March 22, 2013

"It’s not what you don’t know that kills you, it’s what you know for sure that ain’t true."
-MARK TWAIN

Often unknowingly, we perform risk-reward calculations in our daily lives. Something as basic as eating dinner at a restaurant involves risk, though you may not realize it. You risk injury as you commute to that dining venue. You risk illness when the food is prepared. And, at the end of the meal, you risk fraud when the server processes your credit card. While likely subconscious, these are risks you have analyzed and deemed worthy of taking. The purpose of this little anecdote is to remind investors that risk really is constantly around us. Furthermore, the notion of avoiding risk altogether is foolishly impossible, yet risk becomes acceptable when we can identify it and analyze it. But ultimately, risk is most dangerous when its presence is undetected. In today’s investment world, risk is as unobserved as it’s ever been.

In the 1950s, Harry Markowitz introduced modern portfolio theory (MPT). Along with MPT came the framework of the Efficient Frontier (see the chart below). Sixty years, and a few Nobel Prizes later, this way of categorizing risk and return is considered Gospel in the world of portfolio construction.

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Investment managers around the world use MPT as the cornerstone for assessing the amount of risk in a given portfolio. For clients who seek the least amount of risk, and are willing to forgo higher returns, investment managers typically increase the allocation to those asset classes at the lower left of the curve (i.e., cash, Treasury bills, corporate bonds). Clients seeking "aggressive allocations," and higher returns, are likely to hold more securities toward the upper right. This all may seem rather routine and obvious but there is one small problem: Given the forces at work within the financial system today, the Efficient Frontier completely misstates risk and return. I am not the only one who believes this to be true. Recently, I sent an email to Charles Gave, co-founder of GaveKal Research and Capital, and one of the most respected investment strategists in the world. In the subject line, I typed, "Efficient Frontier," and in the body of the email, I simply pasted the chart shown above. Below is the email he sent in reply:

Dear Tyler

I keep telling clients since prices at the beginning of the risk curve are all controlled by the central bank, so are the volatilities. The central banks have suppressed the volatilities but they have NOT suppressed the risks which will come back one day. So the least dangerous part of the curve is the extreme right where there is still some market determined volatility. To reduce the risk, one has to increase volatility, which is a very strange result, and the only way to reduce the risk is through diversification at the extreme right. All that is very strange.

CG

This is counterintuitive. For three decades, we have been in a bond bull market as yields have fallen (meaning prices have risen) from the historic peaks of the early 1980s. Bill Gross, who co-founded PIMCO, which now manages over $2 trillion (yes with a T) in assets, has said even he thinks long-term treasuries are a short. What’s driving this bubble in Treasury bonds? Since 2008, the Federal Reserve (along with central banks around the globe) has undertaken an unprecedented policy of monetary easing. The Fed has grown its balance sheet from 6% of GDP in 2008 to almost 20%. For those of you who think that speaking in percentages can distort statistical truths, the Fed has expanded its balance sheet from just under $1 trillion in 2008 to almost $3 trillion through 2012 (see chart below). No matter how you slice it, we have seen an unprecedented period of easy money policies, not just domestically but also by central banks around the world.

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Their goal has been to stimulate growth by forcing investors to rotate out of safer assets into riskier assets. The S&P 500 is up over 100% since the bottom in March of 2009, making stocks a primary beneficiary (so far) of these dovish policies, as seen in the chart below.

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However, as Charles points out, the byproduct of ultra-easy monetary policy is artificially inflated asset prices on the left side of the Efficient Frontier (clearly, many asset classes on the right side of the curve are also being pumped up by the central banks, just less). This means that assets which are universally accepted as the least risky are, in fact, the most risky. I can’t recount how many times I have heard people say things like, "I don’t want to risk losing money, so I’m in all cash." Many investors mistakenly believe that cash is the foolproof way to protect their assets.

Since 2008, if you have held cash, you have lost 11% of purchasing power as inflation has averaged just under its historic average of 3.2%. What happens if this easing binge triggers the inconceivable…. above average inflation? (Hint: Cash would be closer to jester than King.) Those willing to dismiss inflation concerns are convinced either that the central banks will stop easing or continued easing simply won't lead to increased inflation. We remain skeptical that one can count on global policymakers to orchestrate an elegant exit from what's become a very sticky situation.

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Even if you dismiss inflation as a serious threat, you're not out of the woods yet. This week, the government of Cypus did a 180. One week after the country's president announced a tax on bank deposits was essentially out of the question, a "tax" was placed on ALL bank deposits. We think the precedent this sets may trigger such a severe backlash throughout Europe that the tax will never take effect. Astute observers point out that Cyprus is a minor concern. After all, its GDP is smaller than that of Tucson, Arizona. However, it's a microcosm of what's likely ahead for the larger, struggling European countries, particularly its Mediterranean neighbors.

