From: Ben Hunt
Sent: Sunday, October 07, 2012 8:56 PM
To: Ben Hunt
Subject: Donald Rumsfeld and risk management

I write these irregular notes to share my thoughts and views with people who have indicated an interest in hearing those ideas and how they impact the Procella portfolio. But I also write these emails as a self-help exercise, particularly after a weird, frustrating week in the markets. Both efforts run the risk of self-absorption, so I'd welcome thoughts, comments, or questions from anyone reading this note. Feel free to forward to anyone who might be interested. And if the email barrage is too much, please don't hesitate to let me know that, too.

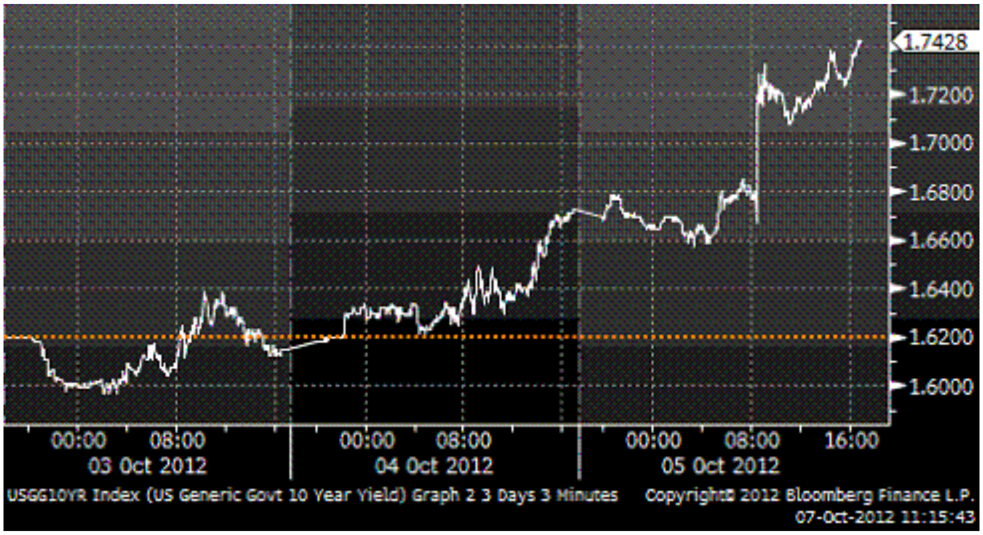
The email title references Donald Rumsfeld for his koan-like statement on decision making under uncertainty: "There are known unknowns; that is to say there are things that, we now know we don't know. But there are also unknown unknowns -- there are things we do not know that we don't know."

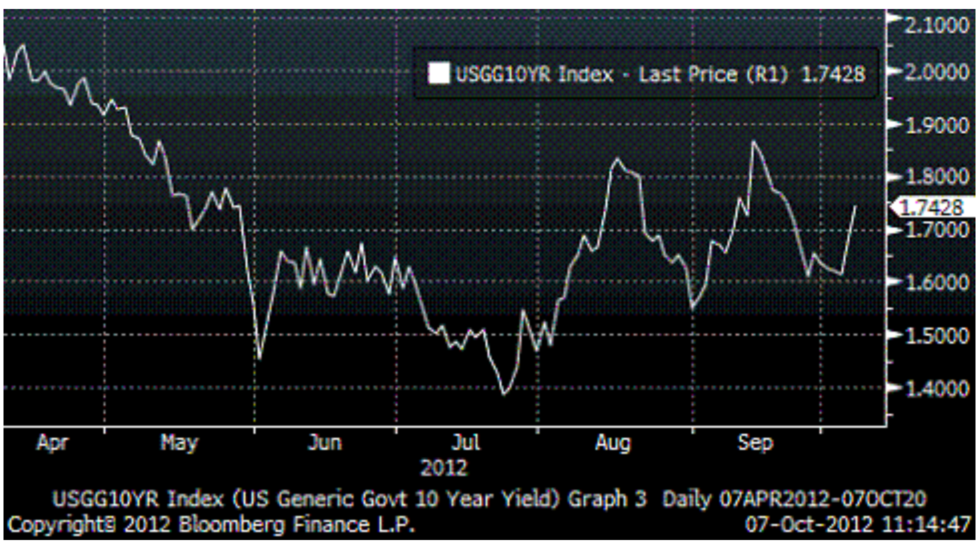
I think about this concept of known unknowns and unknown unknowns all the time in the context of portfolio risk management, particularly when you have -- as Procella does -- a portfolio of policy-driven exposures where the full range of secondary or collateral exposures may not be immediately obvious. A known unknown is a risk factor that we know exists. It might be part of a process that is difficult to predict (low confidence in the point estimation of an outcome at a given point in time and/or a wide range of potential outcomes on either side of the point estimation), and it might be part of a volatile process (low persistence or stability of outcomes over time) ... but it is analyzable under these parameters. I can develop and communicate a risk/reward assessment around known unknowns.

