Another Problem with Low Rates

The Federal Reserve’s wealth transfer strategy of shifting purchasing power from savers to borrowers has other unintended consequences apart from plundering the thrifty in favor of the profligate. If you run a fixed income fund, ten-year treasury notes with a 2% handle doesn’t create much raw material from which to manufacture some income for your clients. The inadequacy of the yields jumps out, and many thoughtful bond managers have been drawn, or even forced, to reject such poor compensation and to adjust their positions in anticipation of fairer, higher yields.

Thus has the Pimco Total Return Institutional Fund (PTTRX) missed this year’s rally in bonds. Having concluded earlier in the year that U.S. treasury yields offered scant return for the risk, they shunned them publicly and completely through the debt ceiling crisis and into the most recent bout of risk reduction in the third quarter. It was a completely reasonable view to take – they may not have drawn comfort from the fact that we shared their outlook, but we did and so this article is not about bragging that we outperformed Bill Gross. Pimco’s long track record speaks for itself. The point here is that artificially low yields perhaps added urgency to the quest for better fixed income outcomes than were on offer for a passive investor. Positive real yields of, say, 2% (which would require interest rates 1-2% higher) at least afford the plausible option of passively investing and taking what’s on offer. But since today’s yields reduce purchasing power after taxes and inflation, any red-blooded bond manager is virtually required to shop around for alternatives. For a bond fund as big as PTTRX the bets are necessarily big. Their boycott of the U.S. treasury market caused them to miss a fall in yields from simply ruinous to ridiculous.

Just because a view has been wrong is not sufficient reason to change it. That statement doesn’t apply to traders with leverage, since holding one’s convictions too strongly can lead to bankruptcy. But for the unleveraged, new information is the only thing that’s really important. Bond yields have fallen this year and being underinvested has been wrong – so far. But the new bond yields are less attractive than the old ones, and while economic growth has moderated in recent months the long-term outlook is scarcely that much worse than in the Spring. Active government involvement in the bond market is designed to drive other investors away. Ben Bernanke could as easily hold up a sign during his regular testimonies before Congress saying, “Savers, We Don’t Want Your Money”. What can be more eloquent than the active competition of the government with private savers for its own debt? How loudly should the message be broadcast? If the government wants bonds that badly, let them take the lot. Go elsewhere – senior loans, Master Limited Partnerships, dividend-paying stocks. The government wants savers to consider such alternatives, and will continue to drive them out with derisory yields until they get the joke.

Meanwhile, Bill Gross wrote a rare mea culpa. Well put, and you’ll find no criticism of his past actions here. Pimco have more recently completely switched gears on treasuries and now own them – in fact, if anything based on the aforementioned letter Pimco’s economic outlook is more negative than consensus. Retaining the mental flexibility to move 180 degrees from bearish to bullish is extraordinarily difficult. Most people can only manage moving back to neutral, so kudos to Bill Gross for not letting a few dropped fly balls cause him to lose his nerve. I can’t claim such dexterity – or more accurately, I continue to believe far better alternatives to bonds exist.

Savour the Moment

Sometimes you feel as if you'd like the world to stop right where it is. For most investors, arriving at work and checking their portfolios over coffee this morning should be one of the most pleasant beverages they've consumed in many months. After the misery of the third quarter culminating in September's testing of every reasonable investment thesis, sanity is finally returning. The Europeans have avoided disaster; the Germans have crammed voluntary losses on the banks (who have only themselves to blame for owning so much Greek debt in the first place). The banks say they will recapitalize through retained earnings rather than dilutive secondary offerings. The EFSF will be stretched as needed (although details are still sketchy). Life as we knew it can resume, and risk assets are cheap. Enjoy the view, like gazing across a beautiful vista on a sunny day. Touch the moment and savour it. Of course there are problems, and the moment won't last. But for now, just look and let September's nightmare recede.

So having done that, what's next? Well, having engineered a voluntary loss of 50% on holders of Greek debt and thereby avoiding an actual default, the market for sovereign credit default swaps (CDS) appears superfluous. Cautious buyers of Greek debt (were there ever any?) who bought credit insurance (i.e. CDS) have found it a waste of money. Sovereign defaults are at the end of the day as much political as credit events. Rating agency assessments of countries are political judgments, and maybe we're witnessing the end of one corner of the CDS market. Bankers have warned that reduced hedging opportunities will reduce the appetite of banks to extend credit – that may not be a wholly bad outcome given the amount of poorly conceived credit they've extended in the past. But reduced credit in the near term combined with Europe-wide fiscal retrenchment will stifle growth.

