com

VOLUME 7
ISSUE 18
OCTOBER 7, 2005

INSIDE

Listening In
Globalized Economy Puts Our Creditors In Control, Florida Hedge Fund Manager Says;
PAGE 1

Guest Perspectives
Ian Harwood
Core Inflation Is Set To Remain Subdued Despite Energy Quotes

Sholom Sanik
What The Copper Market Is Telling Us

Trading Ideas
The Liscio Report
Look Who's Been Buying Stocks

Talk Back
Morry Markovitz
Late Night Economics

Acute Observations
ALL ON WEBSITE

RESEARCH DISCLOSURES PAGE 8

listeningin

What, Me Worry?

Inflation Is Not, Repeat Not, The Issue, Says Spyglass's Paul Brodsky

*As **Paul Brodsky** mildly puts it, "We're not PIMCO." For one thing, **Spyglass Capital,** his—for lack of a better term—hedge fund, is based not on the nation's Left Coast as the bond behemoth is, but on the west coast of Florida, in Naples. For another, it manages considerably less than Pimco's billions. What Paul runs, through Spyglass, is a very narrowly focused investment program that provides liquidity in the market for complex mortgage securities and that's produced an average annual return since its 1996 inception of 13.25% (through August). And that's despite suffering through a recent two-year stretch (March '03-March '05) of negative returns. That searing experience has left Spyglass with fewer clients and Paul with some piquant views on the hedge fund world—as well as a distinctly non-consensus view on rates—which he shared early this week.*
KMW

You've been through the wringer, as a hedge fund manager, Paul—
One thing I can say is that I've experienced almost a full cycle as a hedge fund manager –

A hedge fund has a "cycle"? Then what's all this about yielding consistently positive returns?
Marketing, pure and simple. There very much is a hedge fund cycle, and it is quite interesting. At least, there was with me. I shouldn't foist my experience on everyone else, but it's an amazing business in that the people in it can be incredibly intelligent, and also incredibly stupid—and I include myself in the latter as well as in the former! The business of running a hedge fund challenges you to either go outside of your skill set or not. But there are all sorts of pressures to do so. It's a fascinating topic.

On which you've written a bit to your investors —essentially contending that the flood of money pouring into hedge funds has compromised a lot of investment models and threatens the funds' performance? Gee, overcapacity will do the same thing to hedge funds that it does to any industry?
That's it. If I were to encapsulate my views, I would say the hedge fund manager as well as the hedge fund investor is now forced to decide what it is he wants to be—though neither knows it yet. By that I mean that the hedge fund manager has to decide if he or she is trying to build an enterprise in the hopes that he can eventually sell it for some multiple of his enterprise value, or if she wants to build a business that tries to generate fees from performance. It's very difficult, I think, to build both in one organization. Not impossible. But my attempt to do both was not successful, and I am still forced everyday to come to terms with what it is that I am doing in managing an asset management company, as is everyone else in my shoes. It's very easy to get seduced because if you show competence and successful returns and good performance, money flows in over the transom from every corner of the globe and from people that you've only met in passing or haven't even met. And, by virtue of the amount of capital they're throwing at you, we're wired and trained by regulatory bodies to assume that their money is sophisticated capital.

Which is bad assumption No. 1?
Sure. It's an interesting dynamic. Just because there's a lot of it, it is certainly not necessarily the case that it's sophisticated capital. Now, that doesn't

welling@weeden

Published exclusively for clients of Weeden & Co. LP

Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

Weeden Securities Corp. Board of Directors
Donald E. Weeden
Barry J. Small
Robert A. Cervoni
Timothy McDonald
Robert DeMichele
Daniel V. Panker
Richard Sharp
Richard Schmaltz
Craig Hetherington
Christopher Mahler
Todd Trimmer

welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com.

First-class postage is paid at Stamford, CT

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright Act imposes liability of up to $100,000 per issue for such infringement. welling@weeden does not license or authorize reproduction by clients or anyone else. However, multiple copies are available to clients upon request and limited reprint arrangements are available. Copyright 2005, K.M. Welling and Weeden & Co. LP. All rights reserved.

necessarily imply that in my view hedge fund investors are foolish. Although there was probably a bad decision, way back when, to get into this business, that doesn't mean that they're stupid. They're just following their mandates. So they are kind of circling around the hedge fund conduit business, or the funds of funds, or the platforms and people that are aggregating others' capital and allocating it out to various hedge funds. The thing is, they have no tolerance for down months. They have no tolerance for volatile returns. They have very little understanding of the investment programs the managers of their hedge funds are undertaking, or that they're investing in–

It's stunning how quickly the worst aspects of the institutional consulting business have been grafted onto the world of hedge funds–

Well, hedge funds certainly no longer resemble those of 1996, when we first opened. I remember a fragmented cottage industry comprised of funds managed by iconoclastic traders–who often had interpersonal skills suggestive of working alone.

What a diplomatic way to phrase it!

Anyway, now hedge funds have been socialized. There is virtually no barrier to enter the hedge-fund business and a steady stream of managers–some competent, some merely highly bombastic–are hoisting their colors. From a behavioral perspective, the hedge fund industry's popularity is likely being fueled by the excitement that naturally accompanies the opening and de-mystifying of previously cloistered institutions. But its rapid institutionalization is a shame, because in my view, the hedge fund business model is far superior to the traditional institutional model. The thing is, hedge funds have been marketed to investors with all levels of investment experience and sophistication as an alternative asset class–which they aren't. Hedge funds are nothing more than vehicles built to freely allocate discretionary capital in the capital markets–

For a fat fee!

