

Investment in the era of unintended bets

Joseph Mezrich

Nomura Securities International, Inc.

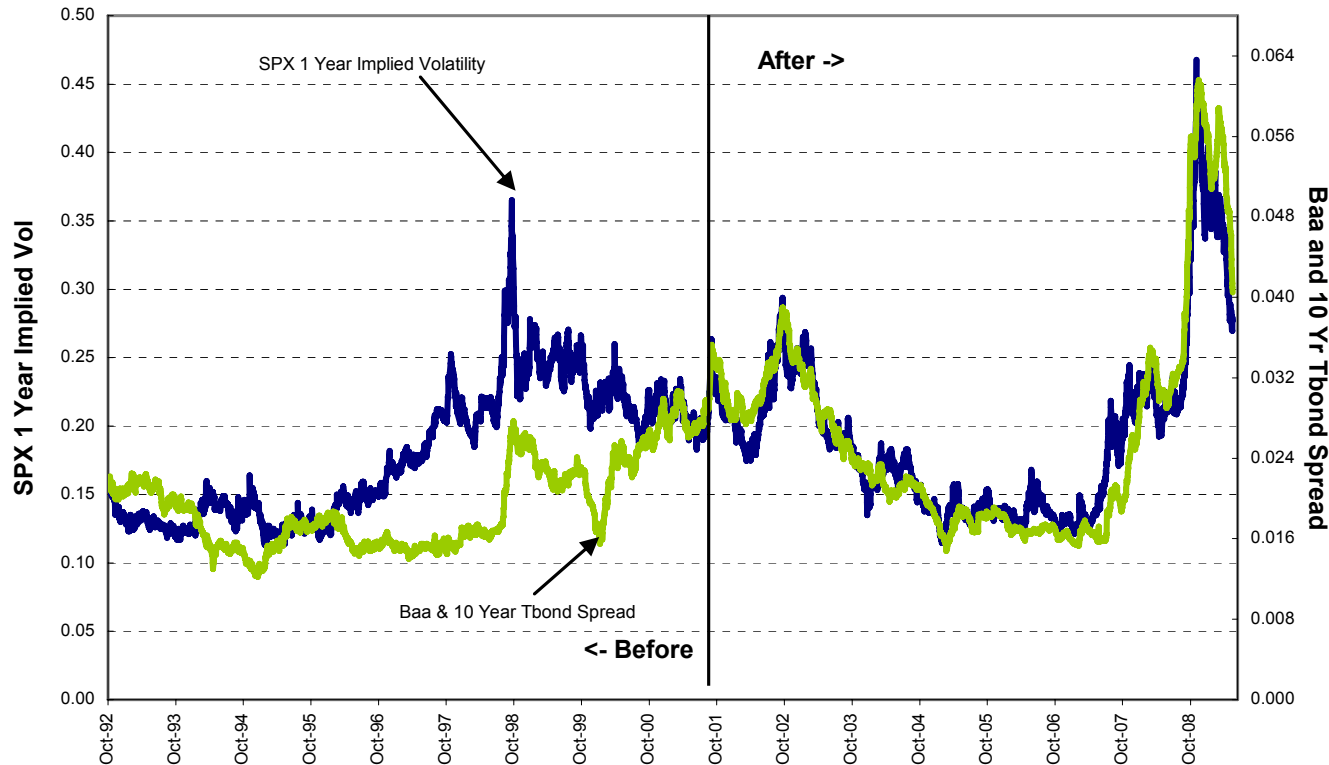
16 June 2009

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All together now

The legacy of financial engineering

Systemic risk will likely change in magnitude but won't go away



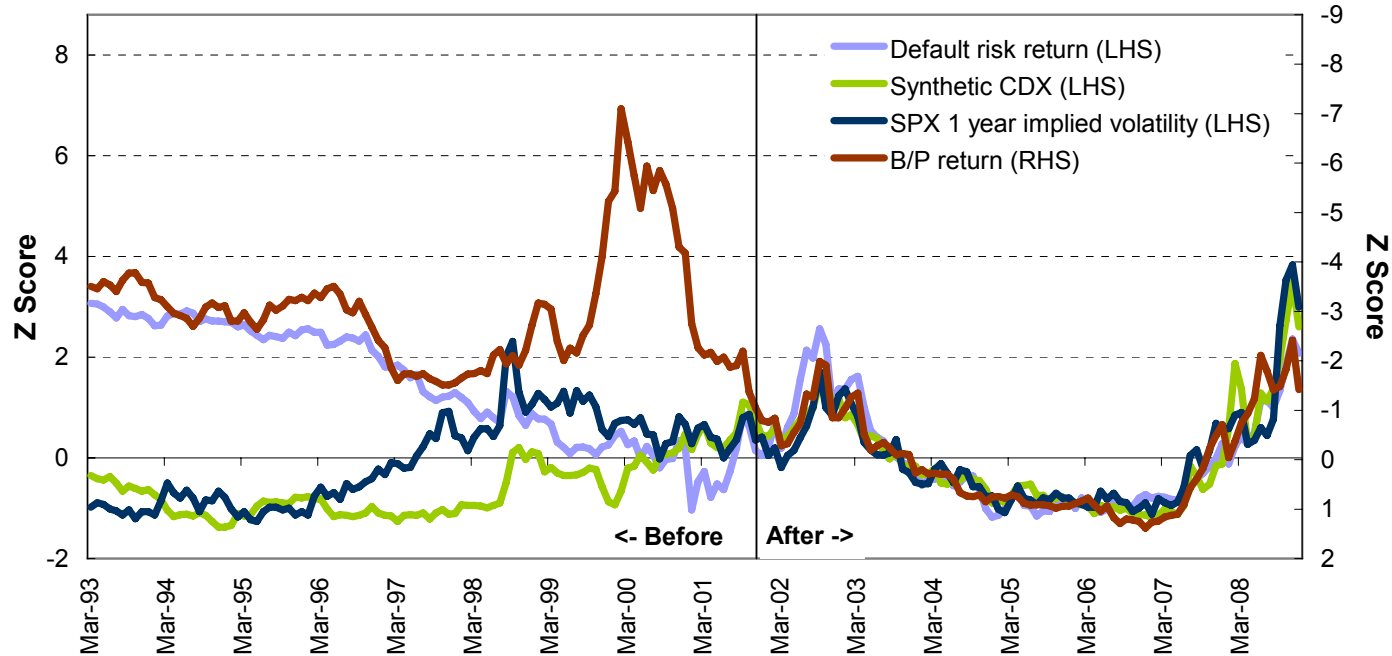
Note: Shows the 15-year relationship between the volatility implied in 1-year S&P500 index options and the spread between Moody's Seasoned Baa corporate bonds and 10-year US treasuries. The vertical line in the chart separates what seem to be two regimes: "after" when these risk measures tracked each other and "before" when they did not track each other. Last data as of 6/4/09.

Source: Nomura Securities International, Inc., Opitionmetrics, Federal Reserve and Moody's.

