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Déjà vu All Over Again

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

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I trust this letter finds you well as 2010 draws to a close. It has been nerve wracking but ultimately positive year for investors as we continue to put some distance between ourselves and the lingering tumult of 2008/09. I wish you and your families well in 2011, and I deeply appreciate your continued very strong loyalty and trust, and I look forward to a long and prosperous future.

Déjà vu All Over Again

This essay title is from Yogi Berra, its deep investment meaning borrowed by Sir John Templeton with his quip, “The four most dangerous words in investing are, ‘This Time It’s Different’”.

Investor sentiment today is as negative as I can recall in 30 years. At a recent dinner party my comments on the positive potential of the world economy were met by a brick wall of disbelief. Fellow guests would have none of it – US debt, Irish financial collapse, the Chinese steamroller, US property values; all were trotted out as signs of impending doom.

The disbelief is the other side of the brick wall that met my skepticism about Nortel in 1999, when I said – to the same group - that Nortel at $122 didn’t stand a hope of working out[1]. Investor sentiment at that time was optimistic, to say the least.

[1] See ‘What a Stock Bubble Looks Like’, April 1999, www.chrishoran.ca

The déjà vu was unmistakable. Last time, skepticism met the brick wall of public opinion. This time, optimism. The disbelief is exactly the same, yet totally different, than last time.

The gloom today obscures the fact that the world economy is growing, and great investment opportunities present themselves. Four of the five largest populations in the world are growing their economies between 6% and 9% per year – a rate that will double their size in less than 10 years. Think about that – doubling the standard of living of almost half the population in the world would be one of the greatest accomplishments in human history.

Gloomers should note that unemployment in Germany is at a 30-year low, and US retail sales growth has been at 5% for most of 2010. US non-financial corporations have more cash on hand than at any time in the last 30 years, putting them in an excellent position to begin a virtuous cycle of investment in people and equipment.

Corporate treasurers know a bargain when they see one: When you have tons of cash and your stock is cheap, you buy your own shares. Standard & Poor's projects that US corporations will buy back $300 billion of their own shares in 2010, having already bought $77 billion in Q2 alone, according to Nick Murray, a long-time industry advisor.

Individual investors want none of the optimism. Individual investors are shunning shares of those same high-quality firms. In the 12 months to September 2010[2], individual investors have collectively sold or redeemed almost $9 billion of shares in Canadian, US, and global companies, continuing a trend almost identical to 2009 figures. Even as the values of those shares have risen about 80% from the low of March 2009. The trend in the US is more pronounced.

Where did the money go? We can't track exact dollar flows, but a very similar amount, about $9 billion, went into bond funds[3]. Bonds are now at the lowest yields in the memory of almost anyone alive today. Because bond yields move inversely to their price, the lowest bond yields in memory equate to the highest prices in memory. (See 'Primer on Bonds' page 5)

People are willing to pay almost any price for the apparent safety of a bond – for instance, an issue of 2 year US Treasuries actually went at a negative yield in the summer of 2010, as reported in *The Economist*. That means buyers paid more than the value of the bond plus interest. Hard to believe. But true.

The poster child for value stocks these days is Johnson & Johnson (J&J). J&J has a dividend yield of 3.5%, and has increased its dividend *every year for 48 years*. Very strong financially, J&J has $19 billion in cash, is one of only 4 AAA-rated companies in the US, has a globally respected reputation and sells products throughout the world, according to Danny Bubis of Tetrem Capital Management.

The dividend yield on J&J is about 35% more than a 10-year government bond yield. As Bubis says, I can't tell for sure if the J&J dividend will go up in the next 10 years, but given management's record it probably will. If global growth continues at the 5% estimated by The Economist for 2010, the dividend may go up substantially.

So government bonds are more expensive than stocks like J&J – for the first time since the 1950s. Bond buyers today prefer a 2.5% yield that has no hope of going up, instead of a 3.5% dividend that could easily be 50% higher in 10 years.

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[2] Investments held in mutual funds as measured by industry association IFIC, 12 mo to 09/10.
[3] Over $20 billion has flowed into balanced funds, many of which are predominantly bonds.

Why are investors so negative about high quality companies? Why are they preferring to put billions and billions into investments [bonds] that are currently popular because they have done well in the recent past, yet have no prospects for increasing income, no prospects for growth, and not even any ability to provide purchasing power for today, never mind 10 years from now?