Certainly. And hedge funds *do* have merit. The managers' personal money is at risk along with investors, for one thing, which implies a high level of prudence. Most hedge funds–theoretically at least–are focused on specific strategies or markets in which they have uncommon expertise or an edge. Plus, hedge funds ostensibly seek either positive annual returns regardless of market or economic conditions (absolute returns), or superior risk-adjusted returns. And being structured to capture uncorrelated returns makes a hedge fund's value proposition vastly superior to traditional investment vehicles that offer long-market exposure only. Because a fund that actually hedges, even if only partially or occasionally, *should*, over time, generate returns truer to the underlying economics of its core assets or strategies. But the trouble is, the hedge fund industry, or so-called industry–

You're implying that's a misnomer?

Yes. It's really not an industry, but it has been experiencing industrial-strength inflows of capital. That very popularity is going to produce big problems, as I see it, growing out of a dangerous combination of unrealistic investor and manager expectations, which are all wrapped up in inadequately protected structures.

Go on.

I see lots of investor capital starting to slosh around in the hedge fund world in search of a Holy Grail that simply does not exist on a broad scale. What everyone wants is a portfolio of hedge funds in which every fund boasts: A narrow investment focus, No capacity constraints, Consistently superior returns, Low performance volatility, and Broad and deep management company infrastructure. At the same time, I see many managers who are so eager to strike while the iron is hot that they are happy to imply they can actually deliver the Holy Grail. They've embraced boilerplate blueprints to set up their funds to appeal to the broadest possible cross section of investors. They've listened to the marketing types and set performance objectives that imply double-digit annual returns with exceedingly low performance volatility and little market or economic correlation–and at the same time they've adopted short-term fund liquidity provisions that reflect the expected underlying liquidity of the funds' core assets. Meanwhile, they've blithely agreed to cumulative high watermark provisions on annual performance fees that *appear* to promise investors the manager will work cheap until their NAVs rise again to their highs, but in reality *assure* investors that their manager will lose much of the brain trust that originally attracted them to the fund, at the first sign of a setback. It just doesn't make sense. Most funds' target returns imply that they are exploiting perpetually cheap or inefficient markets at a time when hedge funds are, arguably, overcapitalized and valuations are stretched. Not to mention that their liquidity provisions imply that they're operating in markets that are perpetually efficient. But how do you extract inefficiencies from an efficient market? The logic is missing.

Don't get me started on "efficient" markets.

Okay. My real point is that the institutional asset allocation process is a bad fit with hedge funds. Active management, sophisticated arbitrage strategies, predatory

> **"I don't think this country's 25-year disinflation run is over. If it looks like a duck and quacks like a duck, it's probably a duck. My charts quack loud and clear–inflation isn't the problem to fear."**

asset selection, manager instinct and the liberal use of leverage characterize many hedge fund strategies–even disciplined ones. But those sorts of things terrify the typical institutional asset allocator. So hedge fund promoters have adopted at least three layers of marketing platforms, superfluous business-school catch phrases and applications, and costly, cumbersome and needless operational infrastructures. None of these, typically, adds to a hedge fund manager's understanding of market value or puts hedge funds any closer to achieving their return objectives. In fact, these extraneous trimmings only exist to commend the wisdom of hedge funds to investment committees wary of looking like foolish early adopters of absolute return or risk-adjusted strategies. It would be bad enough if this institutionalization process were merely patronizing. But the effete controls it has inserted into every hedge fund manager's day have probably already reduced returns and disappointed many of the very investors who demanded them. Put simply, there is a significant and dangerous gap between managers' understanding of what drives risk-adjusted returns and the understanding of most investors.

How so?
Just for starters, because most investors think they're *diversifying* by investing in hedge funds.

Sure, non-correlated returns are part of what you were just calling the Holy Grail.
Yet most of the arbitrage strategies used by the best-capitalized hedge funds–long/short equities and convertible bond arbitrage–are highly correlated with equity market dynamics, such as market direction, volatility and funding costs. Not to mention that *more than 75% of hedge fund capital* is invested in equity or equity-linked programs. Investors rationalize this on the basis that long/short equity funds have no directional bias and high yield or convertible bond funds provide fixed-income exposure. But practically, that doesn't wash. Most long/short equity funds are net long the market and *depend on market volatility* to generate returns, while most fixed-income funds rely on some form of carry trade that *suffers from market volatility*. Additionally, convertible and junk bonds are merely equity market derivatives–or vice versa. The upshot is that institutional hedge fund investors mostly rely on equity market volatility for outsized gains and bond market inertia to support that position–whether they know it or not. So a stock market that grinds lower at the same time that there's a sudden change in the level or the relationship of interest rates is going to lead to poor returns across the board.

Isn't it within the realm of possibility that sophisticated hedge fund investors really *want* to be so exposed to equities?
Sure. Maybe they all see intrinsic value in the equity market, or believe their managers are the best stockpickers in the universe. But I doubt it. And finding a good stock picker is a lot different than throwing tons of capital at a market under false pretense. It seems plain to me that the alternative investment universe is not an alternative asset class. Most committee-oriented, consensus-seeking, out-sourcing investors that allocate capital to hedge funds are explicitly paying at least twice the fees necessary to bet on a rising stock market. Which adds another layer of risk and potential investor disappointment.