All together now

The legacy of financial engineering

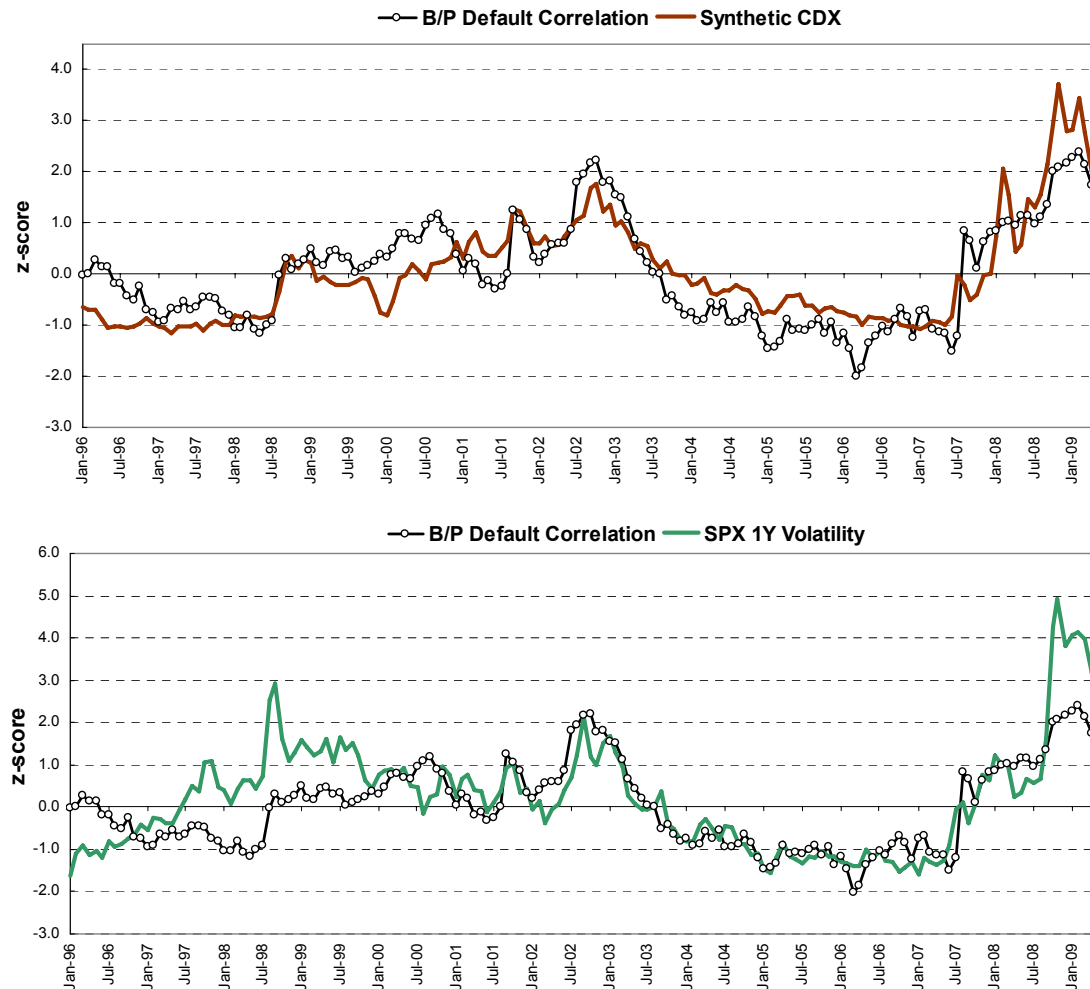
Systemic risk will likely change in magnitude but won't go away



Note: Shows z scores of cumulative monthly long-short factor returns of B/P and default risk (long low B/P and long low default risk). Also shows z scores of SPX 1-year implied volatility and synthetic CDX (post 2004 Markit's index of Credit Default Swap market risk, before 2004 implied CDX values imputed by spread between Baa corporates and 10-year T-bonds). The "before" and "after" line in the exhibit is placed at November 2001, the end of the 2001 recession. B/P factor returns based on decile spreads in Russell 1000 and default probability factor returns based on quintile spreads in S&P500. Decile or quintile baskets are rebalanced at the beginning of month. Last data as of 12/31/08. Factor returns do not include transaction costs.

Source: Nomura Securities International, Inc., Russell, S&P, Compustat, Worldscope, IDC, Ex-Share.

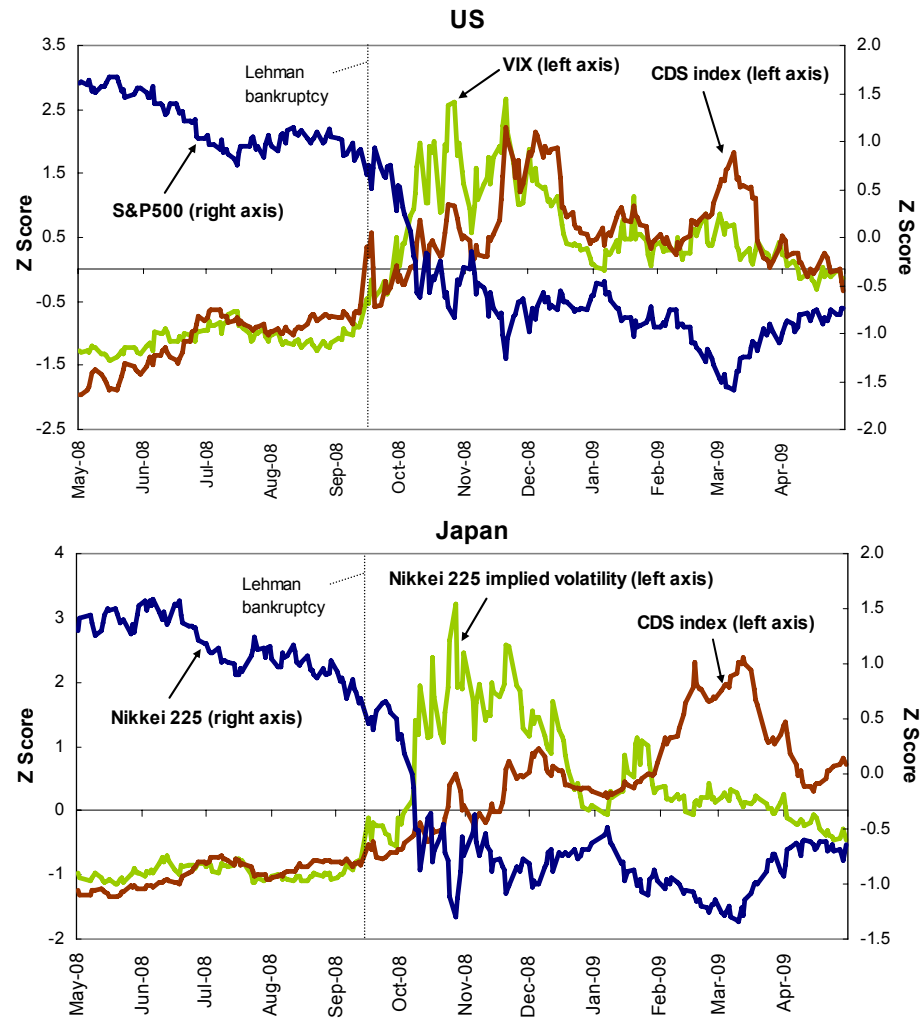
B/P-default probability correlation and major risk measures



Note: The B/P-default probability correlation is based on the B/P score and the logarithm of default probability in S&P500 universe with 0 default probability stocks excluded. B/P spread is based on differences of the median B/P between top and bottom quintile baskets based on default probability. Synthetic CDX is CDX since the end of 2004, but extended before that by using the linear relationship with bond spreads, where the coefficients are estimated by the time series regression from 31 Dec 2004 to 4 Feb 2008. Last data as of 5/29/09.

Source: Nomura Securities International, Inc., Markit Group Ltd., Optionmetrics, Federal Reserve, Moody's, Merrill Lynch/Bloomberg, S&P, Compustat, Worldscope, IDC, Ex-Share.

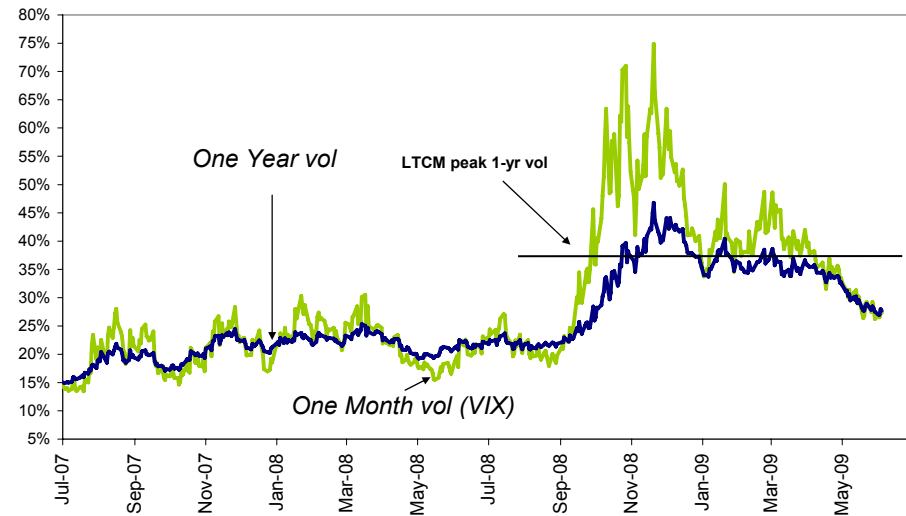
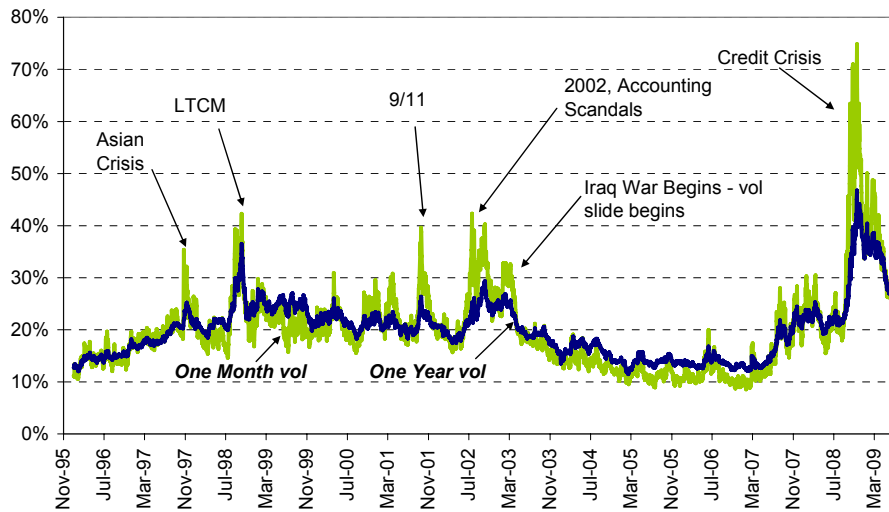
The stock market shifted focus from equity volatility to credit risk



Notes: The charts show the path of credit risk (CDS), equity volatility (VIX for US, Nikkei 225 implied volatility for Japan), and the equity market for US (S&P500, top panel) and Japan (Nikkei 225, bottom panel). Data are from 1 May 2008 through 30 April 2009.

