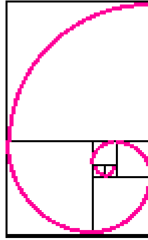

# Sand Spring Advisors LLC

## Hedge Fund Firestorm Soon To End

**By,**

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As long-term readers know, the timing of this letter's release has varied from month to month. Usually I try to wait for the markets to offer up a clear new path or new theme, and then hop on the keyboard when this new path has become compelling and clear. I generally want to avoid wasting readers' attention span with long extrapolated ponderings on different possible market rhythms, and instead just deliver strong conviction in one core view.

As a forewarning, this month's letter may unfortunately not live up to this past goal.

The simple fact is that as I have sat at my trading desk over recent days, I have seen a tremendous push-pull of different factors that have yet to fully line up in a cohesive manner in my head. At moments recently, I get to the point where I think everything finally makes sense, but then, a day or two later, the markets offer up a completely different feel. In other words, there has been very little follow-through to technical set-ups that initially look promising, and this has become increasingly frustrating. It's a bit like being a doctor trying to detect a steady heartbeat in a patient, but the heartbeat keeps skipping a one-off odd beat.

As a matter of background, I generally started the summer with a fractal vision that the S&P was in a "stumbling lower"- mode towards 1165-1175 Fibonacci support.

I was then correct in late June to anticipate an oil and commodity reversal lower (that transpired as of mid-July) – a decline that in ways (and on certain days) would psychologically support the market, but in other ways (and on different days) would make it easier for the S&P to fall – particularly given the heavy actual weighting of energy stocks within the S&P 500.

Our July 31, 2008 pi cycle date then came and went with potentially different interpretations – as previously discussed.

Then last month, I wrote that my focus was changing towards anticipating a stronger dollar, still weaker commodity markets, and higher U.S. interest rates – while I anticipated that the U.S. equity market was getting less dynamic in its directionality and increasingly stuck in a choppy trading range.

The dollar did subsequently strengthen (even a bit farther than I had expected); gold and silver collapsed (again, somewhat farther than initial expectations – at least for silver); and equities have subsequently been stuck in a range. But as my single greatest frustration, the 10-year U.S. Treasury market has remained strongly bid.

It was at this moment that the U.S. Treasury came along with its sudden "conservatorship" plan for Freddie Mac and Fannie Mae. Since this move potentially doubles the footings of the U.S Treasury's balance sheet, I immediately expected my previously frustrated bearish view of the U.S. Treasury market to finally start to work. I also turned more bullish U.S. equities, starting to believe that courtesy of government intervention, the equity market's low for the year might have been seen.

As I type, equities have indeed gone strangely "bid" over recent days – even as yet another crisis in confidence has hit Lehman, AIG, and Merrill Lynch. Equity market leadership has in this instance been taken over by previously beaten-up home building and consumer sensitive stocks. The thinking seems to be that Wall Street may be broken, but that the government's explicit guarantee of Freddie and Fannie paper will lower mortgage rates, and let the consumer keep on partying a bit longer. The analogy here might be: When a drunk is about to keel over, just keep him going with one more drink.

Meanwhile, Hurricane Ike came barreling into the Gulf of Mexico, but oil and gas markets refused to blink last week – seemingly unable to rally.

Never have I quite seen such a hodge podge of odd sector rotation.

And then the "key" to understanding these markets occurred to me. To make sense of the "hodge podge of sector rotation," one must first separate the real economy from the financial economy. Has anything that has transpired over the past eight weeks really been that related to the real economy? Or has it just been a maelstrom – a firestorm, so to speak -- of stop-loss orders from hedge funds all stuck in the same crowded trades?

Hedge funds may represent less than 20% of total assets under management in the U.S., but they represent some 80% of average daily equity market trading volume. Arguably, the clear and correct way to be rationally positioned for the longer-term is to be long energy and infrastructure stocks, versus short consumer and housing stocks. But such positioning has been absolutely <u>disastrous</u> across recent weeks. One by one, for risk management reasons alone, hedge funds have had to puke this or that energy or infrastructure bet, and cover shorts in this or that housing or consumer-sensitive stock.

