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In Pursuit of Value

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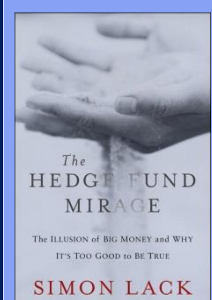
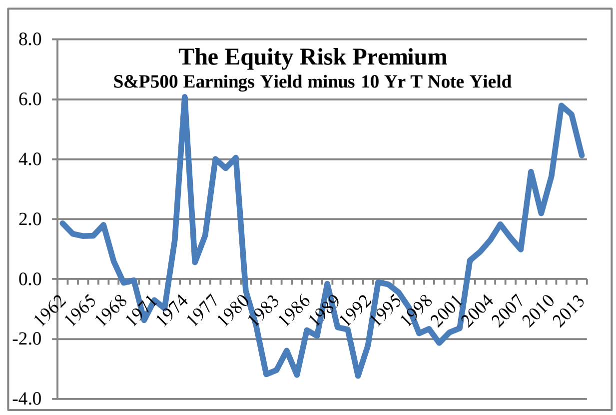


Quarterly Outlook

Some observers have been calling the end of the secular bull market in bonds for years. Bonds have certainly offered unattractive yields for some time, but Fed Chairman Bernanke's June press conference may just represent the definitive moment. By offering more detail on the necessary criteria for the Fed to reduce its bond buying, he certainly altered the psychology of the markets. The Tapering of Quantitative Easing, specifically how soon and how quickly, will consume much analytical effort in the months ahead.

A not-unrelated challenge looms for a great many financial advisers and brokers in explaining to their clients just why they hold so much of their portfolio in bonds. Still-fresh memories of the 2008 financial crisis along with robust central bank buying have delayed many unpleasant conversations. Now that the prospect of fixed income markets having to rely for support on commercially driven investors is less theoretical, the dismal return outlook of an entire asset class is becoming quite apparent. The Fed has been remarkably open about their thinking. On their website is displayed the voting FOMC members' consensus forecast for equilibrium short term rates. It's 4%, although missing is the date by which FOMC members expect to return to equilibrium. No doubt tightening of short term rates remains a long way off – late 2015 based on the Fed's own forecast. However, it's struck me for some time that an investor buying ten year treasury securities at 1.6%, where they were just a few months ago, or even 2.5% where they were more recently, might draw a quizzical look from Ben Bernanke if turning to him for moral support. A central bank's goals are quite different from those of a private investor, and the Fed's actions and public rate forecasts make that plain.

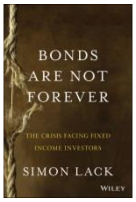


Nonetheless many investors own fixed income assets with yields that virtually guarantee a loss of purchasing power after taxes and inflation. For better or worse, clients of SL Advisors are not part of this conventional wisdom since we don't invest in fixed income. Return-less risk is for others. A recent report from a very large investment firm to its high net worth clients acknowledged the poor return prospects in fixed income but noted that the low or even negative correlation between stocks and bonds can reduce portfolio volatility. It's somewhat short of the robust validation that a conventional allocation to bonds requires. Indeed, if you think you'll benefit from investing in an asset with poor return prospects because it'll lose money unpredictably, lottery tickets can serve the same purpose. They also offer a negative expected return and are uncorrelated with other assets. More seriously though, cash is also good. It will of course lose value over time, but you'll always know its value and that certainty supports more equity exposure which is the only place where potentially inflation beating returns can be found.

The problem for many advisors in recommending cash or even short term bonds is that yields don't even cover their fees. We recently reviewed one trust account that held a significant percentage of fixed income assets reflecting the client's low risk tolerance. The bonds yielded 1.5%, coincidentally the same as the annual management fee (the trust business can be quite lucrative). Since the trust was also taxable, the result was that while the Federal government and the trust company were making money out of this investment, the client regrettably was not. One consequence of the shift in outlook for bonds will likely be a great many more uncomfortable conversations between clients and advisers about a fair split of quite meager spoils.

The Equity Risk Premium, defined here as the difference between the earnings yield on the S&P 500 (inverse of the price/earnings multiple) and the yield on the ten year treasury note, has been an advocate for more equities and less bonds for a few years. Stocks remain substantially more attractive as the chart shows, but a consequence of the recent rise in bond yields has been to ever so slightly shift the balance between the two. We're still some way from where bonds could be considered appealing, and the equilibrium on the chart is 0.4%, some 3.6% away. A 6% yield on ten year treasuries, which is what this implies given current equity valuations seems implausible today and may never happen as long as central banks see fit to hold large amounts of U.S. government debt. So we may not be avid bond buyers for many years to come.

Bonds Are Not Forever



Apropos of the current investing climate, it appears that the timing of my new book, *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors* will be more fortunate than I had any reason to expect when I began writing it last year. It lays out the case against fixed income investing against a backdrop of too much debt and a financial sector that's probably bigger than we need. It will be out by the end of the Summer. A more detailed description will be in next month's newsletter.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

Pension Investing in Hedge Funds

It's now eighteen months since *The Hedge Fund Mirage* was published. It continues to receive attention, most recently in an article in The New Statesman. A few weeks ago I presented at the Trustee Leadership Forum, a group affiliated with Harvard University that brings together public pension fund trustees so that they may share ideas and generally benefit from the insights of their peers as they manage the retirement savings of millions of public sector workers such as policemen, firefighters and teachers. Many of the trustees do not have a formal background in Finance, and politics is a frequent if unwelcome companion to their deliberations. Public pension funds often operate with unrealistically high return assumptions, as much as 2-3% above those used for corporate pension funds. They are subject to different, non-GAAP accounting rules which lead to some odd outcomes. One is that they calculate the net present value (NPV) of their retirement obligations using the return they expect to earn on their assets. As The Economist pointed out a few weeks ago, under this framework holding cash pulls down the expected return and also increases the NPV of their liabilities. A pyromaniac pension fund manager who burnt the 0% yielding cash held by his fund could, under current rules, improve his pension fund's status by driving up the rate used to discount liabilities even while reducing the assets available to pay for them. Cash can be a drag, but it's not as bad as that.

One trustee brought this point home to me by noting that following my advice to avoid hedge funds with their 8% consultant-supported return target would similarly worsen her pension fund's deficit by lowering the discount rate for liabilities. Such is the cost of rejecting a high return asset. If only it was so simple. Evidently the expected return on hedge funds isn't subject to much rigorous analysis or even a passing resemblance with the most recent several years of history. The trustee further noted that such an increased pension deficit would invite political pressure to curb payments to beneficiaries. It was a revealing exchange, and illustrated the unique set of challenges facing today's public pension trustees. A flawed accounting framework combined with a political environment that invariably prefers to defer pension contributions is creating its own set of future challenges. So when hedge fund apologists point to pension money flowing into hedge funds as institutional validation of the asset class, they are confusing the bizarre world of public pension accounting with what they believe to be sophisticated investment insight.