With unknown unknowns, on the other hand, it is – almost by definition – next to impossible to develop a risk/reward assessment that has sufficient practical usefulness to be part of an investment exposure. If you're losing money on an exposure and you don't know why, I think the only responsible course of action as a portfolio manager is to reduce that exposure. Actually, I'll go further than that ... if you're *making* money on an exposure and don't understand why, I think the only responsible course of action as a portfolio manager is to reduce that exposure. If you're losing (or making) money for reasons that you think you understand, you may also decide to reduce exposure, but at least that decision is (or should be) the result of a risk/reward assessment.

Here's a concrete example. About a month ago, between Draghi’s OMT announcement and Bernanke’s open-ended QE announcement, I came to the conclusion that I no longer recognized what makes the Euro-USD exchange rate go up or down. All of my known risk factors for understanding this exchange rate (and that includes amorphous or opaque risk factors such as sentiment and narrative) suddenly seemed to be immaterial. Something was making EURUSD go up and down, and the timing suggested that it was probably related to ECB and Fed policy, but it was nothing that I understood or had anticipated in my risk/reward assessment of shorting Euro-denominated equities. It was an unknown unknown, for me, anyway. I'm sure there are investors who are on top of what's moving EURUSD, but I'm not one of them. Fortunately this is an exposure that can be easily and cheaply hedged away, so that's what I did.

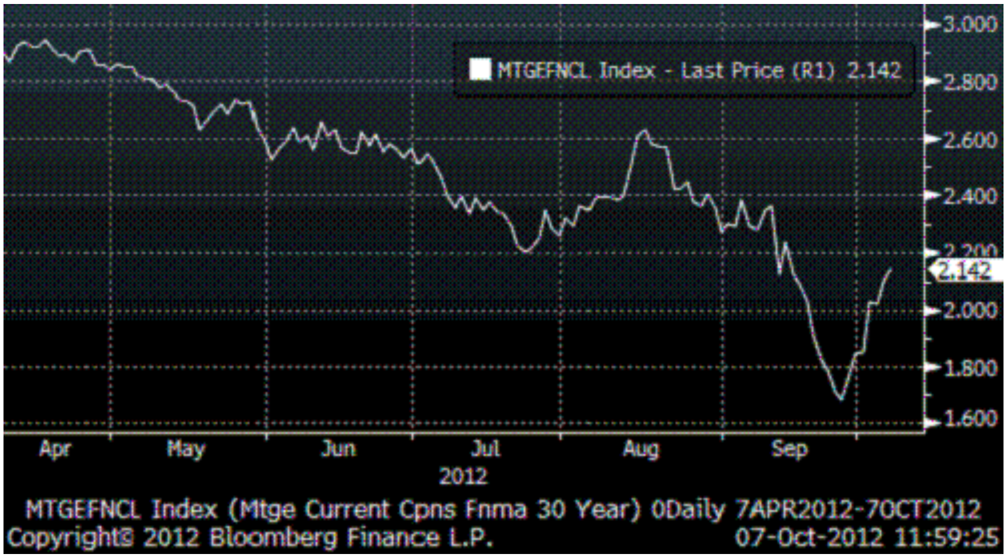
I don't have a direct exposure to US Treasuries, although I follow UST's and Bunds closely as a proxy for market perception of systemic risk. When I look at the recent price movement in UST's, particularly what happened on Friday, I am left scratching my head and wondering if there's not an unknown unknown in play here, too. Here's the 3-day chart and the 6-month chart for 10-year UST's:





I understand that we had an interesting jobs report on Friday, but I think it's hard to look at that report and say, "Whew! Systemic risk is now substantially reduced." I also think it's hard to look at that report and say, "Wow! Open-ended QE is already having a positive impact on labor conditions." And if those were the positive reactions of market participants, which might explain risk-on selling pressure on safe haven securities like UST's, then why did risk-on assets like equities and crude end the day down?

Let me suggest another interpretation for what's going on. Here's the 6-month chart for the 30-year Fannie Mae current coupon:



After open-ended QE was announced, I wrote that it was entirely possible (in fact, I thought likely) that mortgage rates would actually end up higher as a result of the Fed's policy, not lower as the Fed ostensibly intended. That assessment looked pretty stupid through September 26th, but it doesn't look so stupid now. Maybe it will look stupid again in a week. We'll see.

I think that open-ended QE is a really big deal for two reasons. First, it prioritizes the growth mandate above the price stability mandate. That has (or should have) a dramatic impact on investors' inflation expectations for the future, and an equally dramatic impact on other countries' trade and currency policy expectations for the future. Second, and I believe even more importantly, *it transforms QE from an emergency treatment for an acute economic trauma into a standard therapy for a chronic economic malaise*. We have seen this before in US political history, particularly in the 1930's, and the result is always to institutionalize the policy within the edifice of government. Without a significant regime change in the US in the very near future (for example, a Romney win in November and a John Taylor-esque appointment to replace Bernanke in January, 2013), I believe that massive asset purchases by the US central bank will become a permanent part of the US political landscape. The rate of asset purchases may wax and wane in the years to come, and might even be negative for short periods of time, but the program will never be unwound. The politicization of US monetary policy will be complete.