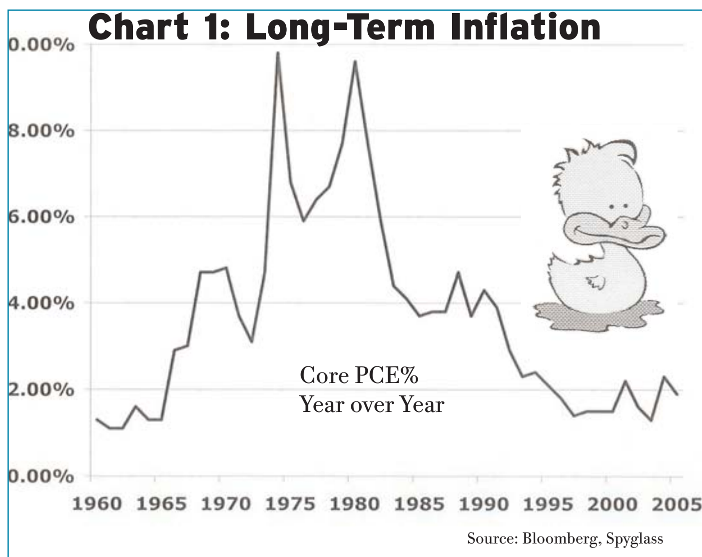
But surely they recognize that–
Okay, perhaps they're following the herd into hedge funds because losses generated in equities are universally accepted as the fault of the market, whereas managers themselves are often blamed for losses in more exotic markets or strategies. I just find it difficult to escape the conclusion that institutional hedge fund investors have gravitated to their comfort zones in long equities. Which tells me that, as a group, institutional investors are structurally incapable of promoting the free allocation of discretionary capital–which is the definition of hedge fund investing.

Vic Harville © 2005 Stephens Media Group all rights reserved.

Ironic, no?
Yes–but also dangerous because institutions now provide an enormous chunk of hedge fund capital, so their imminent disappointment poses significant risk. In the meantime, hedge funds are discounting and reversing economic cause-and-effect in real time, creating a daily self-correcting mechanism that has reduced market volatility. (In fact, I'd suggest to Mr. Greenspan that there is no conundrum. The more he threatens to aggressively fight inflation, the less the market will raise long-term rates.) What's more, hedge fund dominance will continue to reduce market volatility until higher borrowing rates or impatient investors threaten their funding.

Is that what looks like it's happening here?
Who knows? But it wouldn't be all bad. I happen to think that there's simply too much encumbered capital sloshing around in the capital markets, which has elevated valuations to the point of locking in mediocre long-term returns for passive investors–at a time when, unfortunately, investor expectations are historically high. Additionally, much of the active trading capital that determines day-to-day market pricing comes from over-funded, over-leveraged hedge funds. Hedge funds whose investors pay high fees and hold quarterly capital-call rights–which they will exercise at the first hint of disappointment. So if people think hedge fund capital is high velocity now, just wait. I expect significant capital churn as investors move back and forth among hedge funds which will probably diminish overall returns, frustrate managers and investors and lead to hedge fund liquidations.

Sounds *wonderful*.
I know. It won't be pretty for the unprepared. I suspect that the capital markets will see a significant unwinding of leverage–and so become less liquid–in coming years. I am also fully aware that's anything but a consensus view. And I expect hedge funds to take much of the blame for the inevitable downside. Some of it will even be warranted, and more regulation will be forthcoming. The good news is that hedge funds will survive, though I expect the "industry" to, in effect, split into two camps. Not according to size, but function. There will be hedge fund index-ori-



ented funds and absolute performance funds. The first type will be run with an emphasis on increasing and maintaining assets under management. The second will be run by some of us oddballs who just like the process of investing–trying to figure it out and make money from it–and so will emphasize absolute performance, regardless of assets under management. This is just a completely different business than asset gathering, fee gathering, manufacturing fees, and maintaining those fees–being closet hedge fund index managers, in effect. Neither type of hedge fund will necessarily be superior to the other. They'll just do different things. The first will be an outlet for the mass of indexed capital seeking to receive returns more reflective of underlying economic conditions. The second will allow the diligent to speculate with greater efficiency. We are already seeing things develop in those directions. I just happen to think that investor and manager expectations are so unrealistically high at this juncture that churning among hedge funds will grow tremendously and that hedge fund managers themselves are going to get awfully frustrated, and do what I have done.

Which is?

I may be early, but I have pulled in my horns and crawled under my shell and closed the fund to new investors for a year. This is after, as you know, going through a wrenching period of negative performance–and watching a big chunk of capital fly out the door. Spyglass has definitely seen interesting time. Granted, the fund was down about 12% last year and it's flat this year. But even including that stretch–which, don't get me wrong, was very painful; In the business we're in, we are a liquidity provider, so there were forced asset sales–*we have posted a 13.25% average annual return since inception in 1996*. Our experiences last year were disheartening, and I am sure our losses were exacerbated by having to send capital back and so having to make sales in an illiquid market, but I am still here, despite being *under* a high-water mark.

By now, readers are questioning your sanity.

Sure, usually when you see a hedge fund going through this experience, you see its talent walking out the door. But at Spyglass, I happen to be the guy who makes all the investment decisions, so we're still in business and we're doing okay. By contrast, a lot of other hedge funds have really been formed by asset aggregators, so they have all sorts of partners doing all sorts of things–and who go off in search of greener pastures at the first sign of a down year.

Adios, amigos.

It's over. But I don't think that either the investors or the managers in the hedge fund industry are set up for that harsh reality of the business. Between you and me and the world (because everyone knows this but no one really admits it) there are usually just one or two guys, or a small team, that create the value in a hedge fund. Everyone else is support. So if you think you know what you're doing and that you can generate returns in some market or some strategy, it hits you. "Well, gee. Why don't I just go back to the Street and get a prop trading position? I can probably cut a deal, or just run my own money, or run money just for friends." So what you're probably going to be left with in the hedge fund industry–while there will still be great talents running funds–is many managers who have pulled in their horns. Who have decided, "I don't need all the exposure and all the headache. I just want to invest and trade and run money." But we're just at the very beginning of that process.

