



Every angel is terrifying.

*Rainer Maria Rilke*

## CROUCHING DRAGON HIDDEN PIG

Irony—my Red-hating, Wisconsin-bred (maternal) grandfather was right: Rock and Roll music is bad for one's health. No less august a body than my alma mater, the University of Michigan, has released a study indicating that iPods can interfere with cardiac pacemaker activity. The danger appears to be amplified if the iPod is playing any song performed by Paris Hilton or Sanjaya. The fact that the study was co-authored by a 17 year old student, and my inability to use an iPod, has given me hope. Maybe all those iPod headphones are stuck in the ears of investors to drown out the squealing of investment banks.

Irony—in the lunar year of the pig, pork prices have risen at an alarming rate, along with other food prices, creating a problem for the Chinese (See Chart 1). Some of this is due to drought conditions, water shortages, and mismanagement of resources, but a good deal of the blame can be placed on the use of corn, soybean and other foodstuffs as the feedstock for ethanol. This issue has potentially far-reaching implications.

For years, China has helped keep a lid on inflation by absorbing higher input costs (energy, food, etc.) and exporting at low costs, destroying

margins in the process (See Chart 2). The U.S. and other importers enjoyed the low cost exports from the Pacific angels, as other Asian exporters were forced to follow suit. However, in the process of such rapid industrialization, financial imbalances grew in China, with China absorbing tremendous amounts of foreign exchange (primarily U.S. dollar) and battling to keep increasing costs from leaking into its own domestic economy. This process may be disintegrating. If China is no longer able to absorb and reinvest its dollars into U.S. bonds and other assets, more trouble looms on the horizon for the U.S. financial markets. The angels have turned nasty. As a result, we have further increased our holdings of non-dollar assets, in addition to growing exposure in vehicles where increased volatility bears higher returns.

The food price explosion has several implications. The idea that corn or soybeans are an optimal solution to the world's pollution or energy problems is ludicrous. To derive large amounts of ethanol from corn requires massive amounts of land, water and energy. The ratio of energy required to that produced is dismal for corn versus sugar cane (See Chart 3). We are much more interested in Brazilian sugar cane

ethanol and we are looking at several investments there. Approximately 40% of Brazilian cars can operate on sugar cane ethanol and almost 70% of new Brazilian cars can operate on sugar cane ethanol, gasoline, or a mixture of both. A fully integrated Brazilian ethanol plant produces ethanol, recycles its own water, and generates its own power by burning the cellulose (stalks, etc.). Additionally,

cause “internal discontent”. Better a dead than dissident population. Recent headlines also point to China’s perception problem as a “quality” exporter, with recalls of tires, toothpaste, toys, tainted medicine, banned food, etc. Not only can the Chinese ill afford such a negative image, as it would derail its export growth engine, but the 2008 Olympics, in Beijing, are only a year away.



Figure 3. Source: Datastream

Chart 1 (Independent Strategy – 12 June 2007)

Brazilian ethanol is much cheaper than corn or soybean ethanol. We will continue to pursue these types of investments. (Ironically, one of the first companies to create ethanol was I.G. Farben, the German conglomerate, during the First World War. The Nazi party, obsessed with Germany’s dependence on foreign [primarily, Russian] oil, made synthetic fuel a priority, placing one facility at Auschwitz.)

Another fallen angel, resulting from the rapid industrialization of China and other developing nations, is an increase in water, air and ground pollution (See Chart 4). The World Health Organization estimates that 750,000 deaths (in excess of normal mortality estimates) in China result, annually, from polluted air, water and food (See Chart 5). Naturally, the Chinese have battled with the WHO over the release of the study, citing that its release might



Chart 2 (Independent Strategy – 15 August 2007)

The prospect of globally televised stories about pollution and athletes unable to optimally perform, due to poor air quality, would decimate the premier global citizen image that China is attempting to convey. To take advantage of this situation, we have invested in several vehicles involved in the clean water, clean energy and clean technology space.

Although Brazil has sufficient amounts of farmland and water to efficiently produce ethanol without straining other resources, most nations, including the U.S., do not. One large land mass, largely ignored by most investors, remains significantly uncultivated and disorganized—Africa. Beset by political problems, Africa has a population of almost one billion people. Currently, Africa produces less carbon dioxide

emissions than Los Angeles (See Chart 6). If Africa ever moves beyond its chronic bad hair day, it could woefully add to the world's carbon emissions problem. Conversely, Africa could become a green breadbasket for the world, as it contains abundant fertile territories. Additionally, as Chinese exports become suspect in terms of quality, Africa could become an important source of cheap and efficient manufacturing. Although we continue to look for opportunities in Africa, it is difficult to avoid the minefields of political chicanery.

Recent tragic bridge collapses and other disasters indicate the need for massive investment in our nation's infrastructure. The American Society of Civil Engineers, in their

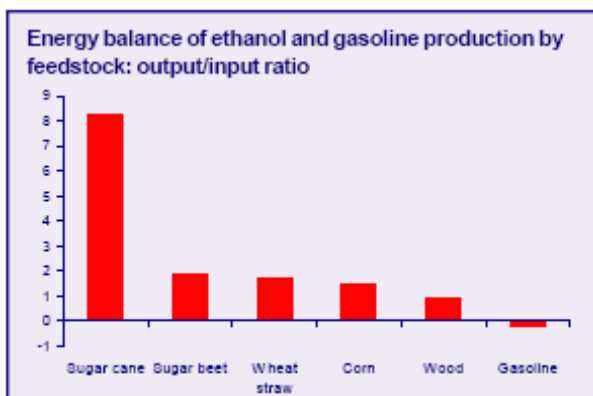


Figure 5. Source: IADB

Chart 3 (Independent Strategy – 14 June 2007)

2005 assessment, gave an overall grade of D to our nation's infrastructure. Bridges actually received one of the highest ratings of any category, with a C (See Chart 7). Unfortunately, most cities, counties and states are either broke or in dire financial straits. Undoubtedly, much of the funding for repairs and replacements will come in the form of public-private investments. That being said, we are actively engaged in the pursuit of investments in this area.