Source: Nomura Securities International Inc., Bloomberg and Markit.

S&P500 implied volatility – equity risk jumped, then exploded, then reverted

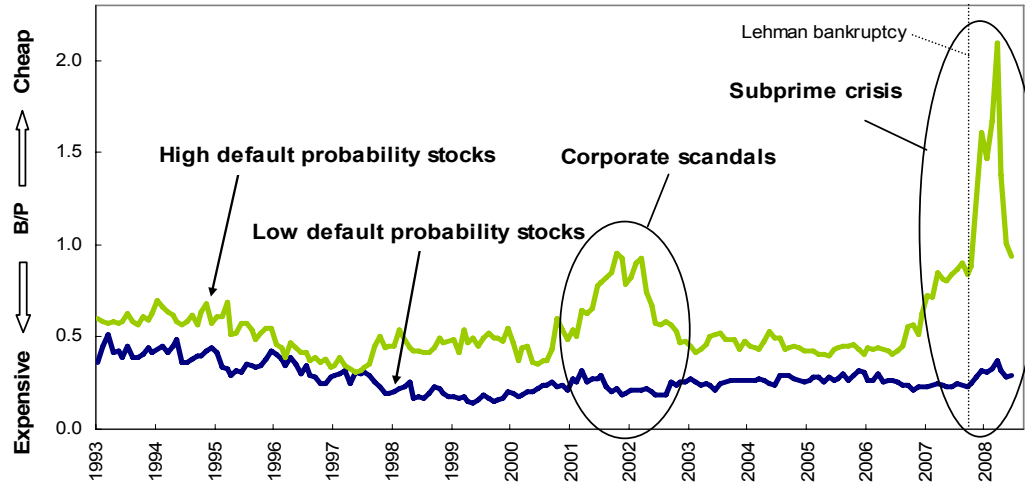


Note: Shows implied volatilities of 1-month and 1-year S&P500 index options. Last data as of 6/4/2009.

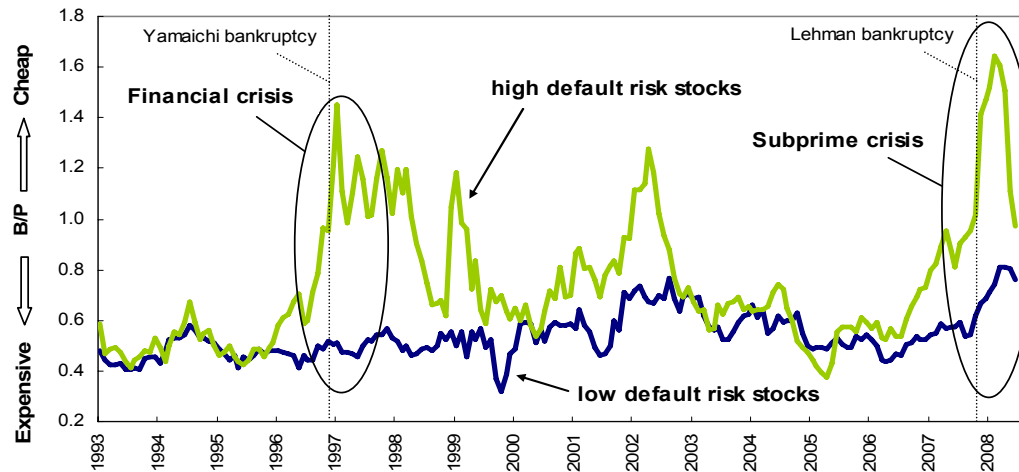
Source: Nomura Securities International Inc. and Optionmetrics.

Valuation and default probability – How fear and relief affect value stocks

US



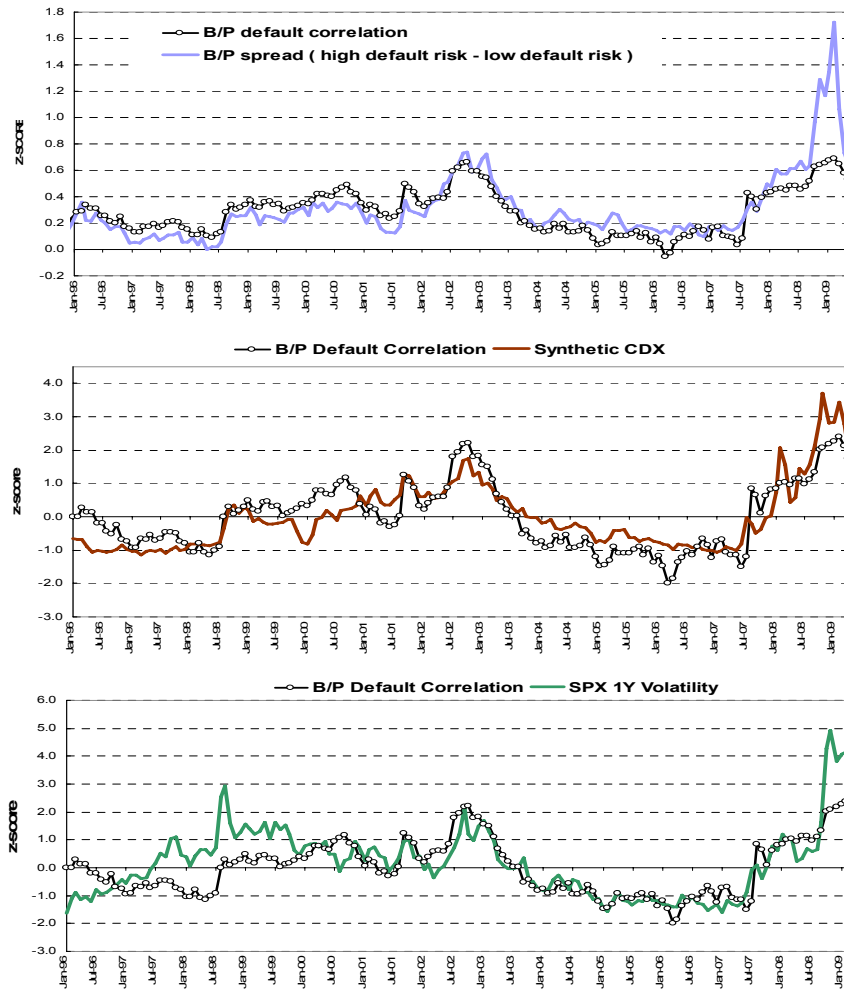
Japan



Note: Green line in the exhibit shows the average B/P for the 100 stocks in the S&P500 (US) and Nomura 400 (Japan) with the highest default probability, blue line shows the average B/P for the 100 stocks with the lowest default probability. Returns do not include transaction costs. Last data as of 5/29/2009.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