Hedge funds also got jostled around being short financial stocks – fundamentally correct in their bearish views, but still subject to huge drawdowns every time the U.S. government has delivered another weekend bailout of one financial institution or another. Credit Default Swap (CDS) bets that in a normal event of default should have paid off on Bear Stearns, or Fannie Mae, or Freddie Mac are suddenly worthless contracts – ripped of their value by last minute Treasury and Fed bailout machinations.

Speaking with different hedge fund managers, many feel that July-September 2008 has been as difficult a period for hedge funds as any time since the LTCM-Russian ruble crisis of August 1998. The key difference between 1998 and this period is that hedge funds are now much bigger, and matter more to available market liquidity (or the lack thereof). Instead of the market simply catching the hedge funds off-guard, and the hedge funds adjusting; many hedge funds have now become so big and so unwieldy that it is not easy for them to make course changes. And when one large hedge fund does try to pull the rip cord on its portfolio, this action ripples through the portfolio of a variety of other managers. Hedge funds may have grown to be more institutional in size, but they have unfortunately also grown to be most un-nimble in nature.

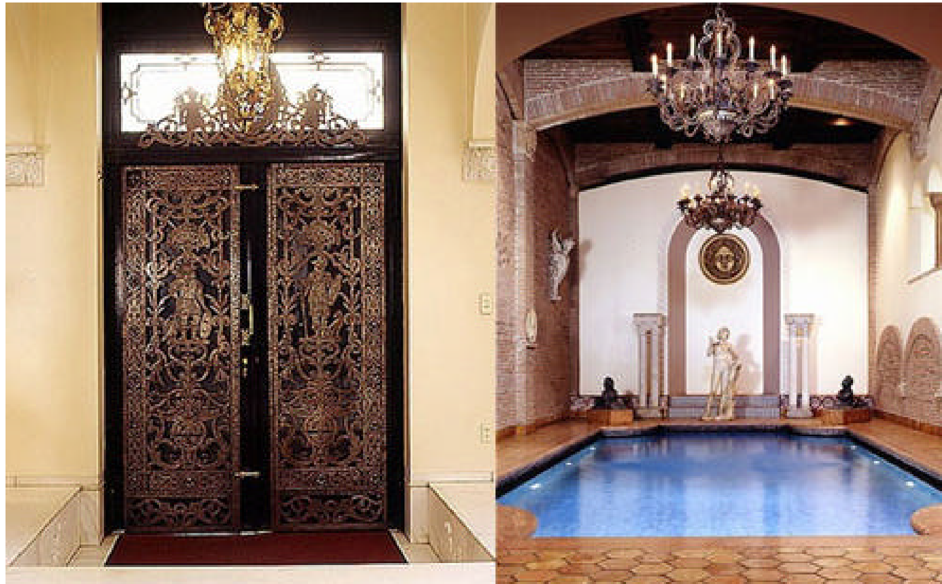
The list of hedge fund casualties is a long one. Dwight Anderson's commodity-centric Ospraie Fund has perhaps been the most public blow-up to date – with its -27% August loss and announced shut-down. But T. Boone Pickens also reputedly fell from grace with a -80% recent loss for his investors. T. Boone was never a man who impressed me with any modicum of risk management ability, albeit until August 2008 he had somehow survived the years with his Texas-hedge double-down long-only mentality. Pickens' recent high profile ad campaign for alternative energy was perhaps an easy tip-off that his long-biased hubris was about to turn problematic.

But the list of casualties goes on. Multi-billion event manager Atticus Capital is reputedly down over -25% ytd. So too is multi-billion manager Tremblant Partners, a fund that has had historic success trading consumer-oriented stocks.

And then there is Phil Falcone at Harbinger Capital. Falcone bet correctly against sub-prime in 2006 and 2007 and made his investors a fortune, and got the reputation as a star rain-maker. Institutional monies poured into his fund. He had also been doing quite well in early 2008 -- heavily long energy and natural resource equities, while heavily short financials. His assets under management had swelled over time to over $20 billion.