For our part, the main challenge to investors remains finding a fair alternative to the paltry yields offered in fixed income. Senior loans continue to be an attractive sector. The ING Prime Rate Fund (PPR) yields close to 6% and closed at a 7% discount to its NAV. When I spoke to one of the co-PMs a couple of weeks ago he felt fairly sanguine about defaults barring a European disaster which, at that time couldn't be ruled out. Meanwhile, high-grade corporate bonds at around 4% with no growth require conditions close to but just short of deflation to turn out well. The gap between the 8% earnings yield on the S&P500 and 2.25% ten-year treasury bonds is somewhat narrower than a month ago but still historically wide. Today is probably not the day to jump into equities, but at a calmer moment they still look like a more attractive long-term investment than bonds. The after-tax return on $100 in ten year treasuries can be beaten by a combination of $80 in 0% cash and only $20 in 2.2% dividend yielding stocks assuming as little as 4% dividend growth. Bonds are at yields that only a QE emboldened government could love.

In equities we remain fully invested. Natural gas E&P names continue to represent the more volatile sector of our Deep Value Equity portfolio. Devon Energy (DVN) is barely above the value of its proved reserves. We continue to believe Gannett (GCI) is very cheap at 6X earnings or less than five times free cashflow. And Microsoft (MSFT) remains attractive at less than 7X earnings net of cash (less debt) on balance sheet. MSFT has been cheap for many, many months. It's not exciting to be an investor – far from it. But it continues to be reliably profitable.

Disclosure: Author is Long PPR, DVN, GCI, MSFT

The Quiet Buying of Shale Gas Assets

The FT notes in an article this morning how M&A activity in the shale gas arena reached almost $50BN during the third quarter, a 135% jump on a year ago. Some deals were large and notable, such as Kinder Morgan's (KMP) purchase of El Paso. Others took place out of the spotlight, but what is clearly taking place is a growing acknowledgment by the major energy companies that domestic natural gas in the U.S. will represent an increasingly important source of energy production. It's here in the U.S., it's cleaner than other fossil fuels (though global warming is yesterday's story) and it's persistently cheap. They very success of so many E&P companies in drilling for natural gas has depressed its price, helping consumers but hurting profitability. When Petrohawk sold their business to BHP Billiton it confirmed CEO Floyd Wilson's oft-stated belief that the assets Petrohawk owned better belonged within a larger company with a lower cost of capital. That statement really is the key to the natural gas story. In a time of abundant and cheap natural gas, the company that has the lowest overall cost structure (including the cost of financing the necessary capex) will win.

As an investor, you have to choose carefully though, and definitely avoid companies that use too much leverage. As a result we've never invested in Chesapeake (CHK). Aubrey McClendon is a great cheerleader for the industry but has exhibited a wholly different risk appetite in the past than we would like. We continue to like Comstock (CRK) a name that's fallen too far. We also think Devon Energy (DVN) is a solid investment trading as it does close to the value of its proved reserves (providing a cheap option on likely but not yet proven assets) and with half its revenues now coming from crude oil production. It’s also all onshore, having divested its offshore and non-U.S. assets in recent years.

But Master Limited Partnerships (MLPs) also allow an interesting angle on the development of shale gas assets. Once the gas is extracted it needs to be processed, refined, transported and stored. This is to a large degree what drove KMP’s acquisition of El Paso; positioning for the huge infrastructure investments required to move natural gas from under the ground to the U.S. consumer. I found it interesting that earlier this month JPMorgan initiated research coverage of MLPs. They used to cover them but the analyst left several years ago and they dropped their emphasis on the sector. But JPMorgan estimates $130BN in capital investment over the next ten years as the industry responds to a shifting mix of fuels to provide energy. The tax status of MLPs precludes them from retaining much of their earnings, so new projects are usually funded with freshly raised debt or equity capital. For an investor this imposes discipline on management, since a poorly conceived project won’t easily attract cheap financing. JPMorgan no doubt sees an attractive long term fee opportunity. Meanwhile, there are ways to participate in shale gas development for the equity investor through E&P companies and the income seeking investor through MLPs. The sector has also recovered strongly from the sell-off in equity markets through September – the Alerian MLP Index (AMZ) is back within 5% of its high reached in April. 6% distribution yields and steady growth help.

