Hedge Funds Missed the Rally. Has Someone Missed the Point?

Star Date 2009 05 19:

Hedge funds have been accused of missing the equity market rally begun March 2009. Let us look at an example of an equity market such as the European equity markets to see why.

Equity markets are up year to date. The Stoxx 600 for example is up some 6% year to date after a 22% drop followed by a 37% rally. Yet it has been a very difficult market for trader and investor alike. Only the truly brave make big money (I am being polite.)

Sentiment worsened almost linearly and certainly monotonically since September 2008 to March 2009. Then suddenly equity and credit markets turned and rebounded sharply. By late April, commentators began talking about ‘green shoots’ of growth and recovery. I guess even a dab of moss after a nuclear Winter counts as green shoots. Equity markets have behaved erratically. Cyclicals led the rebound, defensives lagged it. This is typical of late stage recessions and recoveries, yet fundamentals are far from healthy. Markets, however, are driven by fundamentals only until they are driven by psychology. Healthier is sufficient, the market doesn’t need healthy. The Q1 results season has been interesting. In a normal recession, analysts adjust their earnings forecast slowly, exhibiting serial correlation. As a result, companies tend to miss their forecasts and the street then engages in a staged downward revision leading to more and more disappointment. So violent was the shock to the financial sector, repository of stock analysts that earnings forecasts were cut almost indiscriminately. The rebound therefore was set up well in the 4Q 2008 as sentiment drove forecasters to overshoot. In the ensuing rally, low quality companies have outperformed high quality companies and market breadth simply isn't there. Its not a healthy rally, but shortsellers beware, it could well become one.

Within the Stoxx 600, the sector dispersion is high. In the last 3 months, banks, insurers and financial services outperformed. The rest of the sectors cluster quite closely. Telecoms, utilities and healthcare underperformed. Dispersion is moderate with the exception of the banks. The Stoxx Bank Index rose 48% in the last 90 days in spite of the chronic uncertainty over their solvency and profitability. Guilt by association buoyed Insurers to a 26% gain over the same period. Consumer cyclicals made gains in the high teens. In the same period, Telecoms lost 4.25%, Healthcare lost 6.66%. Getting the sector call wrong would be costly.

Within each sector, dispersion was fairly moderate with the exception of banks and resources. Dispersion in the banking sector in Europe was very high. Ironically, it seemed that poorer quality banks or banks at risk were the better performers while the higher quality, diversified and stronger banks lagged. Some of this was of course for the fact that we are measuring performance from 3 months ago. If we go back further in time, the market is not so silly after all. In insurance and financials, dispersion is also high. Why is this? Is it because investors are more discerning? But how can they be given the opacity and lack of clarity over the financial strength of banks, insurers and financials? If these sectors are being traded as a risk premium trade, should not the dispersion be a lot less? An additional clue comes from the auto sector where dispersion is also high. What do autos have to do with banks, insurers and financials?

If we rank the dispersion of stocks within sectors by sector, we find the greatest dispersion in banks, then autos, then insurers. Then comes the average for the Stoxx itself. The other subsectors come in below the average. That is how stark the skew is. The dispersion of industrials, basic resources, oil and gas, consumer goods, utilities and telcos all exhibited low dispersion, in effect behaving as blocs.

One would have expected that sectors in which there was greater visibility of earnings, where there was less uncertainty of cash flows, would allow the stock picker the opportunity to be more discerning and to then introduce pricing dispersion. Instead we have found pricing dispersion in the sectors with the least transparency, the least clarity, and the least certainty with respect to earnings, cash flow, or financial strength, sectors which if anything, should have been priced as a bloc, and on a risk basis. Why is this?