Bond Risk & Year Review

I hope this letter finds you enjoying the New Year and inspired by all the promise of 2012. In order to present some thoughts on investment strategy, I need to start with a concise overview of what happened last year.

2011 – What you need to know:

Outwardly, the year appeared to be a typical one of defensive stock outperformance. U.S. large capitalizations stocks performed well relative to smaller stocks–with the market led by utilities. Companies offering good dividend yields outperformed those that did not return cash to shareholders. International stocks suffered more than domestics, and emerging markets fared the worst with sizable declines across the board. The news flow was bad, risk came off, volatility was high, but when the dust settled the S&P 500 held its ground to close flat, before dividends.

Given the barrage, passive index investors should be fairly satisfied. Actively managed mutual funds performed poorly in general. The most active managers got shellacked by the volatility. The HFRX Equity Hedge Index, a measure of performance among equity-focused hedge fund managers, fell by ~19%. It appears there isn't much "alpha" left to go around. When investors tire of looking for it, they should come instead seeking out “beta.” We will be well positioned to sell it to them – at fair premium of course.

The most notable development of 2011 came in fixed income. Emerging market bonds performed about on par with broad U.S. bond exposure, despite all the global risk aversion. The JPMorgan EMBI Global Core Index was up ~7% for the year, about equal to the performance of the Barclays Capital U.S. Aggregate Bond Index. Even more notable perhaps was how U.S. Treasury bonds performed in such widely differentiated fashion. The short end of the yield curve (1-3 years) offered a humble ~1.5% (less than the S&P 500 inclusive of dividends,) while the longer maturities (20 years+) offered staggering gains of ~30%. This result was driven by a perfect mix of Federal Reserve market operations, flight to liquidity, and most critically–the pronounced volatility in bond principle caused by low interest rates mixed with long maturities. I will explore the ramifications of this concept later in the letter.

First, how did these results jive with our 2011 investment positioning?

As is normally the case, there were both successes and failures. Regarding stock positioning, the decision to stress utilities was successful. They outperformed both national and international benchmarks, and were the leading sector of the year. Unfortunately, that benefit was offset by a premature vision to start buying in the alternative energy space also. Despite the fact that the average client allocation to alternative energy was a very low and prudent 0.75% or less of their portfolios, the losses were massive on percentage terms, and psychologically trying. It is a ferociously volatile sector. Minimal solace came on January 3rd, as Chinese solar firm LDK Solar Co. made the first ever Chinese bid for a German solar outfit, Sunways AG. Industry consolidation can’t come too soon. Even a small amount of good environmental karma proved costly for us in 2011.

As for international exposures, most clients started the year with smaller allocations than targeted. We deployed some cash early in the year, with emphasis on Asia. While it appeared sensible to focus on China large-capitalization stocks because they had already entered a bear market and were presenting good historical valuation levels, the pain instead continued. The sustainability of China’s economy is a hot topic presently. I will be going to China for 10 days next week in order to make some qualitative observations to supplement quantitative work. I’m particularly focused on evaluating the quality of infrastructure development, and getting a better understanding of the upcoming leadership transition.

I also deployed funds into German and Vietnamese shares, which continued lower as the Europe crisis unfolded. While I would clearly prefer immediate gratification, these are all positions selected to offer meaningful diversification into resilient nations with unique engineering, export, and demographic strengths. It was wise to work slowly. Dry powder remains to keep bolstering in these beaten-down international markets.

Finally, my preference for underweight exposure to U.S. Treasuries came as a failure in 2011. The Barclays Capital U.S. Aggregate Bond Index rallied ~7%. That performance beat most all stock indices around the world, as the “risk-off” trade prevailed. This was not ideal for equity investors like us. That being said, I made a small push into emerging market credits on the common sense assumption that they looked better prepared to repay what they had borrowed without requiring further borrowing to make payments, which is a good quality to look for in a credit. That decision worked well, as those credits performed about equally to U.S. bond exposure. It was satisfying because most clients had minimal or zero international bond exposure in the past, and it added both performance and diversification benefit for them in 2011.

A brief lesson on bond behavior and risk:

Without diminishing the fact that my view to underweight U.S. Treasuries proved wrong last year, I feel compelled to offer continuing analysis for this bias, because I find no reason to change it in 2012.

Investment professionals often calculate risk by looking at the *historical* volatility of different investments. Despite knowing this approach is fundamentally misguided, they rely on it because it is easy and allows for authoritative-looking presentations on relative risks in a portfolio. However, we know empirically that risk is actually encapsulated in two rather qualitative elements: what are the potential dangers that exist in the *future,* and more importantly, what are the potential consequences of those dangers? Good insights into these questions cannot be found in historical data alone.