If you had more money than you knew what to do with…

So says Don Sturm, owner of two community banks in Colorado. And Mr. Sturm's complaint is not that he's been amply paid (although he may have), but that depositors are flooding in at a rate that outstrips his banks' ability to usefully redeploy the money. This is QE2 at ground level. Investors fleeing the treacherous equity markets are selecting safe bank deposits, but are receiving nothing in return. In some cases banks are actually charging large clients for the privelige of being depositors.

Banks are still struggling to find enough good places to put the money they have. Although the system is awash with liquidity that other necessary component of inflation which is velocity (in other words, how quickly money gets recycled) is notably absent. Hence the ballooning money supply is not yet translating into inflation. But M2 is growing at an increasing pace – according to figures from the Federal Reserve its annualized growth has quickened from 10% over the past year to 24% over the past three months. Still no sign of a problem, and yet ten year treasury notes yielding 2.25% or high grade corporate debt at just over 4% provide scant protection should money velocity reappear and link up with already ample money creation.

On a different topic, how exactly does an investor in Greek debt get comfortable with a "voluntary" 60% loss? To accept any negotiated settlement there needs to exist a worse alternative, and it's hard to imagine what that might be. Since the purpose of a voluntary loss is to avoid triggering a payoff on CDS contracts, it's a stretch to see why any holder of Greek debt who also owned such CDS insurance would accept an uninsured 60% loss rather than endure a bankruptcy and so retain the ability to claim on their insurance coverage. Maybe there are very few holders of CDS who use it to insure against risks they already have. It increasingly appears as if most buyers of CDS protection were smart enough to avoid actually needing the insurance. It's as if most homeowners insurance was owned by people on their neighbour's house rather than their own.

We continue to be short the Euro through a long position in EUO. Although Europe's leaders are clearly focused on the issues at hand, the latest recapitalization needs are being dismissed by analysts as simply covering the loss from a mark-to-market of existing bond holdings at current levels rather than simulating a more stressful scenario than currently exists. The EU's leaders are getting there but at a painfully slow rate, and southern Europe is most likely already in a recesson. As is often the case, it looks as if the economic cycle in the U.S. will be ahead of Europe's, which should provide support for the $ against the €.

Monday Morning Thoughts, October 24th

There's an interesting article in the Wall Street Journal highlighting that banks are increasingly the first source of funds for takeovers – providing more funds that the high yield bond market. Kinder Morgan's recent acquisition of El Paso is cited as an example, but there's increasing evidence that banks are increasing their risk appetite. The Fed's confiscatory interest rate policies are steadily squeezing people out of riskless assets where there's no return to be made. In our Fixed Income strategy we continue to own senior loan closed end funds such as Blackrock Defined opportunity

Fund (BHL) and ING Prime Rate Trust (PPR). The prices on this sector had dropped more than 20% over the past six months, through lower NAVs and prices shifting from a premium to a discount.

Hedge funds are nervously waiting – not for the publication of my book, The Hedge Fund Mirage, but instead to see how big redemptions are going in to the end of the year. The WSJ has an article noting poor performance by some very large funds (Paulson, Maverick and Kingdon amongst others). Hedge fund investors are apparently maintaining their strategy of momentum investing even though it has served them so poorly over the years. Adding to winners and redeeming from losers. There aren't many hedge fund investors who seek out under-performing managers.

We invested in Transocean (RIG) on Friday in our Deep Value Equity strategy. We had previously owned the largest owner of offshore oil rigs last year following the Gulf of Mexico oil spill when its stock traded down substantially on fears of enormous legal liability. Such fears were unfounded and the stock recovered. We exited although well before its high. In recent months concerns of economic slowdown as well as BP's lawsuit have depressed the stock price which is now trading more than 30% below the market value of its rigs (according to research from JPMorgan). There's considerable room for error around such estimates, but this provides a greater margin of safety than on other names in its peer group. In addition with consensus estimates for $5.26 per share in earnings next year it appears attractively priced. BP's lawsuit will no doubt continue to be a cloud over them for some time, but with $17BN in market cap and $25BN in enterprise value they're big enough to handle even a $1BN legal settlement. It also pays a $3.16 dividend which gives it a yield of almost 6%.

We continue to own Gannett Co (GCI). It has been an unrewarding experience so far. It's true they're in the hated newspaper business which continues to shrink every quarter, but they also own broadcasting and digital franchises which look much more attractive. The problem is their publishing division is their biggest, notably the newspaper USA Today. But they are consistently profitable and trade at less than 6X earnings which are expected to grow modestly next year (helped by election-related TV advertising and continued double-digit growth in their online businesses). We'd like to see them buy back more stock but cashflow from operations regularly exceeds $700 million per year (compared with their market cap of 2.7BN), and with minimal capex needs they've been paying down debt. Perhaps the improved lending climate noted above will induce a private equity buyer to acquire what we think is a very cheap company.