But is Falcone really a perpetual rain-maker or just an investor with some guts who got a few calls correct with "peddle-to-the-metal"-type position sizing? Does he know anything about risk management and portfolio construction? Did he ever consider how he would potentially get out of his positions if he was wrong?

Our own past research into Falcone here at Sand Spring showed a very flawed track record while he was at Barclays Bank between 1998-2000 with poor behind-the-scenes referrals from former colleagues. More recent signs of hubris are also easy to spot. In early 2008, Falcone bought the Guccione Mansion on 67th Street and Fifth Avenue (complete with a formal Caligula-like Roman Bath on the first floor) for $49 million, and promptly installed his pet pig named "Pickles" in his own room within the mansion. Crazy stuff.



We do not have access to Falcone's year-to-date performance, but do know that he dropped -16.2% back in July and has surely been doing even worse across August and September. On one recent September day when commodity stocks were down hard, I looked through the 13-F filings on Bloomberg of stocks that Harbinger has been holding long, and the average stock was down -10% in one day!

As LTCM was to 2008, will Harbinger Capital be to 2008? Or will some other mix of hedge funds have to suffice? The recent rapid downsizing of Lehman's balance sheet may easily have put some pressure on various other hedge fund managers who previously depended upon Lehman for their financing.

It all turns into a sad vortex of forced liquidation that even hurts less brazen and conservative hedge fund managers simply caught in the downsizing cross-fire of others.

But just as there was an entropic starting point to this chaos in mid-July, so too will come an entropic ending point. Spot that moment sometime soon across September or October, and then BINGO – <u>the trends of the real world in lieu of the financial world will be important once again.</u> In other words, the stop-loss selling of energy and infrastructure stocks will end; the stop-loss buying of housing and consumer stocks will peter out; and we will revert back to the fundamentals and trends as we knew them before.

One key in this whole process may be the picture of China that we see. One reason people are selling energy and infrastructure stocks right now is the sudden possible "whiff" of a global slowdown. But when we look at the technical picture of the FXI ETF that tracks Chinese stocks, <u>this ETF just reached our long-espoused downside target near 36.50!</u> There should be huge fractal support for this market near current levels. The recent bear market in China appears to our eye closer to ending rather than accelerating.

And if China turns back up, then the whole energy/infrastructure theme also turns back up -- and hedge fund stop-loss actions will abate. I will return to the energy/commodity theme a bit later in this letter.

But first let us zoom in on the immediate financial crisis, and understand what has been pushing it along. Why did the Treasury feel so compelled last weekend to announce a shot-gun conservatorship of Fannie and Freddie – even while the managements of those companies were resisting such a path? Why has the Treasury become so involved trying to negotiate the sale of Lehman Brothers before a sudden deadline this Sunday?

The only answer that makes sense to these questions is that Treasury Secretary Hank Paulson has received warnings from foreign holders of Fannie and Freddie paper, and foreign creditors of Lehman. Paulson has already basically admitted to such. "Fix this problem or risk us fixing it for you by writing some sell tickets" has been the likely tone of these calls. The rumors that we heard for this weekend is that four of the larger Asian banks were ready to pull Lehman's credit lines on Monday morning unless the Treasury could help pull a rabbit out of the hat. <u>In other words, the day has now already arrived (albeit no one wants to highlight it) where foreign holders of our debt are now directly impacting the path of American domestic financial policy. We now have a proverbial gun to our head.</u>