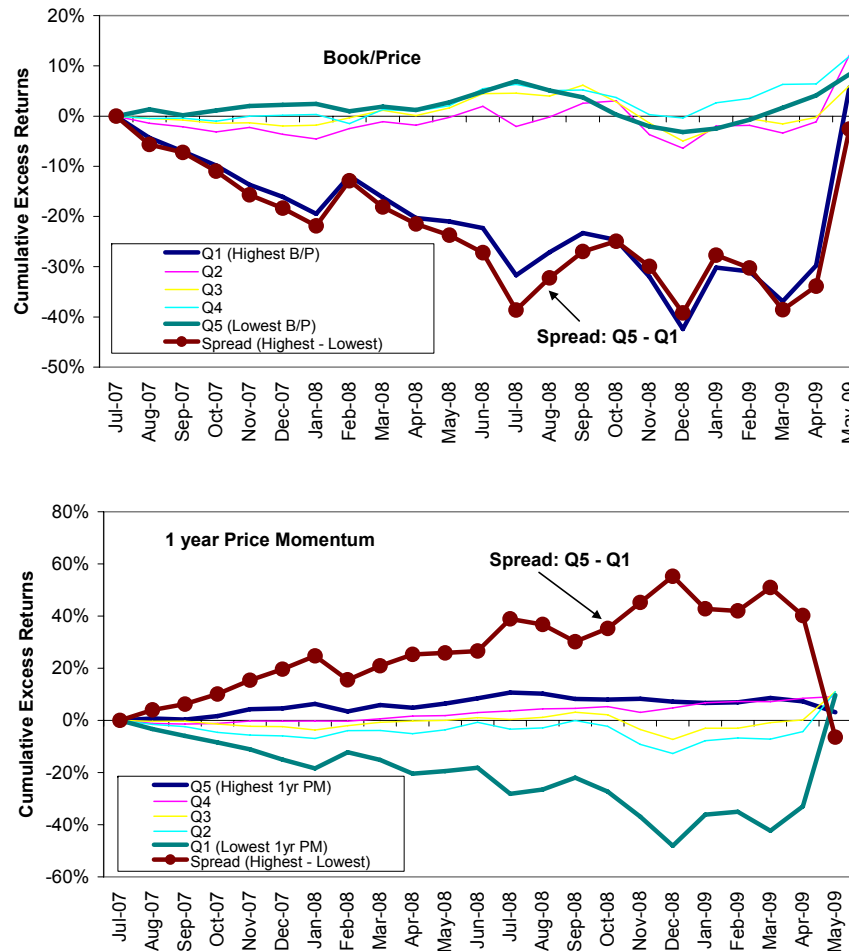
Valuation and default probability – How fear and relief affect value stocks



Note: The B/P-default probability correlation is based on the B/P score and the logarithm of default probability in S&P500 universe with 0 default probability stocks excluded. B/P spread (high default risk – low default risk) is based on the gap between median B/P for top and bottom quintile in S&P500 universe due to the default probability. Synthetic CDX is CDX since the end of 2004, but extended before that by using the linear relationship with bond spreads, where the coefficients are estimated by the time series regression from 31 Dec 2004 to 4 Feb 2008. Transaction costs not included in factor returns. Last data as of 5/30/09.

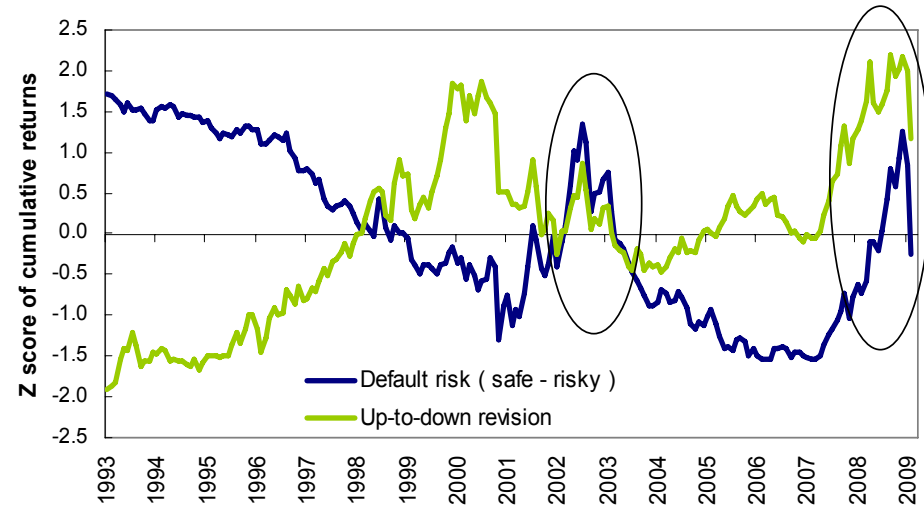
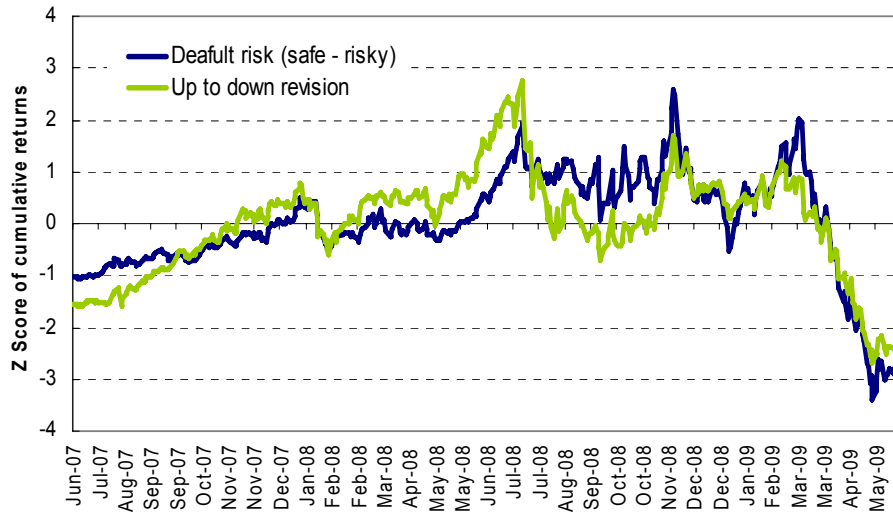
Source: Nomura Securities International, Inc., Markit Group Ltd., Optionmetrics, Federal Reserve, Moody's, Merrill Lynch/Bloomberg, S&P, Compustat, Worldscope, IDC, Ex-Share.

Revenge of the cheap losers



Note: Shows cumulative excess returns over Russell 1000 of each quintile of B/P and one-year price momentum from July 2007 to May 2009 in Russell 1000. Transaction costs not included. Last data as of 5/29/2009.
 Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

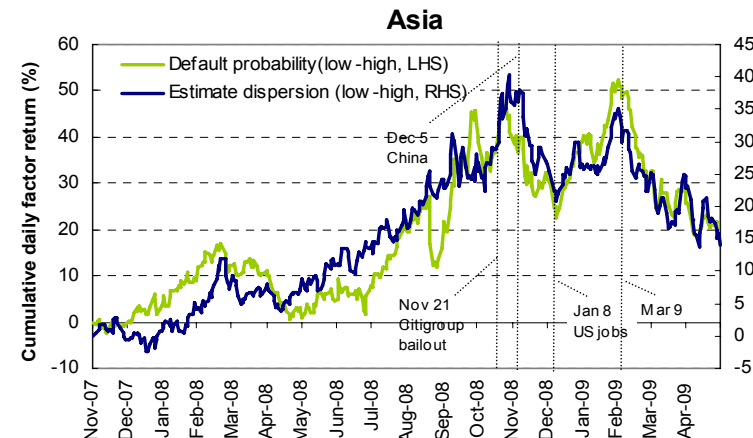
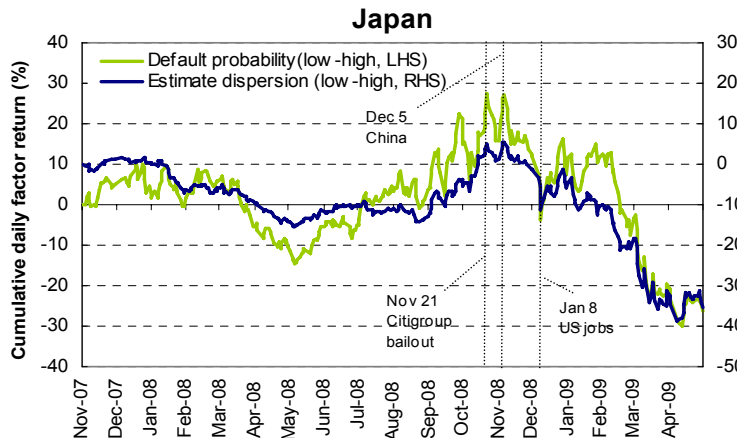
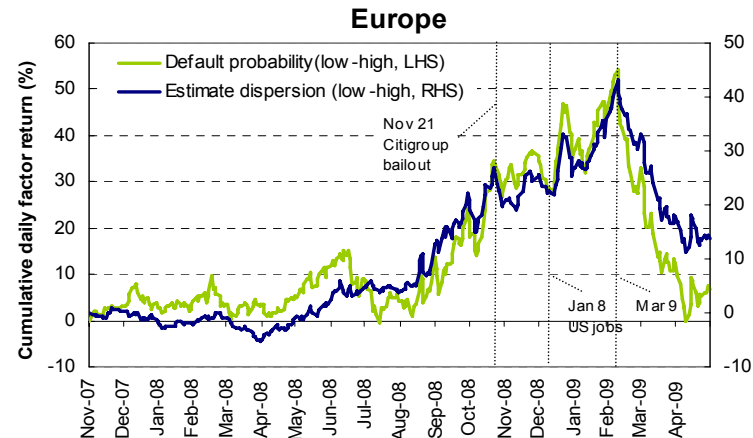
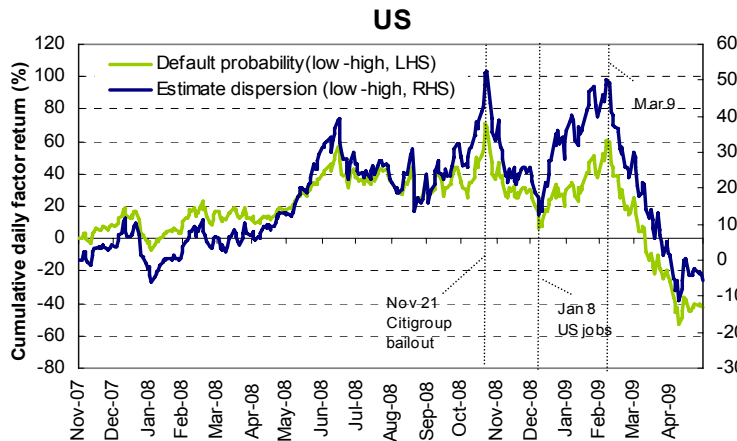
Market turbulence and unintended factor bets



