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VIEWPOINT

Surprising Choices in the Search for Safety

NEAR-CERTAIN LOSS OF PURCHASING POWER VERSUS SHORT-TERM VOLATILITY?

By Jason Petitte, CFA

Since the stock market bottomed on 9 March 2009 through the end of this past August, bond mutual funds have experienced net inflows of about US$900 billion while stock mutual funds saw net outflows of almost US$200 billion. During this period, the S&P 500 returned 123.8% (including reinvested dividends) while a 10-year U.S. Treasury bond purchased on 9 March 2009 earned a relatively meager 22.5%, despite interest rates falling to generational lows. This seemingly poor asset allocation decision on the part of many investors is not entirely surprising because investors have shown an uncanny propensity over many decades for buying high and selling low. Given that yields would have to turn negative for a 10-year Treasury bond purchased today to repeat even these returns over the same amount of time going forward, it is difficult to explain why this trend has accelerated over the past 12 months.

The explanation often heard is that investors are more risk averse than ever after having lived through the financial crisis, the flash crash, and the continuing bombardment of bad news coming from the eurozone. This explanation (although likely accurate) is inadequate because it ignores two key issues: all investors, even those in cash, are taking risk in some form and all investors need to earn a high enough return on their assets to allow them to meet their goals. Buying a 10-year US Treasury at a 1.70% yield clearly won't provide a sufficient return for the vast majority of investors, so investors should be asking themselves, "Which type of risk am I comfortable taking in order to meet my goals?"

Unfortunately, many investors today think they can avoid this question simply by investing in bonds or bond funds that appear to offer marginally higher yields than traditional, high-quality fixed-income investments. Bonds being bonds, investors assume these investments offer them the safety they are looking for plus a little extra yield as a bonus. Yet risk in its many disguises is unavoidable, and investors are taking on significant amounts of credit risk, duration, and leverage to obtain the higher advertised yields offered by these presumably safe bonds.

Many investors have opted to take on credit risk in the form of high yield bonds, preferred stocks, or emerging market debt in order to increase yield. Inflows into these sectors have accelerated in recent months despite the ever-tightening incremental spread an investor gains by taking on additional credit risk. It is also important to remember that the quoted yield on a high yield bond is *before* any adjustment for the probability of default. After factoring in this probability, the incremental yield will not amount to nearly as much as many investors believe, and in certain cases, it could even amount to a lower yield than could have been obtained on higher-quality bonds. Venturing into these credit-sensitive sectors of the bond market also contradicts one of the core functions of fixed income within a portfolio, which is to provide stability during times of distress. Investors may recall that these sectors declined more in line with equities than high-quality fixed income during the six months of turmoil in late 2008 and early 2009.

Other investors have reached for extra yield by extending the duration of their portfolios. An investor who is willing to go out 20 years might be able to earn 3.5% on a high-quality corporate bond or 3.0% on a high quality municipal bond. While those returns might seem attractive relative to short-term bonds yielding less than 1%, the prices of these bonds are very sensitive to changes in interest rates. For example, if interest rates rose 2%, the hypothetical 20-year corporate bond yielding 3.5% (mentioned previously) would suffer a decrease in market value of 23%. Because an individual bond can be held to maturity, an investor wouldn't necessarily be forced to recognize this loss, but the loss will be reflected in an investor's lost purchasing power if interest rates and (presumably) inflation rise. Further complicating matters for investors in bond funds, the option of holding to maturity doesn't exist. Once rates do start to rise, many less-experienced bond fund investors may go running for the door when they start to see declines of 10% or greater in what they thought was a "safe" investment, which will put further downward pressure on prices. Adding insult to injury, many of these bond fund investors could also end up with a tax bill when fund managers sell off bonds that had previously appreciated.

Investors are currently embracing leverage in their fixed-income investments. The leverage is designed to enhance the fixed-income products' yield, but it can also increase the risk during times of distress. Many of us remember the two Bear Stearns mortgage hedge funds whose collapse made headlines in 2007. After several years of posting attractive and consistent returns by buying long-duration mortgage-backed securities financed with short-term debt, they proceeded to lose more than 90% of their value when the value of the mortgage-backed securities fell, forcing them to sell at an inopportune time to cover their margin calls. In addition to some hedge funds that are once again playing that game, other examples of levered fixed-income investments include some closed-end funds and mortgage REITS. When rates do start to rise, these investments will suffer as they get hit simultaneously by a decline in the value of their assets and a rise in their borrowing costs.

