# The Long & Short of It

Quarterly Newsletter

Fourth Quarter 2010

### *Improving, but Not Fixed*

Given the vagaries of early 2010, the question we asked in our last newsletter was, *"What if the uncertainties were to dissipate?"* In the third quarter, we noted that valuations were compelling for many equities, and that, *"All the money currently being printed will surely make its way into prices at some point."* As Washington received a message from the electorate to slow down the changes, the stock market responded. During the fourth quarter, stocks generally returned about 10%-16% to investors, with small-caps outperforming large-caps. For 2010, stock returns averaged 16%, with the S&P 500 at a slightly lower 12.8% due to its heavier weighting in large-caps. Rising interest rates took back some of the exceptional performance seen by mid-year in the bond market. For taxable bonds, the high single-digit year-to-date returns from the end of the third quarter were halved by year-end, ultimately leaving investors with solid mid-single-digit performance.

One of the more interesting developments during the fourth quarter was the decline in tax-exempt bonds as increasing investor concerns over state and municipal budgets accompanied a 7%-9% drop in prices. Although material problems in tax-exempts remain, panics often bring opportunities. Most states and municipalities are not in crisis, but their paper will become cheap along with the entire space. Even for the challenged, the remedy for a budget problem is typically easier to negotiate than the remedy for bankruptcy. However, the public must be educated about this situation as it is political in nature. The media will be more than happy to oblige in assisting with this education, knowing that their sensationalism on the subject matter will sell well in most markets. We will be observers if a panic materializes, ready to offer our monetary support to any prudently run credit that is dragged into the pond by the stampede.

### *New Bubbles Being Blown*

Today, cash balances continue to yield essentially nothing as the Federal Reserve perseveres in its efforts to stimulate the economy. This is not new. The 1998-1999 global recession witnessed multiple interest rate reductions by central banks worldwide. The resulting liquidity triggered the dot-com and mega-cap equity bubbles that ended with the bear market from March 2000 to March 2003. Again, central banks lowered interest rates from 2002 to 2004 to stimulate growth, fostering the real estate bubble that unwound in the 2008 credit crisis.

Today, according to academic and popular sources, the economy has reached a "New Normal" consisting of substantially slower long-term economic growth. While we agree that the aging population in the US will force Americans to live with lower real growth rates and less ability to expand debt, Mr. Bubble is rearing his ugly head again. In fact, as money pours forth to stem the decline of real estate prices, much of this government largesse is flowing into other areas besides real estate lending, creating new misallocations of capital and, yes, bubbles. Although the domestic stock market is now about 90% above its 2009 lows, it remains 17% below its 2007 peak. Similarly, China's stock market has risen 150% above its lows but remains 32% below its all-time peak. In addition, real estate remains on life support, providing many with evidence of the need for more stimulus and low interest rates.

But let's look further. In round numbers, silver, copper, and cotton prices have tripled over the last two years. Sugar and coffee have doubled in the last seven months. Just as water will always find the path of least resistance, liquidity in the economy has to go somewhere. This time, it is flowing into food and agricultural products. As with most bubbles, no one knows when it will pop or if it will continue while the runoff is channeled into other sectors of the economy. But if all this leaves you in need of a little comfort food, relax and have some chocolate. Cocoa remains range-bound and well under its 2008 high.

### *Speculation vs. Wealth Creation*

Prices of commodities can be exceedingly volatile. When they eventually come down (and we do not pretend to know when they will), the drop will likely be frightening. Yet for all this volatility, commodities remain cash instruments. They are neither a means of production, nor are they financing instruments that provide capital to others who control a means of production. They do not create wealth; they store it. Commodities do not command a stream of wealth such as ongoing earnings, dividends, or coupon payments. Like gold and art, they are a store of value, although they may not share the longevity of a troy ounce or a Vermeer painting. As a result, commodities—like currencies—are merely vehicles for speculation rather than investments.

Moving into cash equivalents (e.g., money market funds), we leave behind speculation and enter the world of wealth creation and investment. Many cash instruments can actually be considered fixed income instruments with very short maturities. Investments, unlike commodities, provide more than just a store of value. They offer ownership of the means of production, something for which Americans have always had a great affinity.

***The Role of CAPM***

The way investments are priced in the market is in part explained by the Capital Asset Pricing Model (CAPM). This fundamental theory of modern finance makes the claim that as the risks of holding an investment (a wealth-creating instrument) rise, the return ("rents" paid to the owner) should increase over the long run.

The CAPM holds that the riskiness of a capital asset (stock, bond, or cash held in an account) can be approximated by its volatility. It also suggests that, in the long run, greater levels of risk will be accommodated with greater expected returns. Interestingly, history has proven the theory clearly valid when applied across asset classes, but less so within each asset class. In other words, moving from cash (money market and other cash equivalents) to bonds (fixed income instruments) to stocks (equities) will create increased risk, for which an investor can expect to be more richly compensated. However, within each asset class, the tradeoff is not as dramatic.

For example, consider the difference between long-term and intermediate-term government bonds (US Treasuries) from 1926 to 2008. The summary statistics published in the 2009 edition of *Ibbotson SBBI* show that longer-maturity bonds have required investors to stomach 3.7% more standard deviation (65% greater risk) than with intermediate bonds, while only picking up an extra 0.3% (or 6% better result) per year for all their trouble. 6% more return for 65% more risk? It is hard to see how that would be worth it.

| Investment Instrument | Geometric Return | Standard Deviation |
|---|---|---|
| Long-Term Gov't Bonds | 5.7% | 9.4% |
| Inter-Term Gov't Bonds | 5.4% | 5.7% |
| Small Company Stocks | 11.7% | 33.0% |
| Large Company Stocks | 9.6% | 20.6% |

Similarly, by holding small-company stocks, one has to suffer through 12.4% higher standard deviation of returns (60% greater risk) than with large-company stocks, yet an investor is only compensated an extra 2.1% (or 22% better result) per year for the greater variation in return. For such an increase in risk, our math says the expected return would need to be 4.6% better to be worth the risk taken. This level of increased risk is no small thing when trying to sleep at night during a steep sell-off (something we like to call the "sleep factor"), especially if one is attempting to muster the courage to "buy low" when stocks are inexpensive and out of favor.

***The Merits of Low-Volatility Investing***

Using more volatile stocks will eventually force the investor to put less in equities. As we have seen, this is a decision that is harmful to long-term returns. Rather than pushing for better portfolio returns by owning more volatile stocks, we recommend a heavier allocation to low-volatility equities. Owning low-volatility stock makes it easier for investors to maintain a greater allocation to stocks—a decision that history has shown to significantly increase the expected return of a portfolio. In addition, an investor will have a better "sleep factor" during bear markets and avoid the temptation to panic at market bottoms, which would be even more damaging to long-term returns.

Some adherents of low-volatility investing merely use quantitative screens to look for low standard deviations in the universe of stock returns. At RVM, we stick to the old-fashioned way: doing our own homework from the bottom-up, company by company—looking for certain characteristics and story lines that have historically reduced downside risk while preserving upside potential.

We hope you have a productive remainder of your quarter. Call us anytime; we would love to hear from you.

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