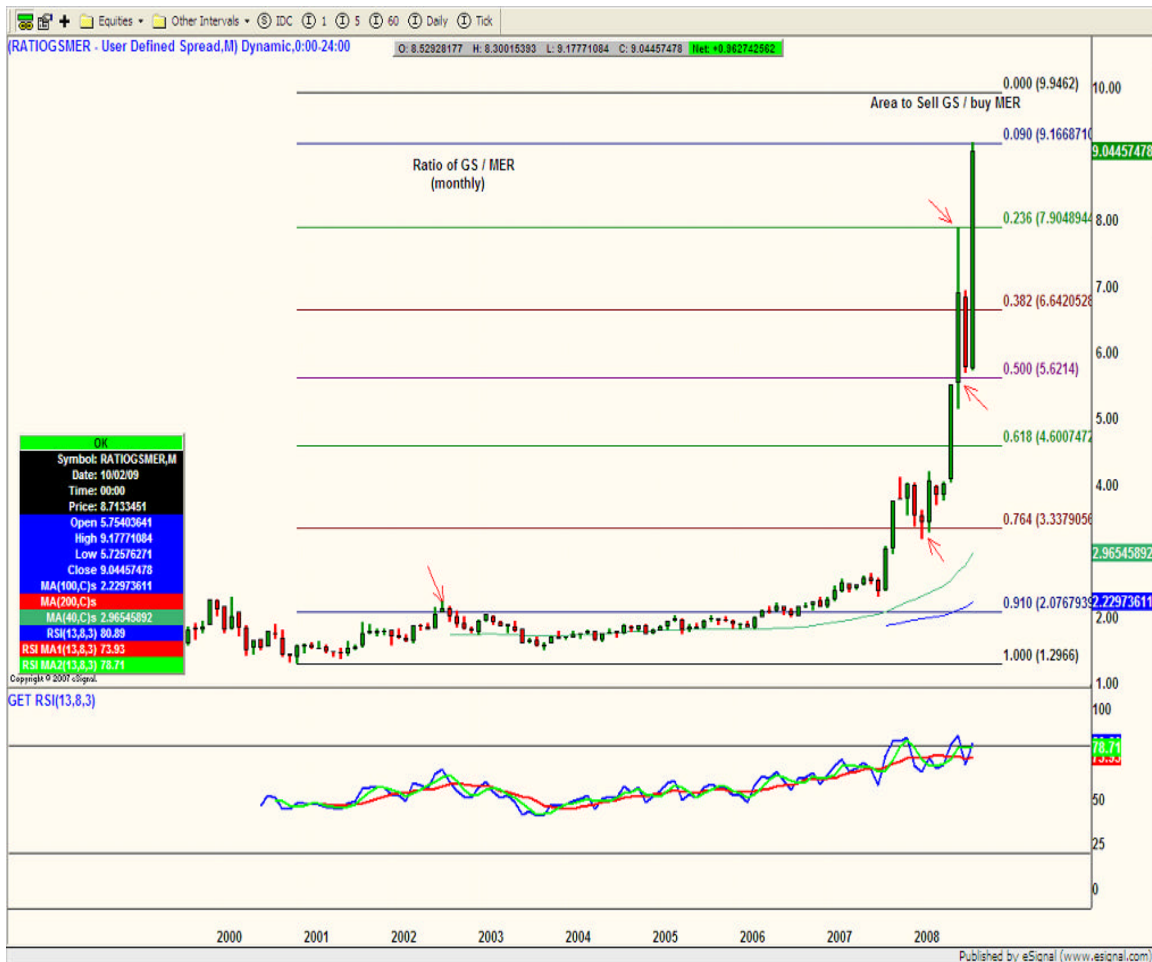
So here is the big-picture dilemma: foreign holders want their paper paid off in full; domestic borrowers (who have the power of the political vote) want to avoid losing their homes. The only way to try to keep everybody happy is to interject the federal government all over everything. Scrap capitalism and free markets, and interject a strong dose of Big Brother socialism. Stuck in the middle at present on the losing end of the stick are the equity holders of the troubled firms – Bear Stearns, Fannie, Freddie, and Lehman. To protect "the greater good," they become the scape goat fall guys, the sacrificial lambs that get wiped out.

The problem is that this type of path by the federal government actually makes it more difficult for other firms like MER and AIG to raise additional capital and survive. Potential distressed investors get scared away from supportive capital injection deals because instead of having a high probability that their investments will work out, they must contemplate instead a high probability that the government could prematurely pull the rug out from under them. All new deals suddenly need some sort of government guarantee so these distressed investors feel protected.

