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Dear Client,

It was a very long time ago that I first identified just how important clients are to our investment thinking. Their questions frequently enhance our analysis and often highlight salient data aspects of markets. In August, we were fortunate to have an exchange with a client that we found to be extremely informative.

This client expressed exasperation at the volatility of the market and his overall portfolio. Now, volatility when performance is good is not as painful as when performance is not good, but through our discourse the real concern of this client became clear - a yearning for his investments to be safe. He wanted investments that were less volatile and would help him sleep at night. This is particularly important given the uncertainty in the world today and is a common refrain repeated by investors today. To seek safety of your capital so you can sleep at night is a desire we fully endorse.

The question then becomes – where is that safety? That's the problem today, where historically strong returns across most asset classes act as a siren call that continues to draw in more capital. These torrents of capital have pushed the valuations for many asset classes into very high, and in some cases, bubble valuations. There is no safety and security of capital in owning an asset at an unsustainable valuation.

In order to address our client's concerns, we must begin by asking what safety and what risk really are when applied to investing. A common rule of thumb used by most investors is that volatility is risk. As value investors, we believe that market prices are often well above or below an investment's true intrinsic value, we disagree with using volatility as a measure of risk. Risk is simply behavior that carries potential for harm, and volatility does not directly cause harm. Instead it's how that volatility is managed that exposes one to real risk – the permanent impairment of capital, otherwise known as real non-paper losses.

So again, where can we find investments that are relatively safe or where we are least exposed to the permanent impairment of our capital? Well, if you had asked this question in 2006, the answer would have been residential real estate - your home. The value of homes only goes up, or so the mantra went. Or at least it did until home prices universally crashed. Today when the question is asked, a common answer you hear is to invest in fixed income, and why not? After all bonds have been perennial winners since rates peaked in 1982 above 15%. Decades of experience have shown each of these investment decisions were almost a no lose proposition. Of course the problem is perennial strong performance leads to herding, which almost inevitably leads to overvaluation and asset bubbles. Moving from stocks to bonds today will absolutely reduce near-term volatility but at what cost, and at what real risk? That's the question we believe is important to be answered.

But wait a second, bonds are different than houses. The story goes that senior fixed income streams are safe, or at least safer than junior securities such as equities/common stocks. In general, that is true. However, today's environment is unique, so we have to question some of these rules of thumb we've lived by. Today we have negative interest rates and an inverted yield curve. We think the market is waving its hands and hollering, "Pay attention! Proceed with caution! This isn't normal!"

Negative Interest Rates

Starting at the first sign that something is amiss, let's talk about negative interest rates.

In a typical situation, lenders receive interest in compensation for loaning out their capital. That's the normal course of lending. Yet today in much of Western Europe lenders not only put their capital at risk, but they even pay the borrower to take their money. This is not a thought exercise, or limited to small amounts of capital. There is currently $15 trillion that has flowed into these upside-down instruments! This is one of those phenomenon that on its face looks so absurd, that it becomes almost easier to convince people that it's so crazy it just might make sense. We choose to take its absurdity at face value.

How did we get here then? As we said earlier, long term interest rates have steadily declined since they peaked at 15% in 1982. Decades of declining interest rates lead those cleverer-than-clever investment bankers on Wall Street to design structured products like CLOs and CMOs, to mitigate declining rates. We all know how that almost toppled the world's economy with the 2007-2008 world financial crisis. In response to this near death experience the world's Central Banks sought to support economic recovery and extended that rate decline. This government intervention has led to significant misallocation of capital and brought about these crazy times in the fixed income markets.

Now, we're not saying there is no logic behind this. In a period of declining interest rates, bond prices appreciate, so investors receive two streams of economic returns: (1) the interest payment prescribed by the loan and (2) the appreciation in the underlying security. Therefore bond investors can still be handsomely rewarded on the appreciation of the security even if they aren't making any interest. Furthermore, so far these investors have been right! The Vanguard Long Term Index Bond Fund (VBLTX) has a total return of better than 22% over the last 12 months. Yes, 22% return for long term fixed income securities! This is an exceptional return for this class of security. The fund holds positions with an average maturity of over 24 years and yields new investors approximately 2.8%. Twenty four years is a dramatic amount of time for risky things to occur, while 2.8% is a modest interest rate to compensate for all of the credit risk and interest rate risk the investor is assuming. Remember, the U.S. Treasury has a continual and expanding budget deficit and its debt obligations reach new highs daily. All hallmarks of a creditor that investors might have concerns about. You sure don't see any of those concerns reflected in the current interest rate.

Inverted Yield Curve

To put it simply, lenders normally demand higher interest rates the longer they agree to lend money to someone, which makes intuitive sense. The further into the future the more the uncertainty. The more the uncertainty the higher the return an investor requires. Therefore a normal yield curve slopes upwards with higher interest rates for longer maturities. When the yield curve inverts, long-term interest rates drop below their shorter dated brethren. So when the yield curve does invert, something is out of the norm.