If the paragraph above gives you a sense of *Déjà Vu All Over Again*, you are on the right track. If it sounds a lot like investors dumping value stocks for technology stocks in 1999, go to the head of the class.

Bonds and Tech Stocks

That's it: the preference of investors for bonds today is precisely the same as the craze for technology stocks in 1999. The situation of course is *completely different this time*. Bonds are not the same as tech stocks.

Except that people are buying bonds today for the same reason they bought tech stocks in the craze of 1999. Back then, value stocks had had a sickening decline and a zero return for 3 years because of the 1998 Far East currency crisis and Russian debt default, while tech stocks produced billionaires.

Today, bonds look great because they *didn't go down* in the recent crisis, while value stocks were mauled. Not only do bonds look great over the recent past, they compare well over longer periods too, having ridden the tailwind of declining interest rates for 30 years.

Don't get me wrong: the common preference today for bonds is completely understandable. Investors have all been traumatized by the financial crisis and nobody wants to live through that again.

However, the preference for bonds is retrospective and therefore highly likely to be wrong, because with interest rates at zero, bonds' performance of the past is a mathematical impossibility. Yes, it is different: last time the blindness was caused by the dot-com billionaires, this time it is the terror of 2008/9.

Of course, bonds won't flame out in a spectacular crash that leaves them 50% below their highs 10 years later, like the tech stocks have. It is, after all, different this time. This time, investors seeking safety in bonds at any cost from the terrible, gut-wrenching stock market volatility of the last 5 and 10 years will, in all likelihood, look back 10 years from now and be disappointed. Or maybe worse.

The first disappointment will be sometime soon, when the currently popular forecasts of never-ending doom and gloom for the world economy are busted by actual growth, and interest rates move up from their low of zero. [Last time was different: it was the balloon of never-ending growth forecasts that touched the pin.]

This time, with world economic growth of almost 5% estimated for 2010 with less than a month to go, people will wonder how they could have thought we were still in a recession that actually ended more than 18 months before. [Last time people wondered how they could have thought Nortel was going to the moon when it didn't turn a profit]

This first disappointment will hit the bond investor between the eyes, just like in 1994, when rates began to rise after that (mild) recession, and bond prices dropped sharply, shocking the bond market with the first capital losses since the 70s.

Ah, yes, sometimes it *is* just like last time. Except last time –1994 - was a long time ago.

The second disappointment will be when all this monetary easing has to be mopped up in the face of a growing world economy, and interest rates need to go up again. Just when bond investors thought the pain of a capital loss was over, they'll get another one. Like stubbing a toe twice.

There may even be a third disappointment. It is possible that rebalancing the trade flows and currency imbalances between the three biggest players in world trade (America, Germany, and China) doesn't go perfectly smoothly. Maybe there's a surprise, say, as Germany or Greece exits the euro, or China exits the US dollar. Or maybe the inflation genie gets out of the bottle.

Ah, yes, just like in the 1970s, when inflation cut the value of long bonds in half[4].

Bonds are not the answer. Bonds may mitigate short-term volatility risk, and that may be a very important thing, but they are most certainly NOT risk-free. Bonds only move the risk somewhere else. Someone trying to withdraw 5% a year from a portfolio of bonds today actually faces a mathematical certainty that their capital will be at least 30% lower in 10 years. After inflation, it will be more like half – where's the 'no risk' in that?

Looking Forward

OK, so enough trashing bonds, what's my advice?

The pessimism of today is understandable, but misplaced. The world that was supposed to end in 2009 has not ended. World trade that stopped in 2009 has rebounded strongly. US jobs, always the last statistic to recover, that were declining by over 700,000 per month in 2009, have been positive for all months in 2010 (except January). The Canadian economy replaced all its lost jobs months ago and Alberta again faces labor shortages. Canada is booming.

All this economically useless government spending is coming to a dead stop after taxpayers in the US and Toronto have stepped firmly on the government's fiscal air hose and - guess what – are demanding the same fiscal responsibility from governments that we expect from ourselves. German voters are in open revolt at seemingly endless rescues of irresponsible PIIG[5] governments and bankers. All this is the right thing to do, and will lead to a better future.

My advice is to deal with facts and look forward. Have confidence in the investment plan that we have for your future. Know that my optimism is seriously considered, based on 30 years experience, with the *gravitas* of investing my own money exactly the same way as my clients' (except I own no bonds). Your portfolio has been designed to fit your specific situation. Be skeptical in times of confidence, and more importantly, have confidence in times of fear.