Note: Each factor return is normalized for the period through 5/30/08. Based on quintile spreads in S&P500. Transaction costs not included.

Source: Nomura Securities International Inc., I/B/E/S

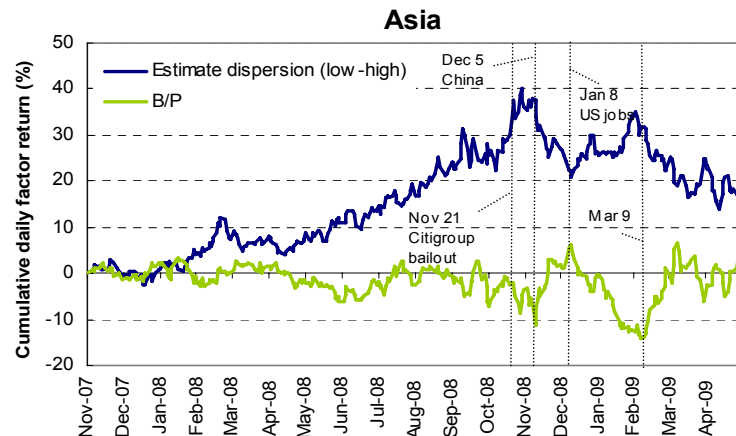
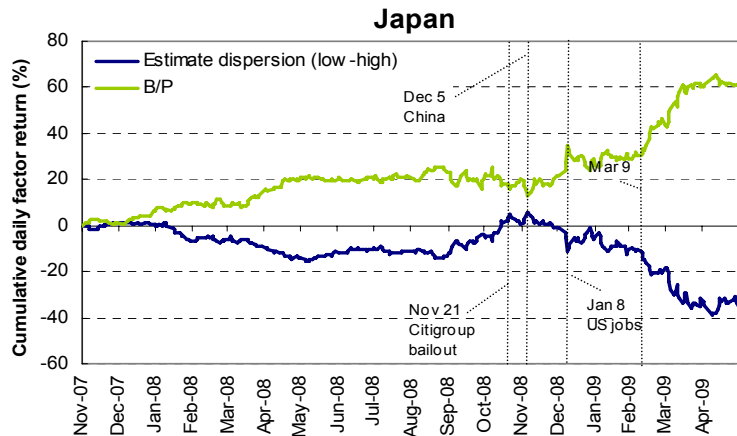
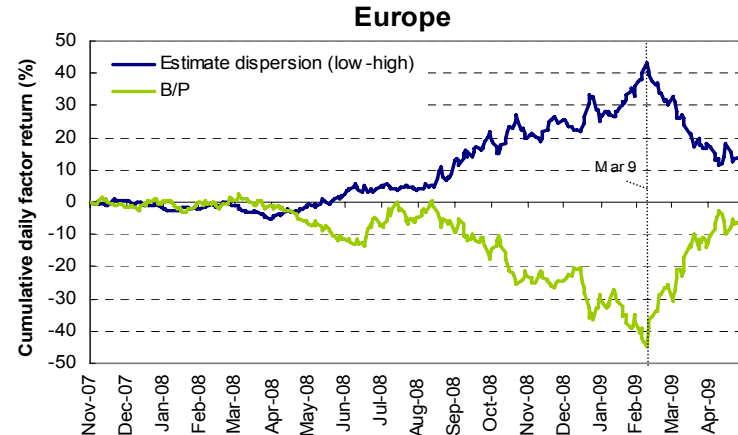
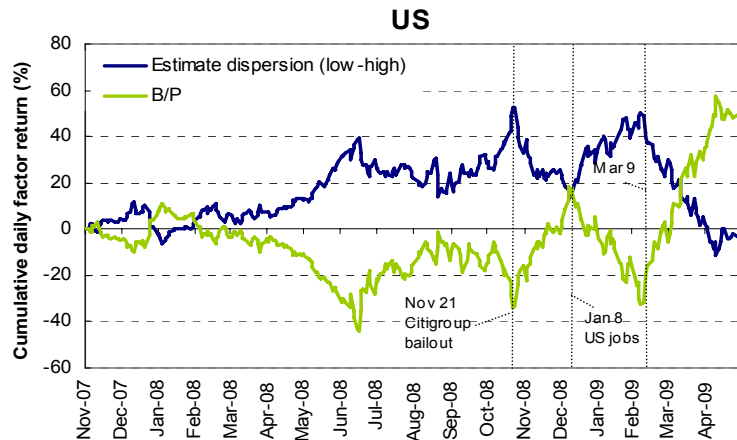
Seeking safety around the globe: Impact of estimate dispersion & default risk on stocks



Note: US = Russell 1000; Europe = MSCI Europe, Japan = NOMURA 400, Asia ex Japan = MSCI Asia Pacific ex Japan (Australia, Hong Kong, New Zealand and Singapore). Shows cumulative return of a factor portfolio that is long lowest default risk stocks while short the highest default risk stocks, and the cumulative return of a factor portfolio that is long the lowest estimate dispersion stocks and short the highest estimate dispersion. US is based on decile baskets, while other regions are based on quintile baskets. Long and short baskets are rebalanced monthly with equal weighting. Last data as of 5/29/2009. Factor returns do not include transaction costs.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, IDC, Worldscope, ExShare and MSCI.

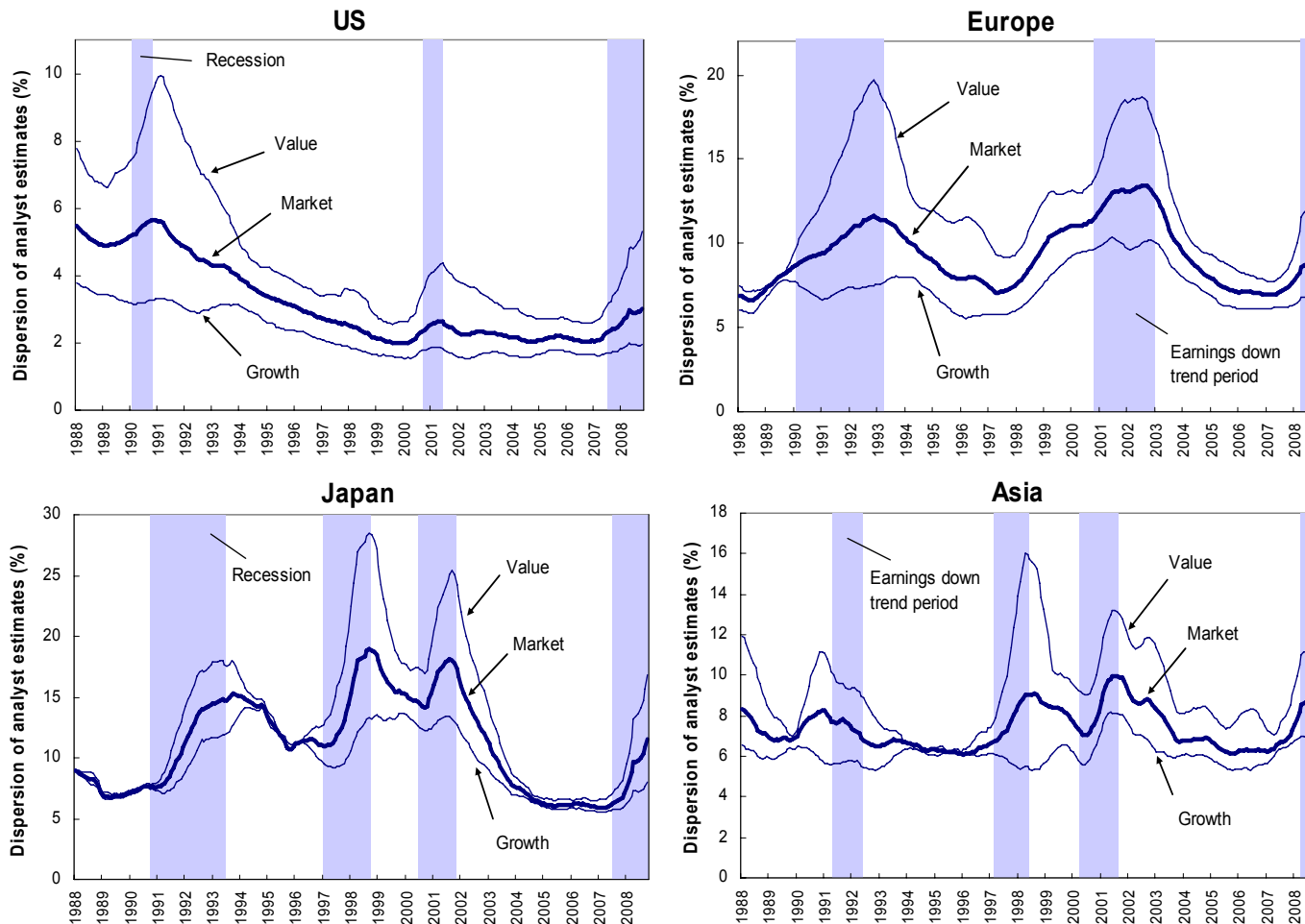
Value fails when risk aversion rises and vice versa: Estimate dispersion vs. B/P