The little piggies on Wall Street received record bonuses last year, prior to the arrival of the actual year of the pig. Some of this was due to the assiduous creation of opaque lending structures (CDOs, CLOs), which facilitated lending to sub-prime borrowers or to private equity firms in need of cheap financing. Much of toxic investment waste ended up in the portfolios of banks, investment banks, hedge funds, foreign governments, mutual funds, and

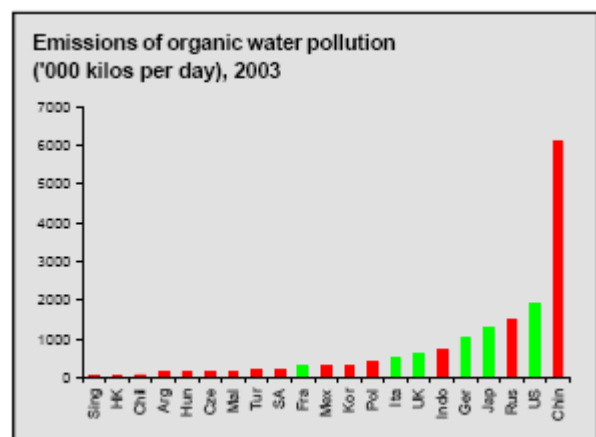


Figure 9. Source: World Bank

Chart 4 (Independent Strategy – 30 April 2007)

other institutional buyers. The angel of cheap and seemingly endless easy money and liquidity kept the process chugging along. (Approximately 25% of U.S. residential mortgages on new homes are sub-prime, and it is estimated that 20% of the sub-prime mortgages sold in 2005 and 2006 will default.) The securities (CDOs, etc.) that are backed by these loans have started to unravel, as fear has returned to the financial markets. We avoided this area, as the risk was inappropriately priced. The recent turbulence in the financial markets represents a re-rating of risk, as investors try to determine the location of the next trap door. Until risk is appropriately priced and appreciated (and there will be, inevitably, an overshoot prior to returning to equilibrium), downdrafts and volatility will continue. Investors have been spoiled by years of low cost financing, low

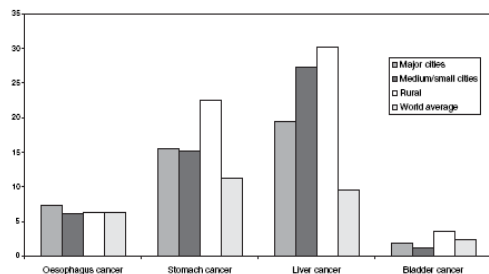
volatility, and easy access to capital. The resulting fallout will eliminate a significant amount of equity from the balance sheets of banks, investment banks, hedge funds and other institutional investors. This process will hasten the contraction of liquidity and continue to depress financial markets and increase volatility.

The central banks of the world will let the markets suffer for a while, as investors had been warned about speculative behavior and inflation concerns still linger. Ultimately, the central banks will cave in and show their hole card by cutting rates, but it will be too late in the game to avoid many of the downdrafts. Usually, the alarm button gets pressed when a major financial institution is in trouble. Our investments in volatility and arbitrage strategies should benefit from such an environment.

J.R.R. Tolkien said, “It does not do well to leave a dragon out of your calculations, if you live near him.” Several dragons loom on the horizon and former angels have turned devilish. Investors may not have accounted for them. It may not be necessary to sweat the sub-prime crisis or carbon emissions, as Eta Carinae, a giant (150 times the mass of the sun) superstar near the edge of our solar system, is about to explode. One result is that we will all be able to read at night, as the sky will be constantly bright. The other consequences are unfathomable. In the event that such an occurrence is not imminent, there is always the ongoing pollution of our water and air, and the slow draining of liquidity from the financial system, as risk gets repriced. With CDOs, sub-prime debt, and our toxic air, water and food, the authorities do not have to look too hard for “dirty bombs”—we have delivered them to ourselves.

As always, we will continue to remain vigilant during this tumultuous period. Our portfolios have been constructed with such potential market dislocations in mind. We will make any necessary adjustments, as the situation develops. If you have any questions or concerns, please call.

FIGURE 1.6 Mortality Rates for Diseases Associated with Water Pollution (per 100,000) in China in 2003 and World Averages in 2000



Source: MoH 2004 and WHO 2006.

Chart 5 (The World Bank, “The Cost of Pollution in China” – 2007)

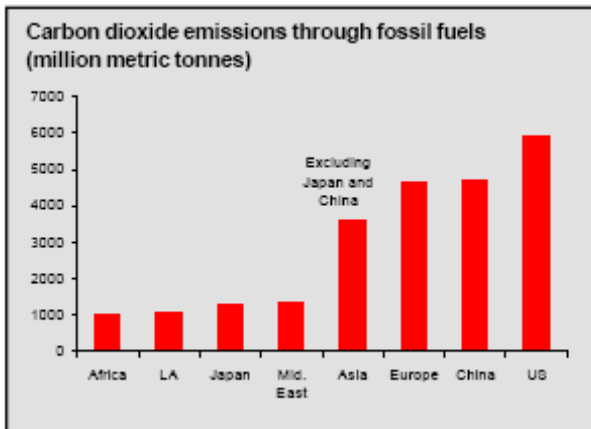


Figure 5. Source: EIA

Chart 6 (Independent Strategy – 30 April 2007)



Chart 7 (ASCE Infrastructure Report Card 2005)