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Investment Newsletter – March 2013

The first topic this month is "The New Normal" – low interest rates and low growth for as far as the eye can see. Our discussion then turns to "The Inflation Trade" - how investors are playing the unprecedented expansion of the money supply that is pushing interest rates below the inflation rate. Looking forward, the newsletter lays out a series of possible scenarios for future economic and market conditions and describes how to construct various components of an investment portfolio to benefit depending on which conditions play out.

Given our unrewarded caution over the last year, the newsletter provides some context to the risk-on versus risk-off decision process and compares the evaluation of such decisions to the security selection process. Strategy level return calculations are unavailable but coming soon.

Low Interest Rates for the Long Run – The New Normal

Over the last 3 months we've witnessed a significant contraction in fiscal stimulus: in January a large tax increase took effect and at the beginning of March the budget sequester kicked in to cut 10% of discretionary federal spending. The stock market shrugged this off and surged to new highs. Monetary policy is the only thing that seems to matter for the markets. Since rising rates are very bad for both stock and bond prices, we can infer from ever rising prices that the market does not expect interest rates to go up in the foreseeable future. This is a somewhat unusual situation because we normally see interest rates rising above the inflation rate when the economy is growing as it has been since 2009.

In this case, however, the Fed cannot raise interest rates without snuffing out the recent rise in the real estate market and knocking down the stock and bond markets. This would likely push us back into recession and the Fed would then reverse course immediately by pushing rates back down to revive spending. In fact we saw this dynamic when the Fed tried to normalize interest rates after we came out of the early 2000's recession. Those rate cuts had pulled us out of recession by spurring a boom (and bubble) in real estate investing. When they raised rates, it popped the real estate bubble and we crashed back into recession. We are now at a similar point in the business cycle. If they raise rates, the demand driven by low rates will evaporate and we'll be back in recession. This dynamic limits the possibilities for returning to positive real interest rates (i.e. interest rates higher than inflation).

Another problem that stands in the way of normalizing interest rates is the deterioration in national finances. The government's interest bearing debt has grown to be very large relative to the economy and tax revenue, and the maturity of that debt is short. This means that raising interest rates would cause a very rapid rise in required expenditures and thus the deficit. If rates and debt go high enough, they could become self reinforcing and spiral upward. In such a case, international investors may conclude that the U.S. will print ever more money to get out of this debt spiral. Then a crisis of confidence in the dollar and the resulting inflation would again drive real rates to 0 and below.

Therefore, despite their talk of normalizing rates down the road, it seems unlikely the Fed will successfully unwind monetary stimulus and raise interest rates above inflation.

Negative Real Interest Rates Drive Inflation Trades

Higher interest rates used to be the norm because savers are interested in what is called the real interest rate – interest earned minus the loss in purchasing power from inflation. If the real interest rate is positive there is an incentive to save and invest. This increases the nation's capital which leads to higher productivity and income growth. If real interest rates are negative as they are now (inflation exceeds interest earned) consumers have an incentive to buy goods now rather than putting money into interest bearing accounts because this will lead to decreased purchasing power later. This incentive to spend rather than save has kept the economy from slipping back into recession so far.

But for those who want to preserve purchasing power and earn positive real returns, they have been driven towards borrowing cheap money to buy assets that will rise with inflation. We see this in the huge rush of money now going back into the real estate market. These purchases are meant to benefit from further rises in inflation by locking in mortgage debt at current interest rates.

Investors are also bidding up stocks as a way to generate some return in excess of inflation. In contrast, long term government inflation protected bonds are priced to yield losses in purchasing power. Risk-averse investors are willing to lock in losses in purchasing power because of the lack of alternative low risk inflation protection. In the U.S. fixed income world, the only way to ensure returns above inflation over the long term is to invest in floating rate high yield instruments – such as corporate loans. Demand for these investments has driven prices up and future yields down. This is part of the reason why our Short Term Income strategy earned such high returns in 2012.

Investment Strategy: Diversification Applied to Economic Scenarios

Diversification is a basic principal of investment management where we seek to lower the chances of very bad outcomes by spreading our money across investments that are likely to perform differently from each other in various circumstances. The most obvious way to do this is to buy many stocks so that when one is doing poorly another will likely do better. If you buy stock in just one car manufacturer you run the risk that it loses out to competitors and goes bankrupt. If you buy stock in all the car manufacturers you will have less downside because its unlikely all competitors in the whole industry would go down (unless the product suddenly becomes obsolete). Taking it one step further, we can further reduce risk by investing in more than one industry. The downside to spreading our bets is that we reduce the chance of very large returns from picking the exact right investment at the exact right time.