Note: US = Russell 1000; Europe = MSCI Europe, Japan = NOMURA 400, Asia ex Japan = MSCI Asia Pacific ex Japan (Australia, Hong Kong, New Zealand and Singapore). Shows cumulative return of a factor portfolio that is long the lowest estimate dispersion stocks and short the highest estimate dispersion, and the cumulative return of a factor portfolio that is long the highest book-to-price (B/P) stocks while short the lowest B/P stocks. US is based on decile baskets, while other regions are based on quintile baskets. Long and short baskets are rebalanced monthly with equal weighting. Last data as of 5/29/2009 for Japan, 4/6/2009 for US, and 4/3/2009 for Europe and Asia. Factor returns do not include transaction costs.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, IDC, Worldscope, ExShare and MSCI.

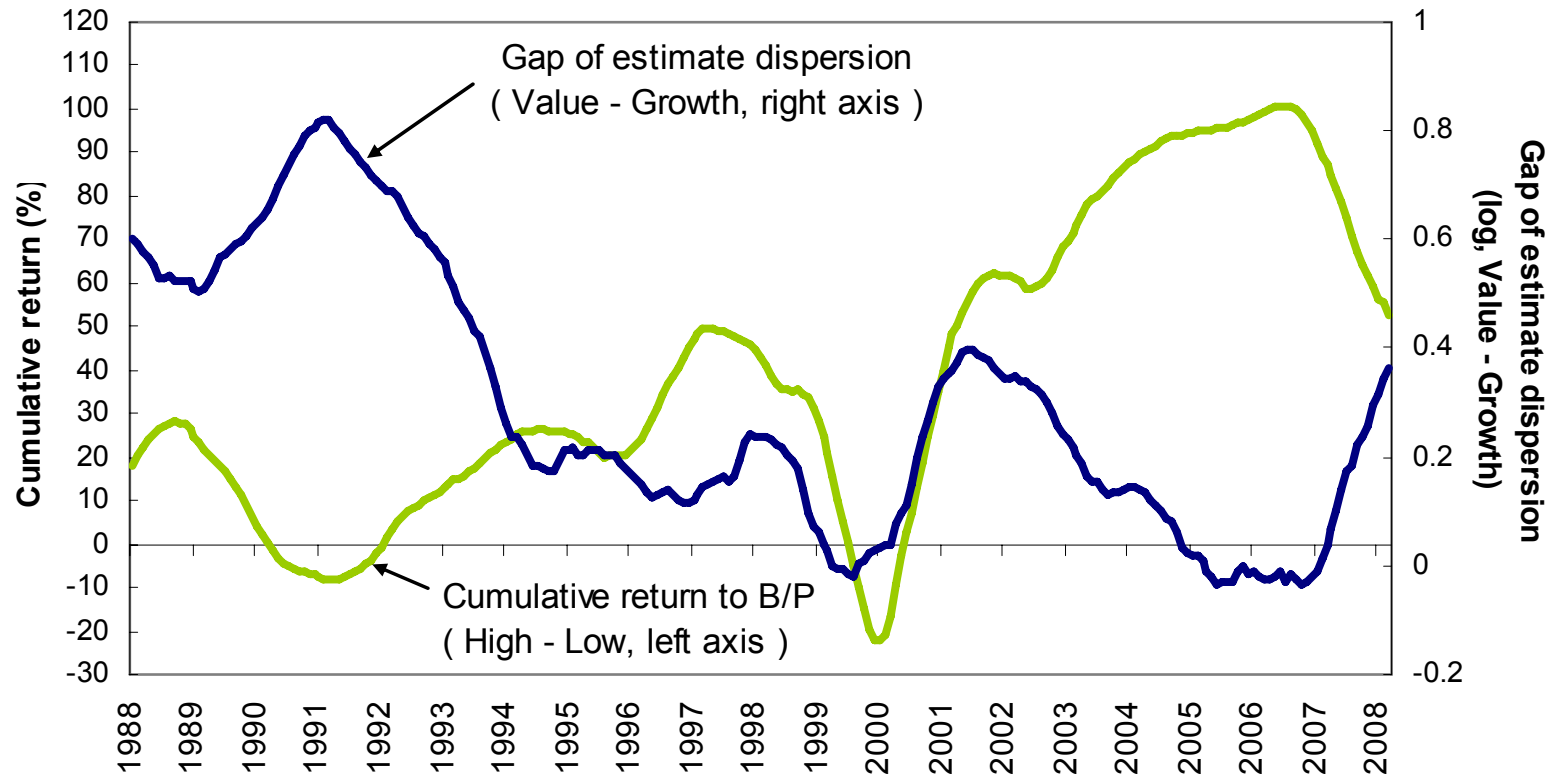
Estimate dispersion and the economy



Notes: The median dispersion of analyst estimate is plotted for value, growth stocks and the universe (smoothed FY1 estimate dispersion using 12-month moving average). The top half of the universe based on B/P is labeled value, the bottom labeled growth. Period of analysis is from May 1988 through February 2009. US = S&P500; Europe = MSCI Europe, Japan = NOMURA 400, Asia ex Japan = MSCI Asia Pacific ex Japan.

Source: Nomura Securities International Inc., I/B/E/S, Worldscope, ExShare, S&P, MSCI, NBER and ESRI.

Earnings uncertainty for value stocks – value's risk premium

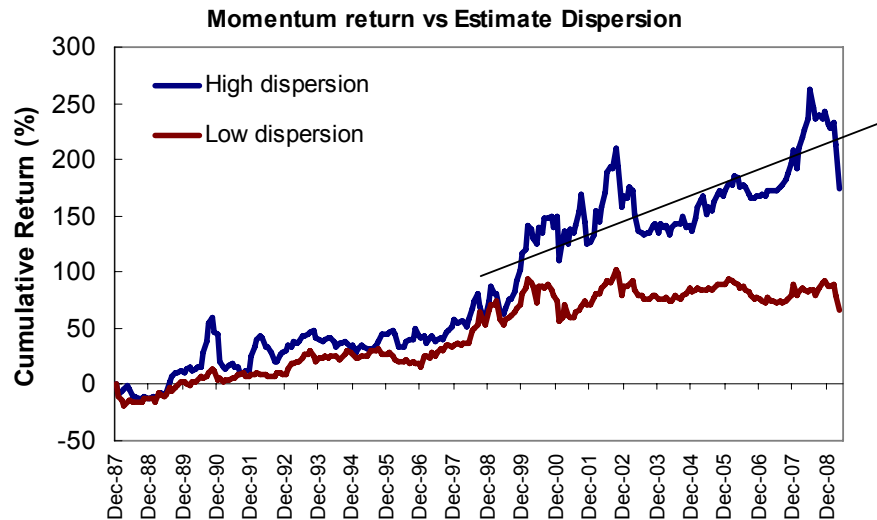
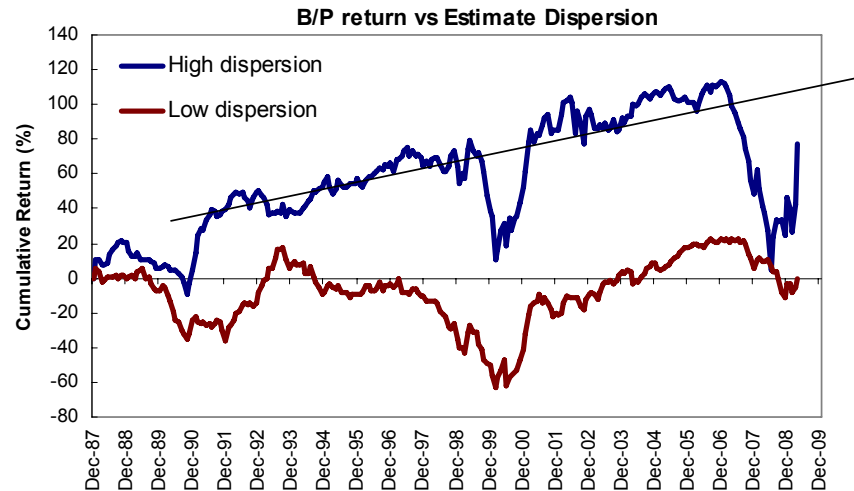