What is causing this is the huge amounts of capital flowing into long-term fixed income. It is important to remember the inverse relationship between interest rates and price. As people clamor to buy fixed income, the bond price goes up so that bonds may even trade above par (that's the money you are owed when the bond matures). This pushes the yields you will receive going forward down, and with them your expected return.

Unlike negative interest rates, occasionally long-term interest rates do drop below short term rates. Historically this tends to happen when there is a 'flight to quality' due to concerns about the economy. In fact this is such a strong historical connection that since 1955 every recession was preceded by an inverted yield curve (though not every inversion has led to a recession). So when long-term interest rates move below short term rates it is appropriate to evaluate the situation.

The predominant reason for this predictive quality of an inverted yield curve is that when investors identify economic weakness they seek the security that bonds have historically provided. If the economic weakness is real, then equities face headwinds of declining earnings. For that reason an inverted yield curve frequently presages an equity market decline. This makes sense, and is the basis for the rule of thumb that an inverted yield curve presages a recession. But these rules of thumb by their nature are not foolproof. I don't believe I need to remind anyone of the rule that you couldn't lose money in your home. That proved to be a disastrous short cut.

What's our interpretation? The Emperor has no clothes!

As we mentioned above, the Vanguard Long Term Index Bond Fund has delivered exceptional performance, while equities have been extremely volatile. We all know well the investor warning "past performance may be no predictor of future results," but performance does draw capital into the winners ($17 billion into bond funds this year) and out from losers. Valuation be damned!

Exacerbating the problem, much of the world's capital is mandated to be invested in fixed income securities, ironically because of the historical safety they provide capital. This trapped capital then has to search for relative yield, and as every investor knows to find better yields you need to accept more risks. The trouble is the options aren't very appealing. While some capital is opting for 1% 10 year Italian government bonds, others have decided to ***pay*** the government of Germany 0.50% to hold their capital in safe keeping. The choice is either guaranteeing a loss of capital and purchasing power or paying the equivalent of 100 times earnings to the government of Italy with a weak economy and political instability in the hope of getting your money back in 10 years.

Going back to the two streams of economic return (interest payments and security appreciation), it is clear that the first stream of income to lenders is de minimus today. So it all falls to the second stream of appreciation potential. Fixed income has traditionally been an income generating instrument while equities have been capital appreciation instruments, but today these two are being flipped on their heads. Fixed income is being treated like a capital appreciation instrument while, for the first time in decades, the S&P 500 dividend yield is *higher* than the Vanguard Long Term Index Bond Fund interest yield. When you consider the valuation on fixed income today the argument that this investment class provides safety and security is at the very least suspect.

In today's world, trying to get appreciation in fixed income is largely a speculator's game. The economic statistics continue to confuse capital markets and the predicted weaknesses haven't manifested to date. But capital flows are convinced the world's economy, including that of the US, will weaken. In anticipation of this economic prediction, capital has flowed into fixed income. History books are filled with losses from capital that were deployed predicting economic trends.

The bottom line is that we have a fixed income market, fueled by mandated capital, government intervention, speculation and fear that we believe has recently lurched into bubble territory!

If fixed income isn't safe, what is?

Valuation, valuation, valuation! Whatever the global metric might be used to forecast future events, most of the common knowledge rules are really just ways to quickly derive valuations. But as fundamental investors we try to avoid these logical short-cuts and look at the facts. What they tell us is that value equities have suffered through a prolonged period of capital flight that has beaten them down to some incredibly low valuations, while the places that escaping capital has flown to have soared to exceedingly high valuations. Fixed income has historically been considered safe because of what is backing it up. Today in equities we believe the cash generative ability of the companies we own is safer than the speculative nature of fixed income due to valuations.

Consider that a stock that is trading at even a 10x PE ratio is the equivalent of a 10% yield, since it would earn $10 for each $100 of it you bought. Now compare that to the current yields in fixed income, where $100 is getting you $1 if you give it to Italy, and is costing you an extra $0.50 if you give it to Germany. Decades ago Benjamin Graham espoused the concept that the market is in the end a valuation machine not a voting (popularity) machine. As such, owning securities with very modest valuations of cash flows is the only place to achieve safety of capital! That is where we are invested.

We think it is important to note that when we talk about the equity market, we are discussing it as a whole. Where we invest is in small to mid cap stocks, and further in value stocks, which make up only 3% of the U.S. equity market. Repeatedly, our niche marches to the beat of a different drummer. Looking back at the crash in 2000, our previously ignored and unloved investments were finally appreciated for their strong economic attributes, while the market languished. As contrarians, we often do not move with Mr. Market. Today our portfolio is even more discounted than it was in 2000 on both an absolute and relative basis.

As hockey star Wayne Gretzky once said, "Go to where the puck will be." We believe that today the puck is in the corner being fought over in the fixed income markets, and likely to be spit out in front of the net any day now. Valuation is a magnet for capital, and our portfolios are full of excellent value.

All the Best,

Bob Robotti

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