How much of your dour outlook do you think is attributable to your own fund's misfortunes?

There's no question that you should take what I say with a grain of salt because of Spyglass's recent history. Clearly, I'm not an advocate for hedge funds, but if your investment model is okay and you're not consistently a bad stock picker, long or short, your hedge fund is probably–over a long period of time–going to out-perform. You are not likely to hit it out of the park as you might as a good long-only stock picker, but you'll most likely outperform on a risk-adjusted basis; certainly do better than a long-only index-hugging manager, and that's after fees.

Isn't closing your fund to new investors sort of an empty gesture at this point?

You could say so, because no one is exactly beating down the door anyway. But there are–not enough, but some–savvy investors who actually look for proven money makers who have fallen. Actually, I can't understand why there aren't more. But the reason we closed is that we feel a moral obligation to those who turned out to be our core investors not to dilute their future returns by taking in new capital–because in our business, taking in new capital would dilute those future returns. And frankly, the reality is that capacity constraints are a real issue, and especially in the more sophisticated strategies. Capacity is dynamic, I can say, in our business. I can't speak for any other business. But there are some markets where it seems there's almost unlimited capacity and some markets where you'd like to send it all back. We're in the business, as I said, of providing liquidity and holding on to what we think are deep value assets. Those assets themselves provide an internal rate of return. So we have the benefit of holding good assets that produce returns based on income. Which means that after taking those hits, if we had turned around and gone out to market the fund and try to get our capital back quickly–though I am sure we could have done it; money is pretty easy to find these days–would have been unfair to our core investors whose cheap assets already on our books would have been diluted. In any event, when something like this happens, you really find out who your friends are.

And that experience inclined you to treat them well?

Sure. Though I didn't really have a choice. But by the same token, I think there are many investors out there who are–whether they know it or not–in the process of auditioning to be accepted by good managers. Here I may be talking about something we won't see until five years or so down the road, but there are going to be some tremendous talents running pools of capital–that may be called hedge funds or may be called simply private equity pools–which it will be all but impossible for today's hedge fund churners to invest in. I'm not suggesting that there will be a formal network or anything set up to vet the experience of investors, or the decisions they've made about managers in the past, but the Street is really pretty small, and these things become known. I hear all the time, that yes, this investor or that throw $20 million at you or $50 million at you–until you have two down months. It doesn't mat-

ter if those down months are only off by 20 basis points each, if you have two down months in a row, you're gone. Because that's their mandate. It may be trite, but if there's one thing I can't emphasize enough, it's that it is not in the best interest of investors to judge the ability of fund managers to profit over the long run based on short-term performance.

Not the sort of reputation that makes you eager to run their money, I take it.

That sort of silliness just makes me back away. I can only speak for myself, but I didn't decide that I wanted to run a private investment partnership because I wanted my every move to be institutionalized. But I didn't give it much thought–and you don't tend to–until some marketers come to you and say, "Well, gee. I can get you untold amounts of capital, if only you will..." So there it is. And it is very seductive.

Sure, earning just a tiny percentage on untold amounts of capital adds up quickly.

So you start to rationalize it. Like maybe it's not greed. "Gee, I know all the money that I will take in won't be spent in long-only internet stocks, so at least I'm doing those guys a favor!" The mind is a funny thing. But my experience was that it became very clear to me, very quickly, that the fun for me isn't in the money-making per se, it's in the successful application of ideas to the investing process. Which is very different from getting in the flow of capital washing over you so that you can pick up crumbs. That's not a lot of fun, it seems to me. Even if you make a lot of money, but you're not really sure why, that doesn't sound like fun to me. It sounds like a bunch a noise. For me, the fun is in trying to put all the pieces together. The money is just the by-product of that process, if you are right. And if you're not right, you get punished by the markets. Timing is a funny thing. But I'm probably doing this because it's the only thing I *can* do. Not out of choice.

Right, everybody who trades complex mortgage instruments just happened to stumble into his or her career.

Okay, it is a highly specialized field. And one reason it is interesting, I suppose, is that I've been told repeatedly by various marketers that at least 85% of hedge fund investors out there simply won't touch mortgage securities. Obviously, they still have some sort of residual memory of the Askin Capital Management scandal, back in 1994. But what's really surprising to me is that anyone whose memory is that long is investing in hedge funds at all.

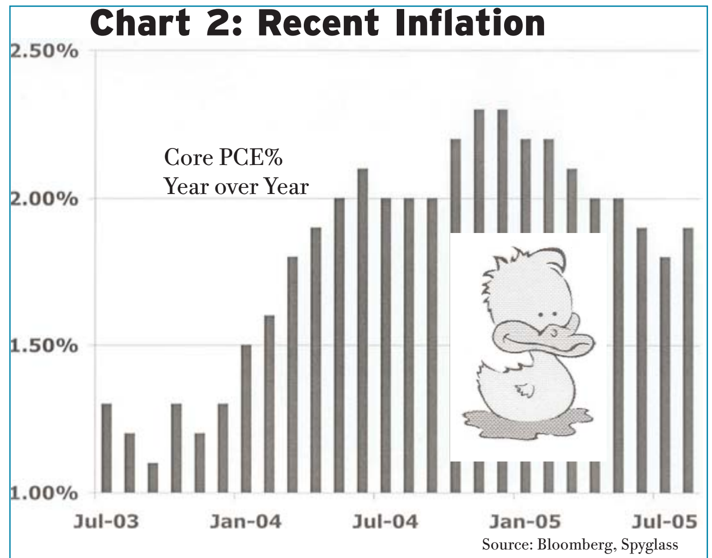
Gee, just because that little hedge fund's failure brought down Kidder Peabody and the entire CMO market?