Note: The S&P500 stocks are divided into two groups, with the top half of the S&P500 based on B/P labeled value, and the bottom labeled growth. The gap of median dispersion of analyst estimate between value and growth stocks is plotted (smoothed FY1 estimate dispersion using 12-month moving average). Returns to B/P are based on decile spreads in Russell 1000 universe (rebalanced monthly and equally weighted) and the cumulative return is smoothed using 12-month moving average. The data are from Nov 1988 through Jan 2009. Factor returns do not include transaction costs.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, S&P, IDC, Russell.

Estimate dispersion and the effectiveness of stock strategies

Why value & momentum are opposites

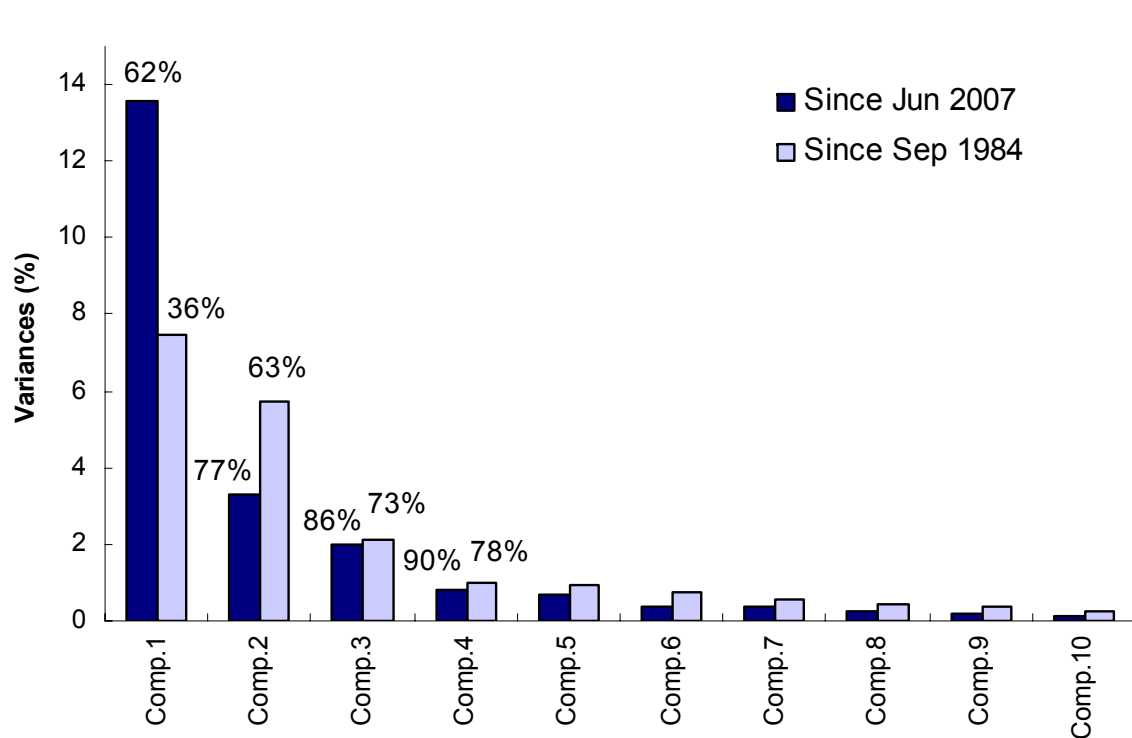


Notes: Universe is S&P500. Top panel shows cumulative returns to B/P (quintile spread base) for highest and lowest one-third based on estimate dispersion. Bottom panel shows cumulative returns to one-year price momentum (quintile spread base) for highest and lowest one third based on estimate dispersion. Returns do not include transaction costs. Last data as of 4/30/2009.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, IDC, S&P.

Principle components of fundamental factors

... is it a single factor world?



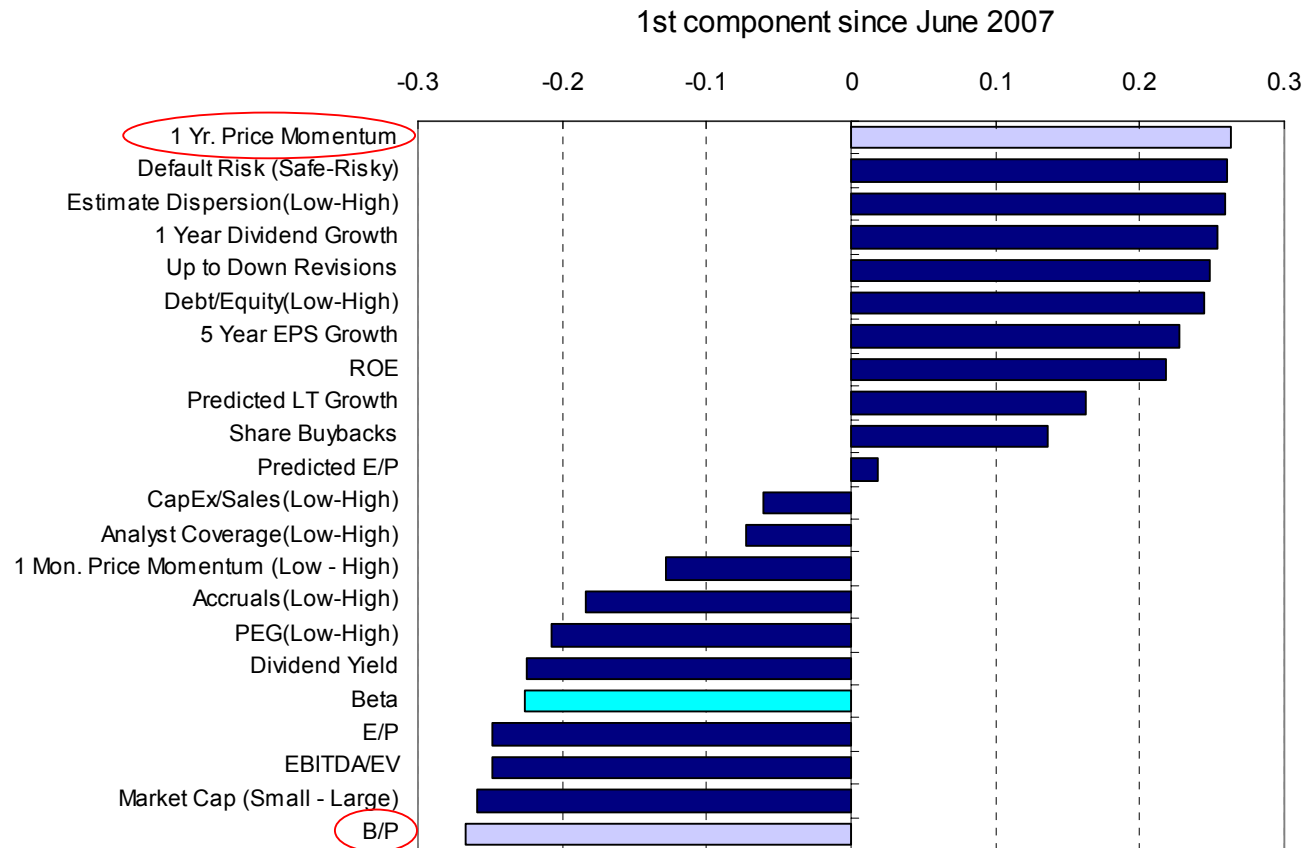
Momentum	1 Mon. Price Momentum (Low - High) 1 Year Price Momentum
Growth	1 Year Dividend Growth 5 Year EPS Growth Predicted LT Growth Up to Down Revisions
Value	B/P Dividend Yield E/P EBITDA/EV PEG (Low - High) Predicted E/P
Quality	Accruals (Low - High)
Leverage	Debt/Equity (Low - High)
Risk	Beta Default Risk (Safe - Risky) Estimate Dispersion (Low - High)
Profitability	ROE
Other	Market Cap (Small - Large) CapEx/Sales (Low - High) Analyst Coverage (Low - High) Share Buybacks

Note: The bar chart displays the variance of the principal components derived from the factor set shown at right, and the number above the bars corresponds to the cumulative percentage of variances. Universe is Russell 1000. The analysis is as of 4/30/2009.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

Principle components of fundamental factors

... is it a single-factor world?

