



- **P.1 Comments on financial & Economic Developments**
- **P.2 Where hedge funds fit into a portfolio?**
- **P.3 Book Review: *A brief History of the Future***
- **P.3 European news**
- **P.4 Selection of Financial & Economic Indicators**

Comments on Financial and Economic Developments



Credit Crunch, or the summer of discontent after a rude awakening

Volatility increased in August as a carelessly constructed house of cards started to fall apart. For all too many months seasoned investment professionals and concerned economists have warned that rash lending practices would lead ultimately to problems. But risk was considered good as long as it resulted in a few extra basis points of return. And then, suddenly, risk became RISK again.

Lax lending practices carry a price, as many bankers are now learning. Ninja loans (lending to people with No Income, No Job or Asset) were great business as long as home prices appreciated sharply. And in a world of never-ending business expansion, it was deemed acceptable for banks to give firms the right to pay interest on their loans in the form of IOUs instead of good old cash.

At the same time, investors drove down the yields of risky assets since they demanded less of a reward for accepting risk. This in turn forced hedge funds to take ever-bigger bets in order to deliver the promised returns. Takeovers boosted stock prices and the stock market started to count on a never-ending stream of debt-financed takeovers. But all good things, it seems, must come to an end.

Credit spreads have started to widen, but by historical standards they remain rather low. So while risk has been rediscovered, it remains at a low level. And yet one has only to see the impact this small reversal has had on some

hedge funds to question the solidity of certain structures. Not all the recently-developed risk-hedging instruments hold up under reverse market conditions. Illiquid markets tend to magnify the problems.

One is reminded of the portfolio insurance schemes of the 1980s and the utter ineffectiveness of many of those instruments when the markets collapsed in October of 1987. Today's instruments may be mathematically more advanced, but they have not necessarily been tested under any and all market conditions. And to base the performance on normal conditions that ignore the possibility of a downturn can prove very costly.

"...Will the Fed once again be ready to bail out the markets if conditions get worse?..."

Will the Fed once again be ready to bail out the markets if conditions get worse? Mr. Bernanke is known to have studied deflation very carefully and thus there is an assumption that if necessary his Fed will print massive amounts of money to bail out not only firms but also the entire market. Should that happen, this liquidity would lead to tremendous commodity and stock market inflation. We are likely in for some very exciting but unnerving times. That unexpected events occur frequently is a lesson that has been forgotten in recent years.

By Rolf Spielmann, CFA

Where hedge funds fit into a portfolio?

The June 7, 2007 of the International Herald Tribune carried an article that attracted our attention. Huge amounts of money continue to flow into hedge funds, partly because of interesting past performances, partly because they are seen as an option to a badly performing bond market and probably mostly because theory says that hedge funds have low correlations with major equity and bond markets.

It is the assumption of low correlation that is intriguing and in the article it is strongly challenged by Ray Dalio, founder of Bridgewater Associates, a firm that manages about \$30 billion. In one of its recent newsletters, his firm examined the correlation of hedge funds with certain market indexes. The findings are remarkable and worth repeating.

"...Over the past 24 months, hedge funds were 60% correlated with the Standard & Poor's 500-stock index..."

The International Herald Tribune article states that "according to Dalio's analysis, over the past 24 months, hedge funds were 60% correlated with the Standard & Poor's 500-stock index, 67% correlated with the Morgan Stanley Capital International (EAFE (for Europe, Australia and the Far East) index of foreign shares, and 87% correlated with emerging market equities (unhedged). They were 41% correlated with the Goldman Sachs Commodity Index, 52% correlated with high-yield, or junk, bonds, and 42% correlated with mortgage-backed securities."

Furthermore the article points out "the letter also parsed the correlations by strategy, which is a more precise way to think about hedge funds, since different types of funds take different kinds of risks. Short-biased hedge funds have a negative 70% correlation with the

S&P index, while equity long-short, the description applied to what most people think of as a hedge fund (betting on stocks that might go up and others that might fall, usually with leverage) had a huge correlation of 84%".

It is this last observation that is so striking. Have hedge funds recently done well because markets have done well and many hedge funds use leverage, or have they had good results because of the genius of their managers? What will happen to hedge fund performances once markets turn down, will they then reflect to a very large extent (or even more, remember the leverage factor) the slide in equity prices?

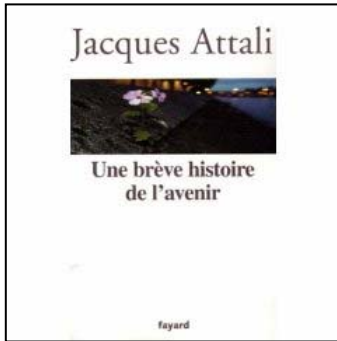
"...No one cares about correlations, or anything else really, until the market heads down..."