It's more likely that they won't touch mortgage securities because they don't understand them as well as they understand the biotech equities they're investing in, but that's not the point. I think it's much easier to invest in equities funds for many reasons. But the No. 1 reason is that you don't lose your job as a fiduciary if you invest in equities and they go down. But you can, if you invest in a mortgage-backed derivatives fund and you lose money.

Which brings up a question. How is it that you happened to pick mortgage derivatives as your career?

Well, you certainly don't wake up one morning and say, "Gee, I want to be a mortgage derivative trader, and I want to run money, because that's what everyone wants." It's a curse, in some ways. I actually started out in the business trading equity index options, right out of college, at the American Stock Exchange. Then Drexel was looking for guys with option backgrounds when mortgages starting taking off in the mid-'80s, and I thought that was a good idea. I should have stayed in equities! But here I am, very happy that I did it.

Even if there are certain things about the way the hedge fund business has developed that clearly give you pause—mostly having to do with its increasingly institutional face, like compliance and style boxes?



Don't they, you? After all, the allocation process of institutional investors, consultants and conduits such as funds of funds requires taking long-term historical returns at face value and performing extensive due-diligence checks on the operational and administrative facets of the fund and its manager. This has a commoditizing effect on hedge fund compliance and reporting standards: Boxes related to manager experience, track record, audits, investment program, risk parameters, fund structure and transparency are checked and analyzed. For what? While legitimate hedge fund managers have nothing to fear, but the paperwork, investors seeking absolute returns should reject all these rigid compliance structures.

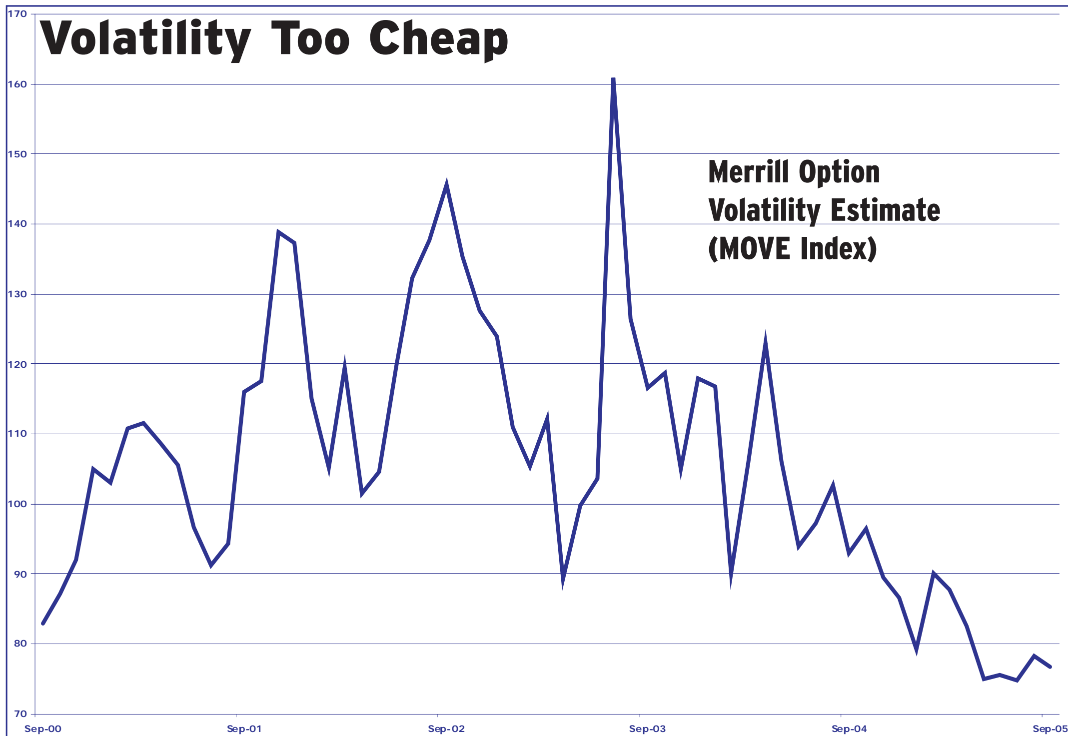
You're saying they're costly and futile?

More than that, the undeniable implication of emphasizing risk control is its corollary: the investor does not necessarily confirm his acceptance of the risks the fund took to generate its historical returns and has not necessarily considered whether the potential negative consequences of those risks would be acceptable in the future. Plus, the danger in real-time monitoring is that it evokes a false sense of risk control for the investor. So when the inevitable disappointment occurs from normal market speculation, reality confronts the meddling investor in the form of a sense of powerlessness. The investor often attempts to remedy this situation by taking action against the source of his reality check. This is usually manifest in the form of a fund withdrawal, and it often comes at the worst possible time. (Never mind there was no situation to begin with–the fund took risk and lost, and in most cases plans to continue taking good risks and profiting.) Yet investors of all stripes have been sold on the benefits of compliance, as well as market and fund transparency.

Are you also against Mom and apple pie?

No. I understand why an investor with no particular edge prefers to think that everyone, everywhere knows everything about their markets and funds–so that they don't have to keep constant vigil. It is also hard to dispute that transparency is beneficial for the masses of investors willing to speculate if, and only if, a level playing field exists. But investors seeking non-index returns should de-emphasize exposure to transparent funds and instead should seek inefficiencies in markets and a little mystery in their hedge funds.

Mystery?



