MV Capital Management E-Update

The Risk Disconnect

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People don't like risk. Yes – we know that risk can bring reward – *no pain, no gain* as they tell us at the gym while we're trying valiantly to keep to our New Years resolutions. Still, when it comes to our portfolios most of us prefer to think about the returns – what we could earn, rather than how much risk we need to take on to get there. Unfortunately life and the financial markets work in such a way that risk and return are impossible to think of separate from each other – they are really two sides of the same coin.

As 2007 gets underway we are pondering whether there might be a bit of a Wonderland quality to the investment markets these days – where things are not quite as they seem. We sense that more risk is lurking under the surface than appears to be priced into present return levels. That concerns us, and that's the subject of this article.

The US equity markets had a lovely 2006 with the S&P finishing up 15.79% and returning just about that same number – 15.74% - on an annual average basis since the beginning of 2003. That's a fairly reasonable showing for a four-year recovery period, and market observers are pointing to all sorts of logical reasons why the good times will continue rolling along in 2007.

What got our attention was not the return numbers so much as the *attendant risk* – or, to be more precise, the relative lack thereof. Volatility has been shuffling along at its lowest levels for the past thirty-odd years. On the S&P 500 Index standard deviation – a common measure of risk – has declined from 22.87% in May 2003 (twelve trailing months' basis) to 5.6% in December 2006. That's a pretty big drop. It got us wondering what could be so much less risky about the world today than it was four years ago.

We looked at risk on a relative basis focusing on the so-called "equity premium" – the additional risk that comes from holding equities over bonds. Our measure was the difference between standard deviation for the S&P 500 and that for the US Lehman Aggregate Bond Index. For the period January 1979 – December 2006 the average risk differential was **8.76%**. For 2006 it was **3.77%**. This number has spiked up or down on several occasions – for example it spiked up to an all-time high of 24.73% after the stock market crash in October 1987 and then plummeted back to 4.70% at the end of 1988 when the world seemed okay again. It has <u>not</u> been sustainable at any particular level for long periods of time. Is it any different today?

We don't think it's different this time any more than we thought it was different when Pets.com had "limitless" profit potential. We do think there are real risks out there, any one or more of which have a decent chance of playing out in the foreseeable future. In fact the World Economic Forum's recent *Global Risks 2007* report made the following point: "Expert opinion suggests that levels of risk are rising in almost 23 risks on which the Global Risk Network has been focused over the last year – but *mechanisms* in place to *manage* and *mitigate risk* at the level of businesses, governments and global governance are *inadequate*" (italics ours).

Why then the disconnect between WEF and the equity markets? Here's what we think. The risks identified by the WEF task force imply major dislocations and disruptions. By its very definition risk is bad only if it actually happens. Investors aren't pricing them fully into their valuation models because they *haven't happened*. And that's okay, as long as (a) the likelihood of such major risks remains low and (b) the eventuation of one risk doesn't trigger a deluge of other *correlated* risks. Let's look at three specific risks to see why that is in fact not the case.

Risk: The shopaholic US consumer becomes the struggling US worker: Stephen Roach, Morgan Stanley's chief economist, noted in a recent report that real labor incomes in the US have grown at roughly half the rate of labor productivity in the past decade. Where has all the income from the other half of the productivity gains gone? Into corporate profits, of course, which as we all know have been on a tear upwards for the past four years.

Risk: China's economic miracle clashes with China's sociopolitical woes: In purchasing power parity terms China is the world's second largest economy and the hub of global manufacturing. Over one half of China's immense population consists of rural laborers who are essentially redundant to economic growth but make for a coming potential social crisis.

Risk: The world stops paying for US consumption habits by accumulating dollar reserves: The world spends over $500 billion each year to fund the US trade deficit and this fact provides for both our domestic consumption habits and our foreign policy adventures. Every time the US dollar declines these assets (China alone has over $1 trillion) devaluate.

The point of putting these three risks out there is that they are interrelated. We import from China, we can buy houses and shop because interest rates are low, our companies can find low-cost workers elsewhere in the world and stay profitable, and we all support this status quo because hey – it's globalization and everybody benefits. Except that not everybody benefits and at some point something may pull out one of the threads that holds the others together…

Or not, and nothing will interfere with the continuation of the high corporate profits, easy access to world trade and stable currency rates that facilitate high-performing equity markets with bond-like volatility levels. That's also possible. We think it's more likely that volatility is going to return, there will be winners and losers and we can make active decisions about how to best position our portfolios to profit from the changing times rather than be caught off guard. Maybe we will run the risk of being more defensively positioned than other managers – but for the sake of our clients that's a risk that we are more than willing to take.

With warm regards,

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