February 8, 2013

January 2013 Investment Commentary

High Yield Corporate Debt Markets

When we published our year-end commentary highlighting the more constructive developments beneath the nihilistic economic rhetoric, we truly thought we were taking a contrarian stance. If you would remember, at the time, the only topic on anyone's mind was the dreaded "fiscal cliff" and the impending debt ceiling crisis relapse. We had outlined our thesis on the fiscal cliff over the prior months, and purposely left the topic unmentioned in our year-end commentary.

Fast forward one month and our contrarian stance from year-end has become the narrative du jour. This isn't necessarily a bad thing, but it is a sign that the market needs a breather for now. While we wish all months could be as lucrative as this January, reality begs to differ. As such, we think this is an excellent opportunity to discuss one of the areas that poses both a risk and a challenge for investors on several levels: high yield corporate debt markets.

The Low Interest in High Yield

Oaktree Capital, founded by Howard Marks, is one of the foremost credit and private equity investors in the world. In Marks' year-end memo entitled *Ditto*, he warns of a pervasive cycle of risk-taking, particularly in corporate credit. When Marks speak, people listen, for he has an outstanding long-term track record. In this particular memo, Marks offered the following warning about high yield bonds(emphasis original):

> They provide some of the highest contractual returns and greatest current income, they are attracting considerable capital. When capital flows into a market, the resulting buying brings down the prospective returns. And when offered returns go down, investors, desirous of maintaining income turn to progressively riskier investments. In the bond world that's called "chasing yield" or "stretching for yield." **Do it if you want, but do it consciously and with full recognition of the risks involved. And even if you refuse to stretch for yield, be alert to the effect on the markets of those who do."**[1]

Marks specifically notes that these "comments are directed more at fixed income securities than equities" and how "equities are still being disrespected, and equity allocations reduced." Several have asked us why equity allocations remain large, while bond allocations are low. Herein lies your answer. In any investment, there is both risk and reward, and the prudent investor pursues a balance between the two. A year ago, Warren Buffett offered the following quote from Shelby Cullom Davis in his annual letter about the state of bond markets: "Bonds promoted as offering risk-free returns are now priced to

[1] Marks, Howard. *Ditto*. http://www.oaktreecapital.com/memo.aspx

deliver return-free risk."[2] This concept of "return-free risk" is a powerful, frighteningly relevant statement about today's bond markets.

Let us step back again and place our caution in context. What we are asserting right now is not the presence of increased risks to the economy, nor are we asserting near-term risks are elevated because of this chase for yield in bonds. The key point right now is how the yield in bonds does not sufficiently compensate for the longer-term risks. Particularly in bonds, these risks can manifest themselves in several different ways. For example, there could be an increase in default rates, or the more likely scenario would be the fixed coupons of bonds failing to offset the dollar-eroding power of inflation over the long run.

Capitalizing on Low Rates

Right now we think there are several ways to take advantage of this environment. One of the best is through what's called capital structure arbitrage. Corporations operate with set targets as to what percentage of the company should be composed of debt versus equity. We purposely seek out companies that are overcapitalized (in other words, are carrying high net cash balances) and in a position to issue very low interest debt in order to repurchase equity. This has the effect of lowering that given company's cost of capital. We talked about this in our September commentary after initiating positions in Walgreen Co. and Siemens.[3] In taking this approach, we are also exposing ourselves to a tangential benefit— those companies with excess cash are also in the best position to increase their dividends.

The second method to take advantage of this environment is through maintaining a fairly consistent cash balance, larger than would be targeted in "normal" times. When recessions hit, interest rates are supposed to fall, leading to principal gains in bonds, along with a continued stream of income from the coupon. Yet with rates and spreads fully compressed, the positives from the portfolio balance effect of bonds is limited. To that end, cash offers a degree of optionality. When equity markets inevitably slide, cash meanwhile holds its value, while bonds would see spreads rise along with an equity decline. Higher spreads lead to lower principal, and a portfolio hit. Lower equity markets enable portfolios with higher cash balances to buy an increasing share of businesses compared to those with higher stock levels. This available 'buying power' provides portfolios with significantly higher reward to the upside.

Why is there a pervasiveness of risk seeking in bond markets, while equities, the seemingly higher-risk sibling of bonds are relatively unloved? Right now it's earnings season, and in particular, these earnings are the end-of-year reports for many companies. Year-end is an opportunity for many businesses to assess their performance and outline plans for the future. One issue that comes up time and again is the under-funded status of pensions and what to do about it. Obviously there are only two ways to increase the level of funding: increase returns, and/or make increased deposits into these pension plans. With

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[2] Buffett, Warren. 2011 Berkshire Hathaway Shareholder Letter.
http://www.berkshirehathaway.com/letters/2011ltr.pdf
[3] RGA Investment Advisors September 2012 Commentary
http://www.rgaia.com/uploads/files/RGA_September_2012_Commentary.pdf

interest rates and future returns in bond markets so low, and equity allocations of pensions already very high, there is little that companies can do. Yet if you listen closely, many of these companies are just now planning (and executing on these plans) a move from equities and into bonds. It is this shift that keeps driving yields lower in bond markets.

