



The Long & Short of It

Quarterly Newsletter

Third Quarter 2009

The Risk Trade

As in the second quarter of 2009, the markets continued to reward riskier investments during the third quarter of 2009, with nearly all investment categories rising in value. Returns ranged from the less risky short-term U.S. Treasury bonds (~+1.5%) to emerging market bonds (~+11%), to classic large cap growth stocks (~+11%), to emerging country stocks and distressed stocks (~+30% and ~+40%).

During the third quarter, the investment media significantly increased its use of a relatively new term, “risk trade.” Searching the internet using Google’s renowned search engine, we found 99,200 occurrences of “risk trade,” with 52,000 of them posted since the stock market bottom of March 9, 2009.

Over the last thirty years, the term “risk trade” has not been part of the curriculum of MBA or CFA programs. Yet since the March low in the market, the term seems to have been covered on

CNBC, Bloomberg, Fox News, newspapers, and numerous blogs as much as junk bonds, biotech, dot-coms, and credit default swaps were in their heyday.

On one of these blogs, the risk trade was described as *“anything that produces positive returns when we have an ‘all is well for now’ feel around the world.”* Going further, the blogger elaborates that *“if no scary things happen, a risk trade should do well, but as soon as something spooks the markets, the risk trade gets unwound. That’s why it needs to be liquid.”* Excessive sophistication is not likely when using the risk trade concept as a determining factor for an investment approach.

The two most liquid risk trades are global equities and currency carry trades. A currency carry trade is one in which an investor borrows in a currency with low interest rates, exchanges that money for another currency that offers high interest rates so as to lend the money out at those higher rates. It could be as simple as selling short bonds denominated in Japanese Yen at 1.0% and using the proceeds to buy Australian bonds paying 5.3%. It may appear to provide only a few percent per year in return, but in practice (and with sufficient leverage of say, 50:1 using futures contracts), any small variation in the markets can be enough to whiten the knuckles of the boldest speculators. The less liquid and more recent version of the risk trade would be commodities, in which large leverage can also easily be established. Most recently, the U.S. dollar is providing the low borrowing rates

Contrarian Value Equity Composite Portfolio Fundamentals as of 9-30-09

| | RVM Equity Composite | S&P 500 |
|---------------------------|-------------------------|------------|
| Number of holdings | 27 | 500 |
| Wtd. Avg. Mkt. Cap. (\$B) | 51.0 | 76.6 |
| Price/Earnings Ratio | 15.8x | 21.1x |
| Price/Book Ratio | 3.1x | 3.3x |
| Price/Cash Flow | 8.0x | 9.7x |
| Dividend Yield | 3.1% | 2.1% |
| Return on Equity | 25.5% | 4.3% |



instead of the Japanese Yen. It is hard to predict what this “dollar carry trade” means to our country’s reserve currency status, though it is hard to see it as good news.

Why the new found popularity for the risk trade? History is full of examples of speculative activity by investors while governments attempt to create a better economy by tinkering with the nearest sledge hammer. Describing similar times during the Roman Empire, the historian Jerome Carcopino wrote that “work might still ensure a modest living, but no longer yielded such fortunes as the imperial favour or a speculative gamble might bestow...speculation was the life-blood of an economic system where production was losing ground day by day and mercantilism was invading everything.” (Carcopino, *Daily Life*, p.80.)

As investors and bankers conclude that the cost of money in dollars (our domestic interest rates) will remain low for a long time, for them it must feel less like a speculation and more like a sure thing. Disappointing economic news encourages our government to continue expansionary monetary and fiscal policies, so speculators take more risk.

It is not traditional investing in the sense of providing long-term capital to sound businesses so that they may manufacture a product or provide a service. For example, it is investing to buy an energy company for its healthy prospective return on investment which might result from the firm’s superior ability to find, produce, market, and distribute its product. It is speculating to buy energy companies because of one’s opinion that energy prices will increase during the next year.

If the U.S. economy were to surprise in the strength of its recovery, our interest rates would rise and the dollar would strengthen significantly, causing great damage to those engaged in the risk trade.