Source: Merrill Lynch, Bloomberg & Spyglass

Sure, from an investment perspective, hedge fund transparency is self-defeating. It doesn't prevent losses from poor investment decisions, nor does it prevent scoundrels from committing fraud (though it makes thievery visible sooner). Besides, when markets become opaque, as they do and will, no amount of hedge fund transparency will protect investors. At bottom, hedge fund investing, like any other type of investing, is not neat and tidy. It is not a science, and therefore not subject to blind reliance on formulaic modeling. Checking due diligence boxes and then deciding whether to invest in a hedge fund implies that the investor, or his agent, knows all the various merits and risks the fund may experience in different markets at each moment, or expects the investment manager to reproduce past reactions to repeating market events. But this is not reality. All bull, bear and non-trending markets are different. Even the investment manager cannot quantify, beyond projecting past events into the future, the manner and timing of all opportunities and risks. Successful investing, in all its forms–including through hedge funds–remains an art. Even though many or even most investors out there fervently wish it weren't so. That's my take on it. And transparency, by the way, runs counter to the artistic nature of investing, in which you have a skill set and try to apply it, and doubting yourself and being impulsive and being disciplined, all at the same time– which I think being a successful investor requires. I mean, you've got to, in my opinion, know when you need to be humble and when you've got to let your ego go and that's where the art comes in. Beyond that, the whole spirit of transparency is that your investors won't be surprised–which implies, of course, that you're not taking risk. And that's a real problem, in an investment program. It actually adds risk. I don't mean to sound like I'm whining and complaining. What I want to point out, though, is that there are a lot of inherent conflicts with reality in the way that hedge funds are being sold currently.

What's another big one?
Perhaps the biggest involves the mis-matched funding that goes on. Almost by definition, hedge funds are trying to invest in markets that may require some patience.

Either that, or they are raising the noise level in the market with frenetic trading to try to avoid posting the dread down month.
Which is crazy. It's not reality. When I was trading at the AMEX, I thought I was a genius because I was selling options premiums. Month after month, after month, I was raking it in, shorting volatility in the equity markets. This was 1984, I was just out of college and convinced of nothing as much as my own brilliance. I knew, after all, that statistically, the odds were heavily stacked in my favor.

So your investment program was duck soup–until it wasn't.
Right. I was profitable every month for 11 months, then I gave it all back in one month. Which is typical, I know now. Then, I knew only the math. Which is fascinating thing, at least for me. Statistically, a three-sigma event is almost never supposed to happen, but it always does in the markets. The five-sigma event that is only supposed to happen once every 10,000 years has probably happened 12 times in my career. The thing is, statistically you can understand why, when you really look at it. It's because you take a volatility assumption that is a long-term volatility assumption, and apply it every day, but the outliers don't figure in. So on a daily basis, each and every day, it's not supposed to happen, but over a stretch of time, you know it's going to happen.

Even so, the market regularly develops amnesia about those little hiccups.
That's right. But I haven't forgotten it since 1984. It's my polestar. I'm not going to be short volatility unless I'm *very* well compensated. Still, I couldn't agree with you more about the market. I think the entire carry trade that most funds are in right now, whether they're fixed income or equity, is a manifestation of that very dynamic. They are short volatility. Spreads on fixed incomes are very narrow.

Makes perfect sense. There's no risk in the markets, or the global economy, these days.
Right. We're just going to keep levering up and we don't care. It's other people's money (very cynically), so let's see how many years of fees we can get out of this thing. It's a very sorry state of affairs. But let's talk about some positive things.

Sounds good to me. Like what?
I'm not sure, but I don't want this entire conversation to come off in a negative way.

Well, I really called to talk about the piece you just sent to your investors, featuring Alfred E. Newman and some wild bubbles. The old Mad Magazine reference is easy: What, Me Worry? But your multi-layered bubble illustrations, I'm not sure I grasped–
I drafted old Alfred into service because it's hard for me to work up much fear of inflation, at least runaway inflation, when I am looking at the broader global economy. It's difficult for me to get all worked up about

U.S. inflation when Asian exporters could take care of that right away by increasing their exports if they so chose. And what I was trying to get across with my drawings of all the interlocking bubbles is that it seems to me that this country's financial markets and economy are essentially becoming a bank. We are importing savings by offering a better rate of return and a safer place than you can find elsewhere in the globe. The thing is, I'm not sure that a bank deserves a high multiple.

In what sense?

This isn't in my letter to investors, but to extend my arguments, I think that we're really of the mindset here that we're in a growth economy, when in fact we're probably not. If you were to strip away the expansion of the U.S. capital markets, which is a direct result of secular economic trends that have transformed the global economy over the last generation–things like demographics, over-capitalization, technologies that have obliterated global operational and pricing inefficiencies and increased worker productivity and the misallocation of risk capital that has fed the boom in mortgage-backed securities markets, and asset-backed securities markets, or more generally the fixed-income markets and derivatives markets, where we *think* we're laying off our risks–

It sounds like you chose the word "think" advisedly.

We'll see. I don't know if anyone knows. But my point is that it seems to me that the amazing growth in the capital markets over the last 20 years is almost the only thing that has kept our growth, our organic growth from operations, afloat. Which means that applying the old Econ 101 metrics about domestic supply and demand, and putting trade on the periphery, because it augments our domestic economy–that just seems like a very archaic framework on which to base an economic opinion in the 21st Century.

So the tidy economic relationships of our fathers' generation just don't apply anymore?

Not in my world, or yours. The bubbles were just my artistically challenged attempt to illustrate how the global economy has evolved over the last generation in response to secular economic trends. My take is that the abnormally long expansion–only briefly interrupted by minor recessions–was the result of those trends. New channels of cheap production capacity have emerged that have not been naturally offset by increased demand for goods and services–Asia, for instance, can churn out consumer goods for the West a lot faster than it can create consumers with the wherewithal to sop up some of that supply. This long-term trend has been extremely disinflationary (See Chart 1) and I think the only thing that has saved the U.S. from outright deflation has been the extraordinary growth of the global capital markets.