Another way to apply diversification principals is to invest for payoffs in various economic scenarios that could play out over your investing horizon. We want to make sure that we have at least some investments that payoff in every scenario that has significant probability of occurring. As mentioned above, there is a price to such diversification. When we ensure that we always get a good return on something in every scenario, it generally means that we're also going to get some poor results from some investments in every scenario. It's like buying insurance: if something bad doesn't happen then you wasted your insurance premiums, but if you don't buy insurance you will lose a lot more if the calamity happens. With that in mind let's look at some possibilities for the future and how various investments would perform in such scenarios.

First let's consider a period of more than 10 years of low growth, low inflation, low interest rates, and low returns on invested capital. I think of this as the "Japan Scenario" because the Japanese have been living in this world since their real estate bubble burst in the late 1980's. Sound familiar? We are experiencing these conditions right now. Investments that provide good returns in this situation are high yield bonds and financial companies that can borrow cheap money to magnify returns on low growth but steady paying investments. For example our Long Term Value strategy is invested in mortgage real estate investment trusts (REITs) that pay dividend yields of 14-15%. Overall we have about 30% of the Long Term Value portfolio in similar financial companies. We hold high yield bonds in the Long Term Income portfolio.

Another possibility is that U.S. and worldwide growth increase back to the rates seen prior to the recession. I call this "Back to Status Quo". Such growth would be very beneficial for more cyclical economically sensitive stocks. These are also referred to as high-Beta stocks, meaning they tend to go up faster than the overall market when times are good (and vice-versa). Energy and materials industries fit this description. Their profits increase rapidly when demand is rising faster than supply. The Long Term Value portfolio has 26% of its total invested in these two sectors.

Despite the recession in Europe and slowdown in the U.S., China's economy is still growing rapidly (if a bit slower than before). Other less developed countries may grow nicely with a shift to domestic consumption growth. This scenario would likely drive higher returns on emerging market stocks as U.S. stocks muddle along with low growth. Our equity portfolio currently has just 6% devoted to emerging markets; additional investments are under consideration.

On the other hand, another possible scenario is that tightening fiscal policies in the Europe and the U.S. push the whole world into recession despite very loose monetary policies. This scenario includes competitive devaluations of currencies around the world. Japan is already on its way down this path and the U.S. is also determined to lower the value of its currency. While this scenario is hostile to almost all investments, gold would shine as the only safe "money". Long Term Value has roughly 11% in gold related investments to provide downside protection in this scenario. Many bonds will perform well in this environment so long as the recession is not too severe and there is no credit market panic.

Even if we avoid a worldwide recession, U.S. monetary policy will likely push the dollar down significantly. As discussed at the beginning of this newsletter there is the possibility that at some point we experience a crisis of confidence in the dollar which causes a large devaluation of the currency. High inflation is also likely in this "U.S. Devaluation" scenario. We would again see big gains in gold but also big price increases in energy and gains in energy company stocks. The inflation of this scenario could potentially do big damage to retirement plans. Therefore, Long Term Value has 31% of the portfolio devoted to gold and energy investments so as to provide returns when they are needed most.

Finally let's look at a scenario I consider unlikely but still a possibility to guard against: "The High Interest Rate Scenario". In this scenario the Federal Reserve Bank gets serious about protecting the purchasing power of the currency. They unwind their bond buying program and push short term rates up by 2% or more above the inflation rate. This would push house prices down and put the U.S. into recession. Stocks and long term bonds will incur large losses in this scenario. It will also be bad for gold and oil. Investors holding cash and short term fixed income will do well as they will avoid losses and have the buying power to buy assets on the cheap in the downturn. We currently have about 18% of Long Term Value portfolio in cash – waiting for opportunities. Most clients also have relatively large allocations to short term fixed income securities which will enable them to become buyers after a major market correction.

Whichever scenario plays out, investors who have properly diversified will have some losing investments and some winning investments. If their assets are allocated according to their goals and investing horizon, they will be in good shape no matter what happens.