In real life, it is foolish to measure risk by what *did* happen. Luck shines on us all at times. It is better to think about what *could* have happened. In 2011, you now know that long-dated U.S. Treasury bonds produced tech-bubble sized 30%+ annual gains. This is the financial equivalent of a Waimea Bay hero wave. While I reluctantly applaud bond investors for pushing the limits of what is possible with their own capital, all of my own leadership and survival skills are telling me not to try to impress anyone by pushing the limits of this fear trade that is causing bonds to rise so sharply. In a generalized debt crisis like the one we are in, we have to be very careful about the bonds we own, regardless of current perceptions of safety. Those perceptions can change quickly.

Now for the technical argument:

Bonds, like most investments, must be thought of as a stream of expected cash-flows. When you purchase a bond you create a negative cash flow for yourself—money goes out. You then take money back in through a series of regular interest payments, and ultimately take return of your principle when the bond matures. These negative and positive cash flows, and particularly how they profile over time, have a dramatic impact on a bond's current market pricing.

This disbursement profile can be summarized using a metric called *duration*. Mathematically, it's the weighted average term to maturity of a bond's cash flows. This is not to be confused with a bond's *maturity*, which is how long the bond will take to be fully retired. *Duration* is actually best understood as a measure of a bond's sensitivity to interest rate changes. A high *duration* bond is a more sensitive bond, which equates to a more volatile and riskier bond.

A few basic relationships can be drawn from the concept of *duration,* and should be known by all fixed income investors:

Less Volatile Bonds	More Volatile Bonds
Short Maturity	Long Maturity
High Coupon (Interest Rate)	Low Coupon (Interest Rate)

Looking at this matrix, you will see that long-dated U.S. Treasuries right now have both characteristics that make for a volatile bond. They are both *long maturity* and *low coupon*, and hence very sensitive to rate changes. Moreover, as interest rates have been stretched to unusually low levels, this volatility has been exacerbated by another characteristic of bond pricing called *convexity.* Technically the second derivative of duration, *convexity* describes how a bond's volatility doesn't change in linear fashion, but actually accelerates or decelerates at the extremes. As interest rates have come closer to zero, bond volatility has begun to accelerate. In plain English, that means 20-30 year bonds are very steep terrain.

You might ask, "Hal, who cares about the volatility? The point is that it's still a bull market for U.S. Treasuries and all that dispersion is positive!" I would have to respond, risk is not about what *did* happen. It is about what *could* happen. Without referring you back to specifics on the U.S. debt situation covered in prior letters, I have to point out that similar sentiment guided the NASDAQ bubble. It was a hugely volatile market, but nobody cared as long as the numbers were moving up. Just as we saw wild 30% capital gains in longer dated bonds this year, it is also possible to see 30% capital losses in short order–the volatility cuts both ways.

The point here is to observe that significant principle risk is being taken on a government promises for interest less than 3% per annum. That is not an investment. It is a speculation, pure and simple. Said differently, if I am willing to endure 30% annual price volatility, wouldn't I rather be investing in assets with much higher expected long-term returns like stocks?

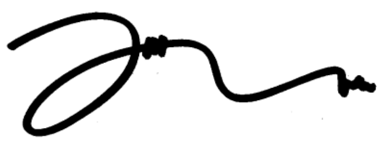
When Iosses eventually hit the tape for these bonds, investors will realize they are sitting on paper they have no real intention of owning to maturity. I would then expect the "flight to safety" trade to take new shape, and a more virtuous cycle to emerge. It will likely be a move out of low-yield bonds, and into conference rooms and stock exchanges around the world. Some individual investors might put a real-estate broker to work, but most large institutions will remain fixated on liquidity and hence be more attracted to equity markets.

Wrap Up:

2012 will see a variety of important tests, and I intend to be patient about deploying both existing and new cash. Values could become even more attractive if these tests are failed. The ongoing rebalancing process will assist us in making our desired movements organically. It leads us to sell bonds and use cash in favor of buying shares. We will keep migrating into cheap stock markets in vibrant economies around the world until we reach our targets. The cash remains not so much due to fear, but to put us in position to accumulate more stocks on any further panic.

As you may know from my last letter, share prices are currently supported by more earnings than have been seen in the majority of market history. Due to these facts, I hope you will consider calling me to discuss if this investment discipline makes sense for your capital. Of course I would enjoy discussing any other opportunities you are exploring for the New Year as well.

Best,



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