

## **Putnam's Divney, Citi's Rhodes Say Investors Ignore Stock Risks**

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By Phil Serafino

Nov. 27 (Bloomberg) -- Investors are more confident than they've been in 13 years that stock markets will continue a steady climb. That complacency has Kevin Divney, manager of the Putnam Vista Fund in Boston, troubled.

The Chicago Board Options Exchange's Volatility Index, which measures expectations for market fluctuations on the Standard & Poor's 500 Index, last week reached the lowest level since December 1993. A similar gauge for German stocks fell to a 16-month low.

"It's a worrisome signal," said Divney, whose \$2.4 billion fund has outperformed the S&P 500 over the past five years. "Eventually risk and return have to come back into equilibrium. When you have an upward market like we've had and a perception of lower risk, it can mean heightened probability of a readjustment in the short term."

Stock markets have rallied to the highest since 2000. Emerging markets, which fell 25 percent in May and June, have almost returned to the records set in May. The brevity of the decline shows investors may be ignoring risk, said Citigroup Inc.'s William Rhodes, who helped lead the restructuring of Latin America's debt in the 1980s and 1990s.

"It would have been better if it had been a little deeper because I think some lessons would have been learned," said Rhodes, 71, senior vice chairman of Citigroup, the world's biggest financial-services company by market value.

### Slower Growth

At the same time that investors expect the lowest volatility in 13 years, growth is slowing in the U.S., the world's biggest economy. Interest rates probably will rise in Japan and in the 12 nations that share the euro, based on the median forecasts of economists surveyed by Bloomberg News. Klaus Liebscher, a European Central Bank council member, said in an interview with Reuters last week that he does "not want to change expectations" that the bank will raise rates.

The CBOE index, known as the VIX, closed at 9.90 on Nov. 21, below its 10-year average of 20.96 and lowest close since Dec. 28, 1993, when it finished at 9.82. The VIX is based on prices paid for S&P 500 options, which are used to hedge against swings in stock prices. Higher readings indicate more concern about

stocks, and vice versa.

Some investors view the index as a contrarian indicator. At lows, when investors see the least need to purchase protection from market swings, stocks may be about to fall because all the good news is reflected in prices.

### Stock Declines

In 1998, volatility bottomed in July, just as the S&P 500 began a 19 percent slide that lasted through early October, when volatility peaked. Asia's financial crisis, Russia's debt default and losses at hedge fund Long-Term Capital Management LP triggered the drop in stocks.

The VIX approached a 12-year low in March this year. By May 9, stocks in the U.S., Europe and Asia had peaked. Then they began a month-long slump that knocked 12 percent off Morgan Stanley Capital International's World Index amid concern that rising interest rates would crimp growth.

The MSCI index has rebounded and is up 15 percent for the year. In the U.S., the S&P 500 has gained 12 percent, while the Dow Jones Stoxx 600 Index in Europe has risen 15 percent and the MSCI Asia-Pacific Index has climbed 8 percent. Even the indexes that were hardest hit in the May-June rout, such as the MSCI Emerging Markets Index, are on the verge of erasing their declines.

Emerging market stocks have gained 22 percent in 2006, heading for a fourth straight year of gains of that much or more. Investors may have forgotten how much money can be lost in those markets, said Rhodes. The MSCI Latin America Index plunged 55 percent in six months from September 1994 to March 1995 as Mexico devalued its currency.

### Market 'Adjustment'

"We had an adjustment in May and June in the emerging markets, but it was very brief," Rhodes, a 49-year veteran of Citigroup and its predecessors, said.

A majority of investors expect a rise in volatility, according to Merrill Lynch & Co.'s latest survey of money managers worldwide. The reason they aren't willing to bet on that rise in volatility, and a decline in stocks, is because they will lose money until the market turns down, said David Bowers, a consultant to Merrill who oversees the survey.

"People are aware that financial market conditions are unusually benign at the moment," said Bowers. "It's another thing to say when that's going to change."

Some 76 percent of the 216 investors surveyed this month said volatility, as measured by the VIX, would rise in the next 12 months. That's the highest reading since the firm began asking the question in the past year, said Bowers. The firm uses the CBOE index as a proxy for global volatility.

### Face Value

Still, some traders and money managers say the decline in volatility should be taken at face value.

Volatility is low in part because central banks have cooled inflation without throwing world economies into recession, said David Gerstenhaber, president of New York-based Argonaut Capital Management LP, a hedge fund manager with about \$400 million in assets. The stock rally may falter briefly, but only because it's been going on for five months, he said.

“The fact that volatility is low doesn't mean that any pullback is the beginning of a bear market,” said Gerstenhaber.

Also, the gauge works better as a market timing tool when it's at highs, he said. A peak indicates so much concern that a rally is about to begin. The VIX surged to 45.74 on Oct. 10, 1998, triple the level of three months earlier, as stock prices slid. The S&P 500 rose 28 percent from Oct. 10 through the end of the year.

### Tracking Futures

Stocks also can rise or be little changed for months, even with volatility this low. The S&P 500 lost only 2 percent in the 12 months after the December 1993 low. The index then soared 34 percent in 1995.

“You're going to continue to see that softening in the VIX and you're going to continue to see this market rally,” said Bob Nunn, managing director of floor operations for Cohen Specialists at the American Stock Exchange. While there may be a brief drop in early December, “we're going to rally right up to the end of the year,” he said.

Bennet Sedacca, president of Atlantic Advisors LLC in Winter Park, Florida, says investors who are lured into the market now because of the rally will regret it. The decline in the VIX shows complacency, he said. “People feel invincible,” he said.

He cited another warning sign that the market may slump: Mutual funds and pension funds that use futures to hedge are betting on a market decline to the greatest extent in at least nine years, according to Sedacca's analysis of statistics from the Commodity Futures Trading Commission, the U.S. futures

regulator.

### 'No Fear'

The CFTC statistics track "short" sales of S&P 500 futures contracts. The last time such bets on stock-market declines set a record low was in March 2001. The S&P 500 fell 37 percent in the ensuing 19 months.

Convinced in part by statistics such as the drop in the VIX and the bearish bets by big-money investors, Sedacca said he has 20 percent less invested in the stock market than he usually does. He oversees \$200 million.

"There is no fear in the market right now, that's what the VIX is telling you," said Doug Monieson, an independent trader of stock-index futures at the Chicago Mercantile Exchange. "You have just an absolute rush to get into whatever type of speculative assets, whether it's stocks or bonds or artwork. There's a lot of money out there and it's being put to work."

--With reporting by Michael McKee, Kathleen Hays and Monica Bertran in New York. Editor: Swardson.

Story illustration: {VIX <Index> GP D <GO>} to see the CBOE SPX Volatility Index for the past year.  
{MXWO <Index> GP D <GO>} to chart Morgan Stanley Capital International's World Index. {TOP STK <GO>} for top news stories on world stock markets.

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