Bulls may argue that this is a near-term positive for US investments, (including stocks) as pandemonium spreads through Europe, causing investors to look across the Atlantic for safety. However, while they may be right for a period of time; at some point, the reality of the US debt situation has to take hold. The chart below clearly outlines the problem we are facing. It's not a political problem; it's a math problem. There are too many benefits promised to too many people with not enough workers to make this pencil out. There is good news and bad news when it comes to America's problems. The good news is that there are numerous credible solutions. The long-term health care obligations promised have to be—and can be—revised in a logical way before we bankrupt the country, as other nations have demonstrated. The bad news is it's an extremely unpopular topic that few US politicians, who continually display all the courage of the Italian army in front of Stalingrad (which, in technical military terms, means not so much), have seriously addressed. Below is a chart outlining the Congressional Budget Office (CBO) spending forecast through 2051.

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So where is an investor to turn? Cash and government bonds face serious risks we've already outlined. Admittedly, the risk in the US is more of a stealthy inflation erosion versus a dramatic overnight "haircut" as seen in Cyprus, with more shearing likely in store for other European depositors. However, even US safe assets are already guaranteed losers, even if we assume moderate inflation. And, unfortunately, that is likely to become even more pronounced if the Fed fails to tighten in a timely manner. (Important note: This is not to say that cash shouldn't be held for tactical reasons right now, such as to take advantage of a market correction.)

Stocks appear to be overly popular with investors as this January we saw massive inflows to US equity mutual funds ($39.6 billion), even larger than the inflow in February 2000 ($34.6 billion), one month before the tech bubble burst. Basically, the decision feels like choosing between getting a root canal or a colonoscopy.

The reality is that investors aren't facing a lose-lose situation, but they must adapt, and quickly. In fact, our clients are, in many ways, positioned to benefit as the consequences of easy money policies and ballooning deficits play out globally. Frankly, the people who are most likely to be harmed are those who have limited or no access to diverse financial instruments and truly prophylactic investment strategies.

Evergreen has been taking steps to protect clients' assets against these risks, even at the sacrifice of current profits. First, while it would be far too extreme to eliminate all exposure to the US, we have started to diversify outside our borders. Specifically, we have been buying Canadian bonds with short maturities paying 3%. To most investors, yields of 3% are about as appealing as watching a TV marathon of Keeping Up With the Kardashians. In all seriousness, 3% yield plus potential currency appreciation, along with the relative safety given Canada's economy, makes it quite attractive. Second, we have been positioning our clients' portfolios tactically by increasing positions with inflation-protected attributes, such as adjustable-rate bonds. Additionally, we have continued our purchases of master limited partnerships (MLPs). These securities provide inflation protection and are a high cash flow way to play the energy boom in America's heartland (which, if it were a separate country, would be a far better credit!) Another key asset class that we think benefits from the central bank actions is gold. We understand the Warren Buffet hatred of gold argument, in which he contends, "Gold has no utility." In certain contexts he is right, but this isn't one of those times. Gold, as noted in the chart below, has demonstrated itself as a way to store value when a currency gets debased (diluted.)

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Collectively, the assets we've been purchasing are meant to not only protect client assets from the outcomes we see playing out over time, but to actually profit from them. Being able to utilize different asset classes as we see fit is a tremendous advantage over many of our competitors. Frequently, investment managers today are confined to specific investment boxes, either because of an investor mandate or simply a lack of resources. (Our global partners, client trust, as well as our own experience, make this a competitive advantage for our firm.) We believe this is a big reason why many of our clients were able to profit from the volatility seen during the last financial crisis.

We want to be clear about our long-run outlook for the US economy: We are not perma-bears. Actually, we are quite the opposite. The US has a lot going for it. The current energy boom has the potential to make the US energy independent. Further, the International Energy Agency (IEA) estimates the US could be a net exporter of oil by 2030. Many people would have bet this could never happen in their lifetime. There were times when saying Elvis is alive, and still leaving the building, sounded less crazy than US energy independence. And, affordable energy isn't the only tailwind. Automation has helped America re-emerge as a player in manufacturing. We are home to 49 of the top 100 universities in the world. Silicon Valley is still the heartbeat of the world's most groundbreaking technological innovations. Last, but not least, our financial system, for all its flaws, is the most nimble, dynamic, and robust in world. It is also now commendably well capitalized.

Getting back to the here and now, we believe the most immediate risks the financial markets face are those in Europe. Regardless of what the media reports, this situation has yet to be addressed. The reality is there are two outcomes: The euro breaks up, which a war-weary Continent seems unwilling to accept. Or, the northern countries, which have lent money and sold goods to the southern countries since the euro was created, foot the bill. Neither resolution is likely to occur without triggering serious instability. Even if this is resolved, it won't address the mounting US debt we have discussed at length in past EVAs. This issue too must be addressed, and if you think the politicians are likely to deal with it in a timely manner and without disturbing financial markets, you have more faith in Washington than we do.

Alas, we do think, as Churchill said, "The Americans will always do the right thing… after they've exhausted all the alternatives." We believe that serious progress on the US fiscal situation will set the foundation for the next bull market. The road will be rocky, but volatility creates opportunity, as we saw in 2008.

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IMPORTANT DISCLOSURES