Riskier Investments Win Again

September 30, 2009

If the rebound in investment returns brought relief to investors in the second quarter, the markets' sustained performance in the third quarter brought gratitude, and arguably even signs of greed.

As with the second quarter, investors continued to pursue higher-risk assets. Domestic and international stocks returned 15%-20%, high yield bonds gained 18%, and REITs were up over 30%. Yields on lower quality junk bonds now are relatively tight compared to Treasury bills, indicating above-average risk tolerance despite high default rates. Since the market depths of March, asset classes from stocks to high yield bonds have more than doubled. Values are still meaningfully below the high-water mark of October 2007, but the rebound is historic.

Oddly, amidst the increased risk tolerance this quarter, short term government bond returns were also positive—up 2%, after being negative for much of this year. Ordinarily, you would expect Treasury bills to post negative returns as riskier assets surge. Does this reflect some risk aversion, or simply manipulation by the Fed (which is buying Treasuries to keep mortgage rates low)? Arguably, it may be a bit of both.

Which Way Now?

Despite the rebound, many investors are uneasy. Cash balances remain high at $3.4 trillion (down from $3.9 trillion on March 11), and those on the sidelines feel mounting pressure to jump back in. For those who have weathered the storm, some fear the market could give it all up once again. The conflicting daily headlines on the state of the economy only add to this uncertainty. Emotions continue to run rampant.

Optimists argue that the worst is behind us. Unprecedented federal intervention has opened credit markets, at least for larger businesses. Manufacturing activity has expanded for two months in a row, inventories are contracting less, and personal income and consumer spending have started ticking upward. Moreover, pending sales of previously owned homes were up for the seventh consecutive month.

Pessimists reiterate that historically high debt levels will challenge economic growth and asset prices for years to come. They argue that government intervention (tax credits for home buyers, artificially low mortgage rates) explains the recent economic up-tick in spending and home prices, which must be temporary. With banks generally unwilling to lend to all but the most credit-worthy customers, spending will likely remain weak (and unemployment high) until debt falls inline with income. This is a deflationary cycle, they argue, that will reward the most conservative and safest investments.

Our View

As we have written before, adhering resolutely to either argument does not best serve long term investors. A "one size fits all" view misses the inevitable opportunities and risks that are unfolding in unpredictable ways, and leads to "market timing," with its dismal record.

Through our history, we have recognized that irrational behavior can dominate the market. We cannot predict the timing and degree of that behavior. Near the market bottom on March 9, as many investors moved to the safest investments, we remained committed to our philosophy and discipline, which has paid off during the rebound. We are proud of that achievement.

There's no question that we continue to think there are meaningful risks ahead. To return to more manageable debt levels, consumers would have to pay down about $4 trillion in debt—over 30% of GDP. That unwinding will take time, and lingering unemployment won't help. Moreover, the Fed is now talking of withdrawing some of its supportive measures, which will require a smooth handoff to the private sector for economic growth. Finally, despite improved recent housing activity, delinquencies remain high even with government aid.

But we are encouraged by two factors, which help keep the probabilities balanced for investors: 1) the majority of the $787 billion fiscal stimulus has yet to enter the economy and may arrive while deflationary forces remain a near-term threat; and 2) cost-cutting by companies may not only boost near-term earnings but also could improve operating leverage even under weak growth scenarios, which could lend some teeth to corporate earnings growth into 2010.

What Does This Mean for Investment Strategy?

Active rebalancing of portfolios is very important in this environment. In equities, technology, materials, and consumer stocks have led the rally. We have trimmed our consumer stocks along the way (we have average exposure there) and added to our holdings in energy, staples, and health care, which are sectors that have lagged this rally and present longer-term opportunity. Consistent with our value orientation, we maintain an above average exposure to materials and industrials stocks. We continue to pay exceptional attention to balance sheets and a company's independence from credit markets.

In bonds and other asset classes, we are mindful that deflation may persist near-term but that the probability of inflation increases in four or five years. We have therefore avoided longer-term Treasuries in favor of better yielding and shorter duration instruments like CDs and agency bonds. Among corporate bonds, we seek to spread risk across issuers and strive for maturities less than four years. For longer term bonds, where inflation poses a risk, we prefer inflation-protected Treasury bonds ("TIPS"). Where appropriate, we have diversified into complementary publicly-traded asset classes through exchange traded funds ("ETFs").

We have stayed true to our investment strategy for our private clients during this dislocation. We were buying out-of-favor stocks during 2007/8, which helped produce our strong results so far in 2009. Our disciplined research and rebalancing continues to balance risk/reward with fundamentals and probable outcomes to help our clients meet their long term financial objectives in an uncertain time.