Such a question is worth asking in view of Bridgewater's findings. The firm of course is neither the first nor the only one pointing out that the non-correlation assumption of hedge funds may be faulty or at least severely flawed. Unfortunately one has to agree with the articles finding that no one cares about correlations, or anything else really, until the market heads down.

As with anything else, one must be careful not to generalize. Yes many hedge fund managers have chosen the easy way and benefit from good times expressed by rising markets, alas as a result ending up unprepared for the not so good times. There are those however who know how to hedge market directional systematic exposures. As with any investment manager, traditional or otherwise, know exactly how he makes money for you, anything else may expose you to risks that could turn out to be highly costly.



Book Review



A brief History of the Future

By Jacques Attali
Arcade, 2008

Jacques Attali tells the extraordinary story of the next 50 years as it can be imagined based on our current knowledge of history and science. He reveals the way in which relationships between nations will evolve and how demographic upheaval, population shifts, work changes, new types of markets, terrorism, violence, climate change, and the growing impact of religion will create mayhem in our daily lives. He also reveals how spectacular technical progress will completely alter work, leisure, education, health, cultures and political systems; how morals that today are considered outrageous will one day become the norm. Finally, he shows that it is possible to strive for abundance, to eliminate poverty, to ensure that everyone benefits fairly from the advantages of technology and limitless marketing innovation, to be free from our own excesses and those of our enemies, to leave a better-protected environment for future generations, to develop new ways of living based on the world's collective knowledge and to create together.

European news

Late 2007 should bring greater growth, says Christine Lagarde

Christine Lagarde, France's Minister for the Economy, Finance and Employment, stated recently that economic growth, which was limited to 0.3% in the second quarter, would be "substantially better" in the third and fourth quarters, since the country enjoys "rather good fundamentals," including inflation that is under control and jobs being created. The impact of the financial crisis will be limited, she said, because France's banking industry is "totally sound" and the banks are only "very slightly exposed" to the sub-prime crisis. "The market readjustment is not a bad thing in itself," she added, referring to the recent correction.

Source : lemonde.fr

Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX
August 31	13357.74	4878.75	2596.36	1473.99	13660.48
Monthly var.	+ 1.10%	- 3.01%	+ 1.97%	+ 1.29%	- 1.50%
Year-to-date	+ 7.18%	+ 6.99%	+ 7.50%	+ 3.93%	+ 5.83%
Year-over-year	+ 17.37%	+ 13.91%	+ 18.89%	+ 13.05%	+ 13.14%



Index	FTSE	DAX	CAC40	SMI	Nikkei
August 31	6303.30	7638.17	5662.70	8881.46	16569.09
Monthly var.	- 0.89%	+ 0.71%	- 1.54%	- 0.04%	- 3.94%
Year-to-date	+ 1.33%	+ 15.78%	+ 2.18%	+ 1.09%	- 3.81%
Year-over-year	+ 6.73%	+ 30.35%	+ 9.64%	+ 8.74%	+ 2.65%

Commodities	Gold	Copper	Crude Oil	Lumber	CRB
August 31	681.90	339.70	73.92	261.00	308.86
Monthly var.	+ 0.38%	- 7.06%	- 5.49%	- 6.45%	- 4.72%
Year-to-date	+ 6.80%	+ 19.19%	+ 21.08%	- 2.61%	+ 0.52%
Year-over-year	+ 7.59%	- 1.54%	+ 5.21%	- 9.53%	- 6.10%



Currencies	\$CAN	¥	€	£	\$AU
August 31	1.0550	115.8000	1.3635	2.0160	0.8180
Monthly var.	+ 1.12%	+ 2.40%	- 0.33%	- 0.71%	- 3.99%
Year-to-date	+ 9.52%	+ 2.73%	+ 3.26%	+ 2.96%	+ 3.61%
Year-over-year	+ 4.48%	+ 1.36%	+ 6.44%	+ 5.88%	+ 7.14%

Alain E. Roch, MBA | President | alain.roch@bluebridge.ca

Rolf Spielmann, CFA | Senior Vice President | rolf.spielmann@bluebridge.ca

Blue Bridge Wealth Management Consultants Inc. | www.bluebridge.ca
 1800 McGill College Avenue, Suite 2108, Montreal (Qc) H3A 3J6 Canada
 Tel. +1 514 845 9165

Blue Bridge is an independent wealth management consulting firm that provides investment advice to high net worth individuals.

The information contained in this report is not guaranteed in any manner whatsoever. It is for information purposes only, and does not constitute a recommendation to buy or sell stocks, bonds, currencies, and/or any other values. This newsletter cannot be reproduced in any way and/or for any purpose without the express authorization of Blue Bridge Wealth Management Consultants Inc.