Security Selection versus Risk Level Selection

Planning and executing an investment plan requires decisions at various levels. Most people think about picking stocks or funds as the key determinant of returns. But the amount of risk you choose to take is the more important choice. It's also the harder choice to evaluate after the fact. For security selection, you can compare your results to a similar risk portfolio to see how you did. For example you might compare a stock portfolio to the S&P 500 or a bond portfolio to the returns of a fixed income index. But how do you evaluate a past decision about how much risk to take? At the point the decision was made you assess the chances of various ways the world could turn out going forward, but only one sequence of events actually plays out for real. If you decide to allocate a lot of your money to risky assets such as stocks, you have the chance to gain a lot, lose a lot, or anything in between. Presumably we want to increase these allocations when we see the odds are better for gains than for losses. If conditions are very uncertain or we expect a high chance of loss, then the right decision at that point is to allocate relatively little to risky assets. If the risk would have paid off, it's tempting to say that the decision was wrong (that's what our emotions say) but this is not correct in an analytical sense. Suppose you can bet on the roll of a die. Sometimes your opponent offers to pay you a dollar for each dollar bet when you roll 3 or better (4 out of 6 chances) but other times he offers a game where you must roll 5 or better (2 out of 6). The smart thing to do is bet more (or only) when the odds are in your favor. The fact that you roll a 6 in the second kind of game doesn't mean you made a bad decision by betting small; it means you happened to get lucky.

I bring this up because we allocated assets to keep risks low for a very long time. As it turned out, there has been a large payoff to taking risk over the last year. This has been painful to watch from the sidelines. The natural emotion to feel is regret. It's important to understand this is purely an artifact of hindsight. For context, the last time we had similar circumstances was after the crash of 1929. From the peak in September 1929 the market dropped 48% to what, at the time, looked like a bottom. From there, the market went up 48% over the next 5 months. This pattern comes close to what we saw in 2008 to 2009. But after the rally in 1930, the market subsequently went on to decline another 86% over the next 27 months. Thus the risk-on decision that would have paid off in the current market cycle would have lost you virtually all your capital in an alternative ending that was very possible. So either risk-on or risk-off can lead to regret, but risk-on at the wrong time can also lead to poverty.

Over the long run we can earn good returns on our equity investments. Security selection in our Long Term Value portfolio has led to better performance than the index over periods of 3 years or more but we can still lag the market in an up market by reducing risk allocations. This part of our strategy helps clients to preserve capital when markets decline, but leads to regrets in up markets. Still, it is prudent to accept the possibility of such regret just as it makes sense to lower your bets when you need to roll a 5 or better to win.

Risk Management, Hedging, and Dry Powder

At Berkeley Investment Advisors we used a hedging portfolio to reduce equity market risk while economic risks were high relative to expected returns from taking risk. In the event that market psychology had reversed and the market had re-priced those risks, we would have used gains on our hedges to redeploy capital into more attractive return opportunities. That hedging proved expensive in the speculative run up of 2012. After the government finished tightening fiscal policy with the imposition of the sequester at the beginning of March, we eliminated all allocations to hedges. We still consider equity risks high. But given the cost of the hedges we are now managing this risk by allocating relatively less to equity and more to fixed income. By doing so, we are keeping some "dry powder" to allocate back into the equity market at the next crisis. Those with cash to spend when the market drops big are those that reap the larger long run returns. Warren Buffet is probably the most famous practitioner of this kind of patience. His firm, Berkshire Hathaway builds up large stockpiles of cash which it invests only when big opportunities arise. During the panic of 2008, Buffet invested $3 billion in General Electric and $5 billion in Goldman Sachs at highly favorable terms. In 2011, he did the same with Bank of America, earning great returns in every case. Of course, we don't have access to Buffet scale deals, but we do follow his strategy of calibrating our allocations to equity according to the returns expected relative to the risks.

A Note on Returns at the Strategy Level

In years past we have reported on returns of a few clients who held varying proportions of their money in our different strategies. This makes it difficult to determine what performance would be for different asset allocations. Therefore, our goal is to calculate returns for the underlying individual strategies. Unfortunately, it has proved very difficult and time consuming to separate out the various components of returns to calculate these more comparable strategy returns. Folio Institutional does provide returns for the individual strategies but our preliminary work indicates that their calculations are not correct. We hope to provide these strategy level returns in the near futures.

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