[4] SML Long bond index, 1971 -1981, Canadian Economic Tables, 13B, Towers Perrin, 1989
[5] Air hose expression from Nick Murray, PIIGs are Portugal, Ireland, Italy and Greece

Primer on bonds

The great bond bull market that began in 1982 is over. The crying will begin with the first uptick in rates. That uptick has begun already as lenders demand high interest rates to compensate for PIIG default risk – what Eric Bushell of Signature Advisors calls ‘The Revenge of the Lenders’.

There will be at least some ‘restructuring’ of spendthrift European countries’ debt in the next little while. You may want to familiarize yourself with how bonds work.

Bonds can be confusing to follow in the daily news because the story can take the perspective of the investor, who is the lender or bond*holder*; or the perspective can be that of the borrower, known as the *issuer*. The difference is important.

A bond is simply a piece of paper representing a loan from an investor to a borrower. The lender – the bondholder - wants a return on his capital in the form of the interest payment, and he also wants the return *of* his capital at the end of the term. If the borrower defaults, then the lender (usually) gets to seize assets of the borrower. Only fair.

The key thing to remember about a bond is that the interest payment is fixed, so that a $1,000 bond issued at 5% pays $50/yr interest, which is why bonds are referred to as ‘fixed income’.

The interesting thing (sorry) about bonds is that they can be traded on a market, and since the interest payment is fixed, it’s the principal value of the bonds that fluctuates. If interest rates decline, the value of a bond rises, and if rates rise, the value of bonds declines.

For instance, if prevailing interest rates fall, say to 4%, and you hold the bond in this example paying 5%, then the value of your bond goes up, because your bond is paying $50 while investors now can only get $40. In this example, a bond paying $50 will rise in price to $1,250 (because $50 is 4% of $1,250).

The converse is also true. If rates rise to say 6%, the value of your bond will drop to $833, because the fixed $50 payment is 6% of $833. So if rates go up, bonds go down, and if rates go down, bonds go up. Once you get that part, it’s easy.

Bondholders can be destroyed two ways: quickly, such as when the borrower defaults, or slowly, such as if inflation goes back to say 7%. If your 25-year bond is paying you 5% or $50, and inflation is 7% per year, then you are losing 2% per year. Your bond will drop like a stone.

So bond prices will fall (and their yields rise) at the first sign of default risk or inflation. Rising yields (and lower prices) are a very good indicator of the market’s risk assessment. The current problems in the Euro zone stem from the bond market belatedly realizing that PIIG bonds should have a substantially higher yield than German bonds, and PIIG bondholders (mostly banks) are having to absorb the resulting losses on their bond portfolios.

Book Review

Economics, and the other social sciences, are based on the assumption of 'rational actors' i.e. people act rationally in their decision making. Investment academics build on this idea with the notion of efficient markets, which postulates that market prices accurately reflect all information, and that there is no way to improve returns except by taking more risk.

The efficient markets crowd faces the behavioral school, which says that human behavior is influenced by certain psychological illusions or heuristics, which distort our perceptions and lead to irrational decisions.

Well, you don't need to be an investment professional to know that there is a grain of truth in each of these views, and hence rich ground for debate. Certainly the technology craze of 1999-2000 and the financial/housing crisis are evidence that not everyone is acting rationally all the time.

The three books in this review each deal with the ideas of debt, perceptions and behavior, and the idea of a rational stock market. Margaret Atwood's *Payback*, a Massey Lecture Series, is a wonderful tour through the human history and cultural side of debt, looking at everything from biblical text to Grimm's fairly tales, the English Revolution and Scrooge.

Predictably Irrational, by Dan Ariely, is about the perceptual illusions that cause humans to make consistent errors. It's a fascinating subject for anyone who wonders how you could possibly pay $21 for a $20 bill, or why people want to hold onto a Nortel stock certificate, hoping it may one day recover.

The Myth of the Rational Market by Justin Fox traces the history of financial market thinking from the rise of rational market theory in 1905 to the financial crisis. A readable combination of detailed history and broad sweep, Fox does a great job of dealing with both sides of the grains of truth.

For instance, the rational markets camp says that stock market prices are difficult to predict and must therefore be correct. Although it won a Nobel Prize for its authors, the idea was dismissed by an MIT professor of similar stature, who called it "one of the most remarkable errors in economic thought, both in the immediacy of its logical error and the sweep of its conclusion".