It's unclear whether investors are unaware of the possible—and most likely permanent—ramifications of the risks they are taking or they simply think they will be able to sneak out of the party before the music stops. In either case, one thing is clear: someone will be left to clean up the mess.

What is an investor to do when faced with the alternative paths of accepting a potentially inadequate return with low risk or accepting a potentially alarming amount of risk in order to eke out a marginally higher return? Perhaps the answer is neither. Opportunity may lie in choosing risks, such as volatility and illiquidity, that many investors often shun despite these risks posing minimal danger of a permanent loss of capital over a long-term time horizon.

Too often, bond investors embrace the view that because bonds are less volatile than stocks they are automatically less risky. The problem with this definition of risk is that the biggest risk most investors face is outliving their money. With real, after-tax returns on bonds at zero (or less than zero), investors should be asking themselves whether the near-certain risk of losing purchasing power is preferable to accepting increased short-term volatility by overweighting their portfolio with stocks in exchange for the likelihood of much higher returns. Even investors who are searching for income can get a higher dividend yield from owning an S&P 500 index fund than they can from owning a 10-year Treasury. Furthermore, unlike the interest payments on a 10-year Treasury after it is purchased, the dividends on the S&P 500 can grow, which is more than likely to be the case because S&P 500 companies are only paying out 28% of their earnings in the form of dividends, compared with the long-run average payout of more than 50%.

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For a more specific example, Johnson & Johnson, one of the few AAA -rated companies with bonds outstanding, has a bond maturing in 2020 that is trading at a yield of 1.8%, and the stock has a current dividend yield of about 3.5%. To be worse off holding the stock instead of holding the bond until it matures, the dividend would have to never grow (despite JNJ's dividend growth averaging 8.5% annually over the past five years) and the share price would have to be 16% lower in 2020 than it is today (despite the stock already trading at a relatively low multiple of earnings). Owning the stock would likely be a bumpier ride, but a relatively dire situation is required for the stock to underperform the bond over this time period.

As with volatility, many individual investors care a great deal about liquidity, yet it is generally not necessary or important for an investor to be able to liquidate most of his or her portfolio at the drop of a hat. This is especially true in IRAs or other tax-deferred accounts in which most investors won't need to take withdrawals for years, and when they do take withdrawals, they likely will require only small amounts of liquidity annually (perhaps 5%–10% to comply with the required minimum distribution rules).

One example of a potential opportunity created by investors' preference for liquidity can be found in the market for non-agency mortgage-backed securities—specifically the senior tranches that were formerly rated AAA. Despite a significant rally in prices throughout 2012, typical seasoned pass-through securities originally issued from 2003 to 2007 still trade at *loss-adjusted* yields between 4.0% and 6.0% with an average life of 5–7 years. Downside risk is relatively low. To lose money, it would take the unlikely scenario of the U.S. housing market experiencing *another* severe decline. Furthermore, a portfolio of these mortgage-backed securities will likely benefit, or at least hold up well, in a rising interest rate environment. Many of these bonds are backed by adjustable-rate mortgages, so the coupon payments on the bonds would rise with interest rates while the generally higher-quality collateral backing these bonds should be able to digest a higher loan payment without a significant increase in default risk on the underlying loans.

Investors have continued to eschew these securities (still considered somewhat of a dark corner of the fixed income market) and their relatively high yields because of the difficulties involved in analyzing and trading them. In other words, investors avoid them because they are illiquid. Even this concern is somewhat misplaced, however, because these bonds generally pay out between 10% and 15% of their market value annually in the form of interest and principal payments, which typically would be more than sufficient to satisfy an investor's liquidity needs without needing to actually sell any positions.

Avoiding risk entirely is not an option. In today's market, managing a bond portfolio and still earning an adequate return requires that investors choose which form (or forms) of risk best allows them to meet their goals: credit risk, duration, leverage, volatility, or illiquidity. Regardless of the choice, just remember, there are no free rides.

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