Disvlosure: Author is Long BHL, PPR, RIG, GCI

Reining in the Rating Agencies

Through the ongoing and mind-numbing complexity of the European sovereign debt crisis, the bureaucrats in Brussels can be relied upon to introduce some absurdity into their deliberations. The latest is a report in the FT that under certain circumstances the EU will suspend the ability of rating agencies to evaluate sovereign credits. Now it's true that markets are generally too reliant on credit ratings issued by S&P, Moody's and Fitch. The basic business model of charging the issuer for the rating is fraught with conflict, as catastrophically revealed during the sub-prime crisis. However, alternative models are hard to identify – increased competition among rating agencies would likely cause a "race to the bottom" in which issuers would flock to those with the most forgiving standards. And charging investors, the actual users of the ratings, is regarded by many as unworkable.

But the downgrade of U.S. debt that occurred in the Summer highlighted the absurdity of the rating agencies evaluating sovereign debt. Unlike a corporate issuer where a detailed financial analysis encompasses most of the necessary work, sovereign credit analysis incorporates a political judgment as well. The U.S. downgrade in the Summer illustrates the rating agencies straying beyond their expertise. U.S. creditworthiness is based to a large degree on a willingness to repay debt, and an opinion on which is as much political as it is financial. The rating agencies have no more insight on the politics than many other informed observers, and as such their opinions ought to be irrelevant except for the fact that so much bond investing is rules-based driven by the ratings that these agencies issue. Many bond investors are required to hold issues with minimum ratings from the three Nationally Recognized Statistical Rating Organizations (NRSROs), otherwise known as S&P, Moody's and Fitch. But really, since sovereign issuers have the ability to tax, their credit ratings are by nature not simply financial. The ratings frankly shouldn't carry any more weight than other sell-side research on bonds.

As sensible as it might seem to ditch the legal support for NRSRO-issued sovereign credit ratings, the EU bureaucrats in Brussels have revealed their own muddled thinking in the latest proposal. No doubt France's impending loss of its AAA rating, a possibility the French regard with horror but which financial markets have already moved past, is the catalyst. The FT reports that under proposed EU regulations ratings will be suspended *during times of financial stress.* So good ratings are fine, but bad ones are not. And presumably the EU's credit experts will anticipate trouble by suspending ratings prior to a downgrade, therefore providing an eloquent and informed signal to investors that perhaps those bonds are not quite as safe as previously thought.

In the U.S. we can be grateful that we don't subsidize such entertaining idiocy with our tax dollars. It must be more frustrating for those sitting in Europe.

The IMF Will Need to Bail Out Europe

The FT has a very good summary of the current state of play in the European debt crisis. Yet another weekend summit critical to the survival of the Euro is upon us. Once again, bottom-up analysis of investments is held hostage to the macro issues at play.

The EU is designed to seek consensus and is antithetical to the type of strong leadership now required. Since no single leader will be held responsible if the whole edifice crashes down, all the political calculations are based on domestic politics. It's democratic, but ill-suited to the problems they're facing.

The FT article highlights some important points regarding the European Financial Stability Facility (EFSF). Although €440 billion sounds like enough money, particularly if used as a first loss guarantee (theoretically increasing its firepower by 4-5 times) that's not what's really available. Prior bailouts of Greece, Portugal and Ireland have reduced this to €250BN – and unsurprisingly these countries have withdrawn their pledges to the EFSF. In addition, €230BN comes from Spain and Italy, and since Spain is quite possibly one of the future recipients of bailout funds the ultimate available funds shrink further.

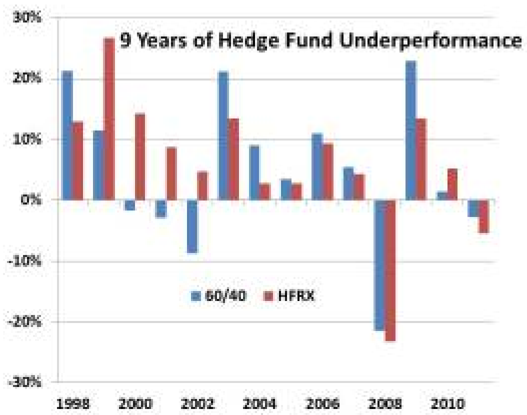
For many months it’s been clear that German taxpayers would be writing a check – either to Greece or to their bondholders. But even that is looking less clear without sufficient bailout funds available. So it appears that the IMF will ultimately ride to the rescue. They’ve apparently already been asked, but the U.S. and U.K. both opposed such a move. One can only imagine the outcry in Congress at such a move. So making such support politically acceptable will no doubt require another round of robust risk reduction, since only when voters are poorer will they accept the need for U.S. money to bail out Europe.