So how does this link to the jobs report on Friday? I think it's very easy to read that jobs report and come to the same conclusion as Jack Welch. To paraphrase: "Are you kidding me? This has to be a politically motivated result." Now I know that academic economists are falling over themselves to say "No, no, no. Noooooo. Of course not. Perish the thought." But count me in Welch's camp. I think that everything that comes out of Washington today is politically motivated and politically edited, and that includes economic data reports and monetary policy. This is not a partisan statement, as I can give you plenty of egregious examples from Republican Administrations. Anyone remember Arthur Burns?

A highly politicized US monetary policy in the form of open-ended QE (and suspect economic data) is an unknown unknown. It's a new, unanticipated, explosive risk factor that no one investing in US markets today has any experience with. We may all have our own ideas about how open-ended QE will play out in markets, and we can come up with historical examples with arguable relevance to our current situation, but the only thing we know for sure is that there's a staggering amount of investor uncertainty here. In fact, I think a big part of what we're seeing in this puzzling (to me, anyway) market action in the first week of the fourth quarter is the result of institutional investors and allocators wrestling with the existence, timing, and impact of a highly politicized US monetary policy in the form of open-ended QE.

My view on the market perception of open-ended QE hinges on the US election in less than four weeks. I don't think it's lost on anyone (including non-US central bankers) that an Obama re-election cements the current direction of US monetary policy for at least another five years (remainder of Bernanke's term plus his successor's four year term), and I believe that this is actually the most important policy consequence of the election. If Obama is re-elected I suspect we will have many more days like last Friday, with UST's selling off sharply and equities muted at best.

If I'm right, then this is a large opportunity for the Procella strategy, as I have identified a set of equity exposures, some long and some short, that are highly levered to this hypothesized monetary policy impact of an Obama re-election. But there is also a potential problem for Procella here, and that's the geographic bias of the current portfolio.

Right now, I do not have a long policy-driven investment thesis for Europe. I may be long European securities for an immediate catalyst (as I was before the June Euro Zone heads of state meeting), but I don't have a long investment thesis. I just don't. Are there less-challenged companies in Europe I could go long to create a relative value trade with the shorts? Sure. But I'd rather just reduce the short gross exposure if I'm concerned with bringing down the short net exposure and its impact on the overall portfolio. This policy-driven short view on Europe is not a permanent or embedded bias to the portfolio, but – based on my 25 years of studying European policy – neither is it a transitory exposure. I expect to be short Europe for the foreseeable future. As a result, when we have days like last Friday, where European markets were all up 100 to 200 bps and the US market closed down slightly, then I lose money. Sure enough, Procella lost 100 bps on the short Europe trade last week, about half of that on Friday. The question is what to do now.

In the same way that I see evidence of institutional investors and allocators wrestling with the impact of open-ended QE in market action during this first week of the fourth quarter, so do I see evidence of investors and allocators shifting exposure away from the US and towards Europe. When even a pronounced Euro-skeptic like Bill Gross says that Pimco is buying a smattering of Spanish and Italian sovereign debt because he wants to get in front of the ECB, that's clearly indicative of an improved general market assessment of the risk/reward associated with European assets. This is another manifestation of "the ECB has got your back" market narrative that I've written about at length over the last two months and has been my investing bête noire ever since Draghi's "whatever it takes" London speech on July 26th, so it's a known risk factor. And if I were considering the short Europe trade as a stand-alone exposure, I would be looking for opportunities to <u>add</u> to the short right now, not reduce it. Events over the past two weeks and events coming up in the next six weeks make ECB action less likely, not more likely, and renewed systemic risk more likely, not less likely. Even the language in published comments over the past week, such as "systemic risk is now off the table" and "a Spanish sovereign bail-out is inevitable, so we're buying regardless of policy announcements" … these are the things that make me lick my chops as a short-seller. In isolation, I am more confident and excited about the risk/reward assessment of the short Europe trade today than I was a week ago.

But the short Europe trade can't be considered in isolation. It's part of a portfolio, where a large risk factor is the net exposure differential between the US and Europe across all portfolio exposures. I think there's an unknown unknown risk factor storm brewing, and it's centered over the US, at the same time that you've got a silly level of complacency around Europe. That can create a powerful narrative around the relative "safety" of investing in European "value" rather than the "uncertainty" of the US. I think this is a ludicrous narrative in every respect, but it wouldn't be the first time for me to think that and have it come true regardless. So that's what I'm watching for, and that's what could make me reduce my exposures overall and my short Europe exposure in particular … temporarily. Ultimately I think that I'm going to make a lot of money on the short Europe trade, but it's going to take powerful domestic political catalysts (as we saw in Spain two weeks ago) to hit the market over the head.

Meanwhile I'm going to continue to focus on post-US election trades. Some (long banks with strong mortgage origination platforms) work regardless of who wins, I think. Others, such as the impact of open-ended QE on inflation expectations and trade expectations, depend on one candidate or the other winning. Either way, I'll be ready.

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