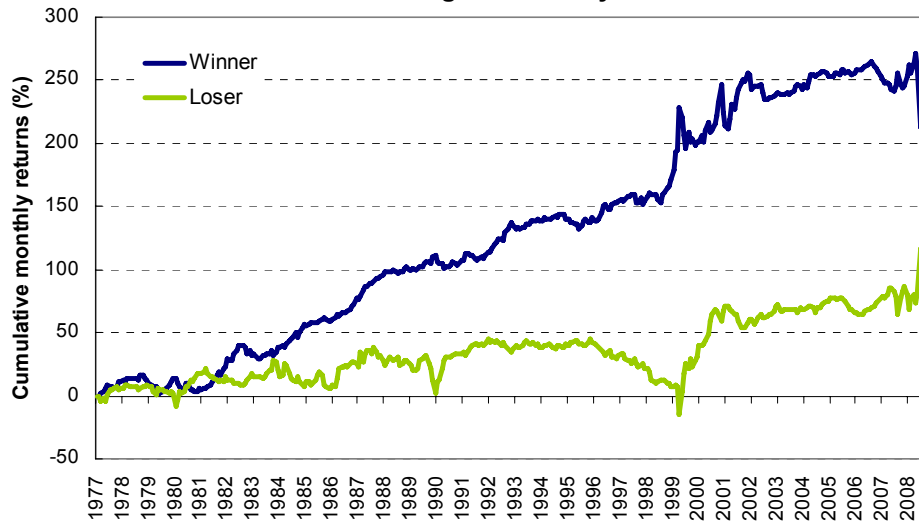


Note: The bars show the loadings of the factors that produce the primary, first principal component for the period since the crisis began. The principal components analysis is based on monthly time series of 22 representative factor returns shown on page 16 from Jun 2007 through Apr 2009. Universe is Russell 1000.

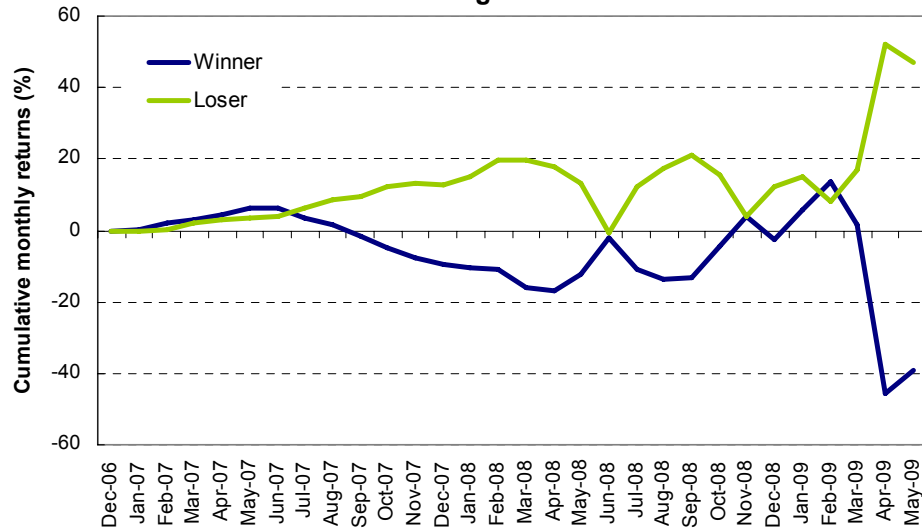
Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

Factor momentum – best/worst 3 out of 22 factors on trailing 5 years

Long term history



During the crisis

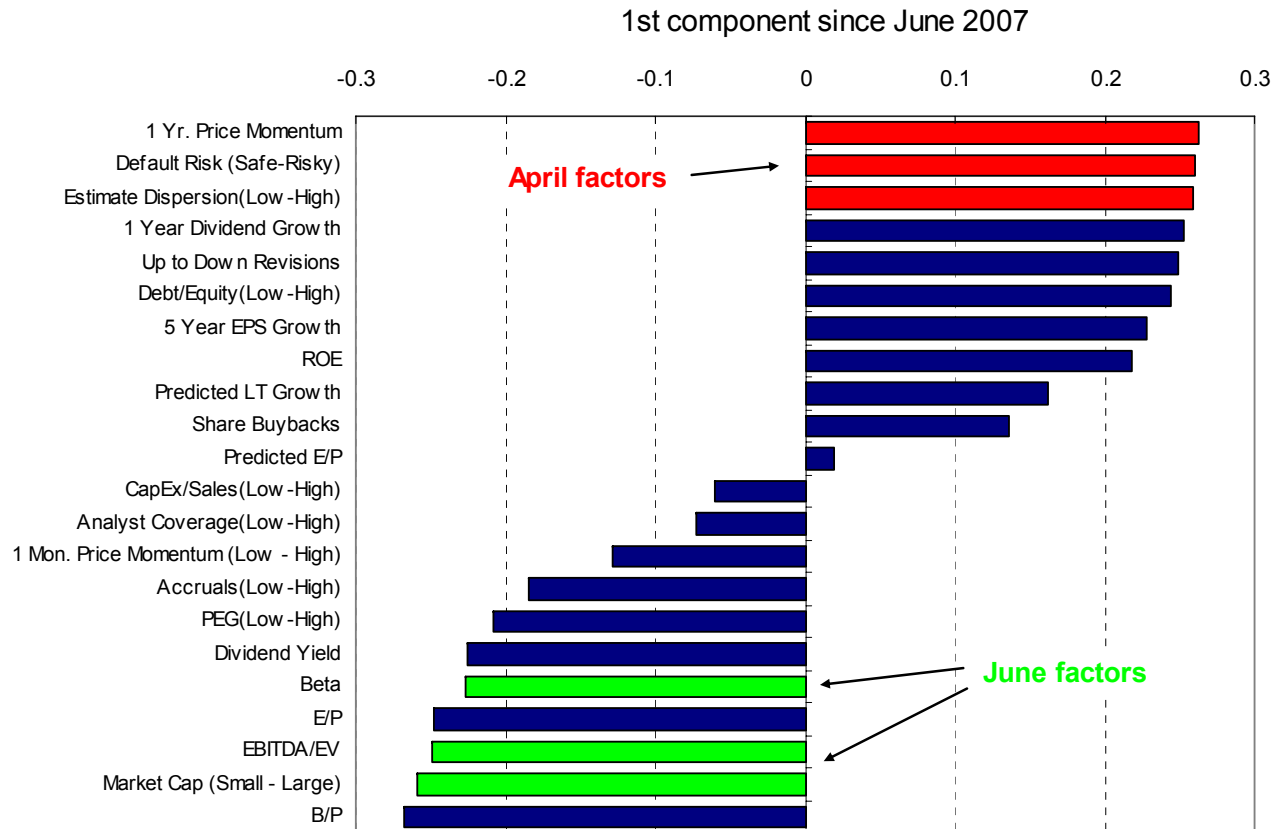


Note: Universe is Russell 1000. The exhibit shows the cumulative return to owning the best and the worst three factors in 22 representative factors, based on the past five years' performances. The analysis ranges from Dec 1977 through May 2009. Factor returns do not include transaction costs.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

Principle components of fundamental factors

... is it a single-factor world?



Note: The bars show the loadings of the factors that produce the primary, first principal component since the crisis began. Universe is Russell 1000. The principal components analysis is based on monthly time series of 22 representative factor returns shown on page 16 from Jun 2007 through Apr 2009. Source: Nomura Securities International Inc., Compustat, I/B/E/S, IDC, S&P.

Investment in the era of unintended bets

- Cash and derivatives, stocks and bonds have been woven together. High volatility only tightens the bond that is a persistent feature of modern markets.
- Is presumed alpha often just the reward for bearing risk ?
- Of course you need to diversify – this can't always be done easily within a region
- But macro forces could make '***Think Global, Act Local***' a key to diversification

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