"Myopic Loss Aversion"[4]

Why is this happening now? The shift from equities into bonds certainly will not be the catalyst for increasing returns for pension funds. It will offer more certainty of returns given an infinite time horizon, but it will naturally lead to lower returns. To explain this choice, we will borrow a phrase from Shlomo Benartzi and Richard Thaler: "myopic loss aversion." While bonds and equities are capital market siblings, through history, equities have consistently offered higher returns. This higher return is formally called the "Equity Risk Premium" (ERP). The average ERP between 1928-2011 is either 4.1% or 7.55% depending on how it's calculated (for reference, right now we are at 5.78% and 6% on a trailing 12 month basis).[5] [6]

In Benartzi and Thaler's paper written in 1995 entitled *Myopic Loss Aversion and the Equity Premium Puzzle*, the authors ask "why is the equity premium so large, or why is anyone willing to hold bonds?" Their answers are twofold: "myopic loss aversion" and "mental accounting." Collectively they attribute this phenomenon to the increased volatility in equity markets relative to bonds, and the behavioral wherewithal (or lack thereof) for humans in dealing with volatility. They find longer holding periods, lead to greater returns in equities. Further, the less frequently one checks his or her portfolio, the greater the return in equities will be. Benartzi and Thaler exlaim "that for someone with a twenty-year investment horizon, the psychic costs of evaluating the portfolio annually are 5.1% per year!" And we know that in this day-and-age of heat maps on CNBC and streaming live quotes on the Internet, a one year evaluation is a long time. Today, we would argue that the real costs are even higher.

The primary theory of investing today—the Efficient Market Theory—holds that volatility is risk; however, Benartzi and Thaler clearly demonstrate that volatility is not risk; rather how humans deal with volatility is what ultimately leads to risky decisions. This new paradigm for understanding markets has been formally named Prospect Theory, and its fathers are Daniel Kahneman and Amos Tversky, the two gentlemen who put behavioral economics on the map. Central to Prospect Theory is the idea that thinking probabilistically is the key to understanding markets, though humans inherently develop heuristics (mental short-cuts) that prevent us from clearly processing statistical odds. We at RGA take these newer studies very seriously, and take steps in order to pull our consciousness forward in assessing investment situations. To that end, we have built a rigorous checklist to run through in our

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[4] Benartzi, Shlomo and Richard Thaler. "Myopic Loss Aversion and the Equity Premium Puzzle." *The Quarterly Journal of Economics*, Vol 110, No. 1 (Feb., 1995) pp. 73-92.
http://www.econ.brown.edu/fac/Kfir_Eliaz/Thaler2.pdf

[5] Damodaran, Aswath. *Equity Risk Premiums: The 2012 Edition*.
http://aswathdamodaran.blogspot.com/2012/03/equity-risk-premiums-2012-edition.html

[6] See: Aswath Damodaran's monthly calculation of the Equity Risk Premium.
http://pages.stern.nyu.edu/~adamodar/

research process. This checklist demands of us a thorough and fair analysis of the quantitative, qualitative and behavioral elements for each and every possible investment.

When we run through this checklist as it pertains to bonds of any stripe right now, the answer is clear. Further, we think it's clear that all those who are increasing their allocation to bonds today, at the expense of equities are a victim of myopic loss aversion. It would be wise to heed the words of Howard Marks and Warren Buffett about this discrepancy today.

What does this mean and why does it matter?

Right now this leaves us quite comfortable with equities and our equity exposure, while we are largely underweight to fixed income. We are not exactly sure when, but are certain that at some point in the future there will be incredible opportunities to buy fixed income securities and portfolios at a fraction of par value. When the time comes, this will leave our fixed income investments in a position that has both better yields, and better capital appreciation potential than the market has offered in recent times.

How we get from today's market to the position we are anticipating remains to be seen. However, we believe that two catalysts can be key drivers of a return to normalcy: an end (or decline) in the rate of asset allocation driving bond exposures; and, an increase in issuance by corporations. Over the past six months we have started seeing issuances rise, and the prospect of a major leveraged buyout of Dell has roiled markets a little bit, but the real turn will take time, and patience will be the key ingredient in the recipe for long-run success.

Warm personal regards,

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