Risk on/risk off. It sounds like bubble creation all over again. So, the risk trade will work until it doesn’t...and when it ends, it will end ugly. Risk on/risk off. It reminds us of Mr. Miyagi’s training of Daniel-san in *The Karate Kid*. Young Daniel was expecting some rigorous “how to” karate training from the master at the outset, but instead Miyagi tells him to do various chores, showing him the precise ways he wants those things done.

After painting the house, painting the fence, sanding the decks and, finally, wax on/wax off the car, Daniel was ready to quit, believing he was being used as a slave. Miyagi then demonstrated that those chores were to build up strength and muscle memory of how to perform various blocking actions. *THEN* Miyagi showed Daniel how to punch, kick, etc. Realistically, these were effective training methods in regards to strength and motion, but were no substitute for the real training to follow.

Risk on/Risk off. It is clearly too simple, yet it seems to be the new functional fixation for so many investors the world over. Perhaps it has risen out of the frustration caused when most of the “diversification” ideas of the last decade, especially international stocks and commodities, saw their low correlations rise toward one (all moving together) when the global meltdown occurred.



It is during a large decline, when low correlation is most needed, that diversification fails. The lack of downside protection offered by emerging country stocks was no surprise to us, as they have behaved similarly in deep economic down-cycles prior to 2008. Unlike the risk trade, this lesson actually was covered in the CFA educational materials. It is one thing to minimize deviation from a benchmark or even to reduce the standard deviation of returns. It is another exercise altogether to reduce loss during a global meltdown in the financial markets.

So perhaps that is where investors find themselves. From late 2007 to March of 2009, investors found that the plan (diversification) did not work, so they panicked and exited the plan (risk off). After March of 2009, needing some form of return and deciding that low interest rates and the tripling of our monetary base might keep the world from ending abruptly, investors have returned, moving quickly to what is working now (risk on).

One of the ways that we work to minimize risk of loss in client portfolios is through credit analysis. In the “behind the veil” world of credit ratings research, Egan-Jones is RVM’s firm of choice. We have always been uncomfortable with the issuer-pay model used by other credit rating firms such as S&P and Moody’s. Having used them throughout the 1990’s, we

| Credit Rating Categories | Common Equity Price Increase from 3-9-09 to 9-30-09 |
|--------------------------|---|
| AA+, AA, AA- | 34% |
| A+, A, A- | 59% |
| BBB+, BBB, BBB- | 81% |
| BB+, BB, BB- | 146% |
| B+, B, B- | 139% |
| S&P 500 Stock Index | 55% |

found that they tended to report the good news about their clients much sooner than the bad. Egan-Jones, who is only paid by subscribing investors, received approval as a Nationally Recognized Statistical Rating Organization in 2007. RVM client portfolios have benefited from their research since 2002, but especially in 2008.

Of the 200 industry leading companies that we follow closely, the average price increase since the March stock market bottom has varied dramatically depending on the credit

rating of the firm. While the price increase of the S&P 500 has been 55% during the period, the average price increase of the common stock of companies when segregated by ratings category has dramatically favored those of lower financial strength, particularly those near death six months ago. The risk trade is on.

As investors, there are risks we like to take and risks we do not like to take. Excessive credit risk is one we do not like to take. In the long-run, it has too often gone hand-in-hand with our least favorite risk: the risk of loss. While there are many elements to our risk management, our primary efforts have always focused on limiting the risk of loss through knowledge of the financial strength (credit), pricing history and prospects (valuation) for the companies in which we invest. The risk that an over-sold, under-loved company with productive assets and a strong balance sheet might survive and even prosper is a risk we seek with every investment we make.



To use a simple shipping analogy, we do not attempt to move all of our cargo from point A to point B by putting all of our goods onto the ship that is moving at the fastest pace in today's prevailing conditions. Instead, we seek safe passage from numerous carriers; each with solid long-term records of safe transport in well-built and maintained ships, as well as a staggered schedule that will not have all our cargo on the seas at the same time.

Clearly, some exposure to credit risk makes sense. After all, investors are paid for taking risks and there are many variations on a strong balance sheet. However, loading up on stocks or bonds of companies with financial strength levels that are below investment grade is not the kind of calculated risks we advocate for our clients.

In our studies we have found only one thing that surpasses the quality of the companies that reach our short list; and that is the exceptional clients we are fortunate enough to know and serve. They are stalwart advocates for our loss-averse approach and we are very grateful for their vote of confidence and the trust they place in us.

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