All in all, this is not a healthy long-term path. But in the short-term, we think that these developments will likely pass somewhat benignly – particularly when we look at the fractal pattern of a stock like MER. Its fractal rhythm is complete to the downside, and arguably is a buy.

If one wants a trading hedge against a MER long, one potential idea might be a GS short. GS now trades at a price approximately 9x that of MER after trading at prices more like 2x for years and years. The fractal rhythm of the ratio GS /MER specifically suggests 9.9x to be a level where this spread should stop widening. On a more fundamental basis, GS has also reputedly

been very off-sides in its proprietary positioning of commodity markets, so prop trading driven earnings are likely to disappoint unless energy/commodity markets can rally back pronto before their fiscal quarter ends in November.




But now for the long-view. Hedge fund storms of mal-positioning in crowded trades will pass. So too will sudden government interventions to assuage foreign debt holders. In the end, simply given the past 30-years of debt-financed U.S. growth, more wealth will be created outside of the United States than inside this country, and increasingly cognizant of the type of situation that has occurred in 2008, this wealth will increasingly look for investments outside of our borders when at all possible. My view of Treasury yields backing up to higher levels will eventually transpire, but to be honest, who knows from what level. The recent dollar bull market will peter out. It has no longer-term sea-legs.

Yes, we are at risk at some point of a globally synchronized economic slowdown, but our pi cycles do not suggest that such should occur right now. Rather, April 2009-June 2011 should be the window for such. This leaves us with approximately a seven-month window across which we believe that global equity markets can bounce, and with them commodity/energy markets that have so recently been taken apart by hedge fund stop-outs.

There are plenty of individual commodity/energy equity chart patterns that look of potential interest. Stocks like EAC and CRT all seem to have missing highs within their fractal rhythms.

EAC : ENCORE ACQUISITION CO,D) Dynamic,0:00-24:00
EAC (daily)
missing high longer-term
0.000 (84.73)
0.090 (79.520418)
0.236 (71.08448)
0.382 (62.64276)
0.500 (55.82)
0.618 (48.99724)
0.764 (40.55552)
0.910 (32.125384)
1.000 (26.91)
GET RSI(13,8,3)
Oct
Nov
Dec
2008
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Published by eSignal (www.esignal.com)

CRT : CROSS TIMBERS RTY TR,M) Dynamic,0:00-24:00
CRT : Cross Timbers (monthly)
missing high longer-term
0.000 (69.78)
0.090 (64.179384)
0.236 (55.11024)
0.382 (46.03488)
0.500 (38.70)
0.618 (31.36512)
0.764 (22.28976)
0.910 (13.220832)
1.000 ( 7.62)
GET RSI(13,8,3)
1996
1998
2000
2002
2004
2006
2008
Published by eSignal (www.esignal.com)

In the gold sector, we also like the fractal look of AUY (Yamana Gold) for eventual new highs.

But perhaps the most compelling single commodity-energy oriented investment might be in the closed-end fund of RAB Special Situations (RSS-LON), now trading in London at over a 40% discount to its underlying NAV. Heavily invested in small cap global natural resource equities, this fund has been decimated by negative sentiment towards the sector and the illiquid small-cap nature of its underlying holdings. But Portfolio manager Philip Richards has posted 1000%+ yearly gains in the past, and we think that he can do so again. There may of course be some overhead resistance in many of his securities as RAB tries to raise liquidity to meet redemptions of his hedge fund (similarly invested as the public closed-end fund), but longer-term, there is also great value in some of RSS's holdings. For those not feint of heart, today's pricing of RSS may represent an exceptional opportunity.

And thus at long last, I have almost have made it through an entire newsletter without even discussing my current view of the S&P 500. To be honest, my simple view is that there is fractal support at 1165-1175 on the S&P, and fractal resistance at 1325-1340, and I would love to figure out which gets reached first. I continue to lean towards the upside being reached first, but do not have high confidence in any path. Retail and homebuilder stocks have already rallied so much that I have a hard time imagining their leadership continuing. Only when I look at charts like FXI and MER do I find my confidence increasing in a rally about to transpire. So stay tuned to the website for updates. In the interim, here is basic picture on the S&P.

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