But of course the U.S. is a net debtor as well. Things will work out – they invariably do when there’s no alternative. But the stage is set for macro issues to overwhelm everything else.

Another Disappointing Year for Hedge Funds

2002 seems like a long time ago, but that’s the last time hedge funds outperformed a simple blend of 60% stocks and 40% bonds. Through 2000-02 during the dot-com collapse hedge funds added value, but since then as assets have flowed in the weight of all that money has steadily dragged down returns. Following a torrid performance in September, the HFRI Fund Weighted Index (HFRX) is down 5% for the year, compared with 3% for a simple 60/40 blend. No doubt much of the selling in September was caused by the over-leveraged becoming less so with urgency – the frantic buying of October looks like its mirror image. It’s looking increasingly as if this will be the 9th straight year in which old-fashioned investing without the use of absolute return vehicles has outperformed the more modern variety.

Part of the problem lies in how some of the biggest funds have done. To take John Paulson as an example: he began the year with $38 billion in assets under management (AUM), around 2% of the entire industry. If he's down around 40% on average across all his funds, that represents almost a 1% performance hit to the beleagured community of hedge fund investors. Given what appears to be modest return expectations among institutions of only 6-7%, that's a chunk of performance to be made up by the rest of the industry since Paulson has on his own knocked almost 1% off aggregate 2011 returns.



Are Dividend Paying Stocks Expensive?

Barron's over this past weekend included an article warning that dividend paying stocks were getting expensive. Author Michael Santoli cited recent work from Vadim Zlotnikov at Bernstein Research comparing price/book valuations on low beta and high beta stocks. On this basis low beta stocks are at the 99th percentile of valuation (i.e. expensive) over the past 50 years, whereas high beta stocks are at the 6th percentile. Low beta stocks don't have to be the same as high dividend yield stocks, although there tends to be a good deal of overlap. The kind of business that can pay a reliable dividend that grows predictably tends also to have less volatile earnings, so it makes sense for the two categories to overlap. Pro-cyclical businesses with high earnings volatility pay low (or no) dividends, conserving cash for less certain times.

Companies that we include in our Hedged Dividend Capture Strategy include boringly predictable names like Chubb Corporation (CB),Kraft (KFT), Procter and Gamble (PG) and AT&T (T). Annual dividend increases of 6% or more are not uncommon among names like these over many years, and they all offer dividend yields that are competitive with high grade bonds (and much more attractive than treasuries). As the future increasingly looks as if it will not provide a fair return to traditional investors in fixed income, investors have been finding other sources of income and dividend paying stocks have been a beneficiary. BernsteinResearch invariably produces high quality work that is supported with reams of data. The increasing price/book multiple paid by investors for such names could indicate that they're becoming relatively expensive, although the wide equity risk premium suggests that stocks are not that expensive compared with bonds using 40 years of data. If you go back a really long way however, Vadim Zlotnikov notes that over 140 years it's not quite so compelling.

But the performance of dividend paying stocks has coincided with falling interest rates, and bond yields are similarly at or close to their 99th percentile of overvaluation by any measure this side of World War II. Such names can be owned as a long-only portfolio or with a market hedge so as to be beta neutral, but the possibility of getting yield with an "equity kicker" appears increasingly compelling.

Carousing in Columbus, Ohio

I spent a most enjoyable day in Columbus, OH at the invitation of the local CFA Society. I should extend my thanks to Tim Steitz, Senior Investment Officer – Equities at the School Employees Retirement System of Ohio for organizing such a well attended event, and also Travis Upton, current President of the CFA Society of Columbus and Director of Portfolio Management at The Joseph Group. I talked about my upcoming book, The Hedge Fund Mirage, and hopefully offered some insights to investors growing their hedge fund portfolios. I also had several interesting discussions with investors about the alternatives to fixed income given government manipulated bond markets and the Tyranny of Low Rates.

I am finding that many investors are most interested in discussing less conventional strategies to generate income given the poor return outlook in bonds. Master Limited Partnerships (MLPs) and our Hedged Dividend Capture Strategy were both of interest to a number of people.