How is that?

Global investors have replaced banks as extenders of consumer and business credit and have become assumers of credit risk.This trend has gone unchecked because capital market regulators have mandates to prevent fraud–not investment risk. They are reactive–not proactive–and are limited to restricted jurisdictions. What's more, market regulators typically focus on protecting small equity investors. They don't scrutinize fixed income or derivative markets as closely, which is where most of the risk is being taken these days. So global economic risk, over the last generation, has been decentralized, defused, but *not eliminated*. Now, instead of residing in your local bank, economic risk has been assumed by pension and mutual funds, insurers, money managers and foreign investors, via the financial markets.

And the big banks are just the midwives in all this?

They now act as financial intermediaries, structuring and distributing financial products to collect fees. And as such, they've actually become promoters of market risk. (Ironically, they've rarely had healthier balance sheets.)

Unless you adjust them for off-balance sheet risks.

Let's not go there; that's a whole other story. But regional banks, by contrast, now assume great risk to generate profits, mostly by lending in local residential and commercial real estate markets. Fierce competition has pushed them to relax underwriting standards and to retain risky loans investors don't want. This means that smaller banks hold the riskiest loans, but so far their amount at risk is a small percentage of the systemic default risk found in the markets.

Why doesn't that give me a lot of comfort? And where's the Fed in all of this?

The Fed is a bank regulator, not a market regulator. Despite all its protests that markets and the economy are now flexible enough to handle financial crises, the fact that the Fed has *not* formally tightened bank-lending standards implies it does not want to risk this theory on its banking system. Formally raising lending standards might give unregulated private lenders an edge over banks, and frighten bank equity investors and depositors. Aside from fighting inflation, the Fed appears to some to be raising fed funds to try to stop bad lending behavior. But we think there is much more to it; instilling prudence among lenders would be an ancillary benefit of raising rates–not the driving force behind the Fed's actions.

And you're firmly convinced that inflation isn't Public Enemy No. 1 again, despite the price of gas at the pump?

Look, the only meaningful inflation over the last 25 years has been demographically driven–in stocks, homes, health care, education.

Nothing important, in other words?

I didn't say that. The run-up in homes seems significant to us now, but it doesn't imply there will be a permanent imbalance of resources that will undermine the long-term purchasing power of a dollar. This demographically driven inflation trend should peak in the coming years as we baby-boomers attempt to monetize our non-income producing investments, downsize our homes and perish in greater numbers. What will remain will be commoditized food, housing, health care, weaponry, technologies, (and, regrettably– culture)–available to all on the cheap.

That actually sounds very deflationary.

What I expect to see is a deflationary environment in which paper wealth declines but overall standards of living do not. A person who shares this view should rationally increase his or her allocation to default-free assets that don't rely on future speculation to hold their value, and decrease current debt, because deflation increases the value of each dollar owed. So perhaps the Fed has been trying to re-inflate the economy in the hope that Americans would begin saving and paying down their debt with devalued dollars? If so, this effort should be commended, but the forces of nature are lined up against it. Meanwhile, by talking up its inflation and lending fears, the Fed has created a conundrum.

Greenspan's conundrum?

No, this is one for prudent bond investors who are supposed to be interpreting fundamental data and positioning assets accordingly. Simply put, there has been no meaningful inflation beyond the minor uptick one would have expected following two tax cuts, a year of 1% fed funds and soaring energy prices. As chart 2 shows, core inflation has actually *declined* this year. Recent inflation fears stemming from higher energy prices are valid, but I think the far greater consequence of higher inflation, (regardless of provenance), in a highly levered economy would be an immediate and severe economic contraction that would quickly reverse any inflationary pressures. But I don't think this country's 25-year disinflation run is over. If it looks like a duck and quacks like a duck, it's prob-

ably a duck. My charts quack loud and clear–inflation isn't the problem to fear.

But it's not only energy prices that have spooked investors–

Yes. We have looming–and growing trade deficits, rising commodities prices and the threat of a weaker dollar. But threats like that to U.S. interest rates have been consistently overcome in recent years by a strong bid for highly rated, highly liquid and relatively high-yielding U.S. debt. Why? because the global investors who buy our debt do not, let me repeat, do not have selfless motives. Asian exporters, for example, are anxious to keep over-leveraged U.S. consumers buying–so they'll continue to fund Asian growth. And according to the U.S. Treasury, China alone has purchased $54 billion of U.S. Treasury and agency issues this year through July. Clearly, U.S. domestic inflation is not a deal-breaking metric for most investors in Treasuries.

Okay, but what keeps them buying?

Fundamentally, two factors have the power to sustain the U.S. economy and the power to overturn it -consumption and foreign capital. Essentially, central planners from emerging economies and investors from more mature economies are subsidizing the U.S. consumer by buying our debt and maintaining lower rates–and they are capable, through their actions, of increasing or decreasing U.S. economic growth.

In other words, financial market participants now fill the shoes central banks used to wear?

Exactly. The key to all this is maintaining a strong dollar–and the Fed knows it. Asian exporters – the supply side of the global economic equation–have the upper hand. It seems unlikely the U.S. can take back unilateral control of its economy amid the transparent, integrated, globalized economy that's evolved over the last 20 years or so. There's no way this country could pull off a race to the bottom of the supply chain, even if we wanted to try. So I think the Fed is hiking rates to maintain an attractive interest rate spread over other global debt in an effort to compete for global savings.

