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Thursday, March 28, 2013

Risk: "Exposure to the possibility of loss, injury, or other adverse or unwelcome circumstance; a chance, or situation involving such a possibility." - from the OED

Dear Friends,

We spend a lot of time seeking to avoid risk, contain risk, mitigate risk, and regulate risk. However, risk is ubiquitous in life and often misunderstood. Whether you are crossing the street, walking down icy stairs, managing a business, or investing your financial assets, there is risk. Risk of doing the wrong thing and risk from doing nothing. Risk is: latent, non-quantitative, subjective, illusive, and undesirable; but, is it avoidable?

If you attended one of my recent presentations, you will know that I spent much of the time discussing perceptions of risk vs. realities of risk along with analysis of how risk has revealed itself and played out over the last exaggerated economic and investment cycle, and, more generally, over the past 100 years or so. One of my key contentions is that the price of safety today is more expensive, and potentially more dangerous, than ever in the history of financial markets. And, this has created investment opportunity in assets many believe to be "risky," but are actually cheap because they are priced with the risks factored in.

Current risk premiums for various assets are at unprecedented levels on a relative basis. The ten year treasury yield is 1.86%, far below the long term average of 6.62%. This compares to a dividend yield of 2.1% for the S&P 500 - meaning that stocks provide a higher annual income than treasuries which normally pay 4-5% more each year. The earnings yield for stocks is 6.9%: higher than the 6.7% yield of non-investment grade (high yield/junk) bonds which have also traded at a 4-5% premium (to the earnings yield of stocks) historically. Money market funds pay a paltry .1% and 1 year treasuries are at .16%. Inflation has averaged 3% since 1926, so bond investors are losing money on a real basis, yet money continues to flow in that direction because investors are mired in the fear created by the real estate credit bubble which burst in 2008, and that fear is fed by ongoing crises, real or imagined, in the United States and elsewhere, most recently Cypress.

What this means, in plain English, is that bonds are expensive. You can hold them to maturity and get paid a meager annual income, but will lose money to inflation and endure unrealized losses at some point since they will trade down in price when the Fed starts to raise interest rates.

Yes, that time will come, perhaps earlier than most expect. The Congressional Budget Office projects that the US economy will return to it's long term "potential" growth rate of 2.5% by 2017. That would require an acceleration of economic growth to over 4% between now and then. This after negative 3.7% growth in q3 2008, -8.9% in q4 2008, -5.3% in q1 2009, and rather anemic growth of 2-2.25% over the last 4 years. However, in the 3rd quarter of 2012 the economy grew at 3.25% which is higher than the 25 year average of 2.5% and the 30 year average of 2.9%. If gdp continues to grow at 2.25% it will take over 5 years before unemployment declines to 6.5%, the level which the Fed says will cause them to discontinue quantitative easing and other stimulative programs. If the economy maintains the 3.25% growth of the 3rd quarter, it would take 1.8 years for unemployment to fall below 6.5% meaning we would be at the Fed target before the end of 2014. At a growth rate of 4%, the US economy would be flying, job creation would be stunning and investor concern would likely turn to the specter of inflation - why not trade one fear for another?

US private pension funds have only 33% of assets allocated to stocks compared to an average since 1960 of 45%, and can't possibly meet their long term benefit obligations at current bond rates. They must reallocate to stocks at some point in time. Corporate and sideline cash levels are at historic highs and mutual fund flows to equities are negative, yet stock markets have enjoyed one of the great rallies of all time from lows in March of 2009. So, what gives?

Financial Markets tend to reveal economic truth before most investors know what it is. They started declining in the fall of 2007, well before the rotten core of credit markets was exposed, and have been rallying since March, 2009 despite most experts decrying the horrors of 100% debt/gdp ratios and enormous annual deficits. I spend a great deal of time on dry websites such as the Bureau of Labor Statistics and this has convinced me that fundamental data on US economic activity points compellingly towards sustainable and accelerating recovery. This is being aided by the actions of the Federal Reserve board, but is primarily driven by rising activity in manufacturing, housing, services and overall improvement in business and consumer confidence. The truth is that growth will solve our problems and it is happening right in front of our eyes. Corporate earnings and domestic economic output are at all time highs and continuing to grow. Initial weekly jobless claims have been falling habitually since June of 2009 which always presages declining unemployment. Re-employing people, thus getting them off entitlement programs and paying taxes again, is key to solving the debt problem.

However, that is not the only thing that will lower the national debt. Intragovernmental agencies, including the Fed, are the largest owners of US debt with holdings of over $4.8 trillion in government bonds. (Note: despite $16 trillion in national debt, the cost of carry/interest payments is lower now than 10 years ago because rates are so low). Once the Fed stops buying debt (by mid 2014), it will begin to fall off the books as it matures and, if they start to sell, that will effectively repatriate capital to the treasury accomplishing the same thing. This is not the only time debt/gdp in the US has been exceptionally high. We entered the Civil War with only $65 million in debt and exited with $2.7 billion which was largely paid off over the next 40 years. Similarly, debt/gdp soared after the 2nd World War and took a lengthy period to be paid down, but the economy grew rapidly in the 1950's and '60's even with the need to rebalance the federal budget as we must do now.

As I write, the S&P has traded above 1,565, the high reached in the fall of 2007. A similar peak was established in early 2000 and many believe we will fail to rise from this level once again. I don't: valuations for stocks are approximately half what they were in 2000 and we are not facing the crisis of 2008, but rather an improving outlook. On average, since 1960, in the periods following recession, stocks have risen to levels roughly 1/3 higher than their pre-recession peak. If this happens in the current cycle, the DJIA would rise to 18,500-19,000 and the S&P 500 would exceed 2,000. Markets have largely traded sideways (with big swings) over the last 12-14 years and, I believe, have set the stage for a bull market cycle that could be as powerful as the rally of the 1980's when stocks went up 250%, or the '90's when they rallied 400%.

I am reminded of a quote from Wayne Gretzky: when asked how he managed to score so many goals his response was: "I skate to where the puck is going, not where it has been." With that in mind, I'd like to suggest readers focus on the opportunities of the current environment rather than the difficulties of the recent past. As Gretzky said, let's skate to where the puck is going - for those seeking superior risk adjusted investment returns, this includes buying US equities, and having a look at securities in Europe where policy makers have embarked on a concerted effort to face economic realities heads up and head on, and trades at a 40% plus discount to the US.

I hope our enthusiasm for the investment opportunities ahead of us is evident in this letter. We have plenty of ideas and a sound strategy for achieving returns. Our goal is simply to engage you in conversation please call or visit to learn more, or to have us review your portfolio.

Happy Investing,

Terry