But long rates haven't shown much inclination to follow–

Over the last few years I've been adamant that market interest rates would *not* rise. I've felt that the long-term deflationary impact of the secular global economic trends I cited would overwhelm more fleeting cyclical factors like provincial inflation. And I continue to think these realities will act as a cap on U.S. market interest rates regardless of any goods and service trend inflation in the U.S. or the Fed's mission to maintain the attractiveness of the buck and Treasuries. Meanwhile, I haven't tried to hide my frustration with the policy meddling that has slowed the reconciliation of U.S. interest rates with global economic fundamentals. It's been painful watching the yield curve flatten as the Fed has raised overnight rates to more historically familiar levels. Over the last two years, the spread separating two-year Treasury yields from ten-years compressed from 275 basis points to just 16 basis points as of last month. Common wisdom has it that the Fed wants to see longer-term rates rise in step with short rates.

You're not so sure?

Well, the logic follows that if longer yields rise, housing prices and levered speculators would begin to suffer, thereby slowing the economy and nipping inflation in the bud. But longer rates are not rising and it's unclear they will. I've argued instead that if the Fed doesn't stop flattening the curve, then the broader market-based economy would soon be blind-sided by forced asset sales across markets. I still think that is more likely.

Now there's a happy thought. One made more likely, now that the Fed has gotten an assist from a couple of hurricanes?

They're trying desperately, I think, to re-inflate the economy, and it's nothing new. They're jawboning inflation; trying to get everyone to fear it, in hopes, that they might produce some. Meanwhile, the government is spending with abandon to repair hurricane damage. But I just don't see that generating a lot of inflation. After all, we've had two tax cuts, 1% Fed Funds and an oil shock, yet here we are. Maybe inflation will rise dramatically from here–but even if it does, the real problem I'd see that causing would be lower future growth, because it would immediately reverse the last vestiges of organic growth in the economy. I think that's the real story. It's not inflation, but it's the way the U.S. economy's operating growth is treading water. If the U.S. economy were a corporation, it would be very mature. But if it issued a bond, it would be at a premium. It would have a premium coupon on it, with let's say a ten-year maturity, to match when the baby boomers start to retire, but it would be callable in a week, or at any time. Because we're so highly leveraged that all it will take, I think, for the U.S. economy to begin contracting, would be any event–and inflation might be it–that gets the U.S. consumer to pull in their horns and the U.S. investor to pull in their horns. These days they're one and the same. What this means to me as an investor is that I want to make sure that I'm not short interest rate volatility– especially that I'm not short Treasuries versus anything else. Because if my logic is reasonably correct, then at some stage there's going to be a flight to liquidity, or a flight to quality. For no apparent reason, one day, Treasuries are going to soar versus everything else, and in a low return environment that's the trade you want on. Following two years of narrow interest rate trading ranges, interest rate volatility is very cheap and I continue to own it to hedge against and profit from the bust. You don't want to be forced right now to pick up nickels in front of steamrollers right now.

Thanks, Paul.

W@W Interviewee Research Disclosure: Paul Brodsky is the investment manager of Spyglass Capital, an investment partnership. This interview is not an offer to sell or a solicitation of an offer to purchase securities of any kind. Return figures herein are estimated net of all fees and charges. Any comparisons have been obtained from recognized services or other sources believed to be reliable. This report may contain forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve inherent risks and uncertainties, and we might not be able to achieve the predictions, forecasts, projections and other outcomes we may describe or imply. A number of important factors could cause results to differ materially from the plans, objectives, expectations, estimates and intentions we express in these forward looking statements. Spyglass does not intend to update these forward-looking statements except as may be required by applicable laws. No part of this document may be reproduced in any way without the prior written consent of w@w and Spyglass Capital. Past performance may not be indicative of future results.

Welling@Weeden Staff Conflicts Avoidance Policy Disclosures

In keeping with Weeden & Co. LP's reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that when published our analyses reflect our best judgments, not vested pocketbook interests of our sources, colleagues or ourselves. Neither Weeden & Co. LP nor w@w engage in investment banking; w@w's mission is strictly research.

All information gathered by welling@weeden editorial staff in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staff (a group broadly defined to include Kate Welling's immediate family) will not buy or sell any security mentioned in the journal for at least one week after publication. Staff will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Staff may not be otherwise compensated for securities recommendations in these pages. No w@w staff will serve as an officer or director of any publicly traded company. All securities positions entered into by w@w editorial staff will be held for *at least* six months unless dispensation is received, in extraordinary situations, from Weeden & Co. LP's compliance officer. Any securities position in any company, mutual fund or partnership portfolio featured in welling@weeden that was acquired by staff in advance of the publication decision will be specifically disclosed at first mention. [No such reportable positions exist.] *And* that position will be frozen for six months from date of publication, again, absent extraordinary dispensation from compliance.

Weeden & Co. LP's Research Disclosures

This material is based on data from sources we consider to be accurate and reliable, but it is not guaranteed as to accuracy and does not purport to be complete. Opinions and projections found in this report reflect either our opinion (or that of the named analyst interviewed) *as of the report date* and are subject to change without notice. When an unaffiliated interviewee's opinions and projections are reported, Weeden & Co. is relying on the accuracy and completeness of that individual/firm's own research disclosures and assumes no liability for same, beyond reprinting them in an adjacent box. This report is neither intended nor should it be construed as an offer to sell or solicitation or basis for any contract, for the purchase of any security or financial product. Nor has any determination been made that any particular security is suitable for any client. Nothing contained herein is intended to be, nor should it be considered, investment advice. This report does *not* provide sufficient information upon which to base an investment decision. You are advised to consult with your broker or other financial advisors or professionals as appropriate to verify pricing and other information. Weeden & Co. LP , its affiliates, directors, officers and associates do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Past performance of securities or any financial instruments is not indicative of future performance. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP is a member of NASD and SIPC.