MV Capital Management Thought Leadership

End of the Free Lunch? A New Era for Fixed Income

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"Money for nothing…" begins the reprise of the classic Dire Straits song about fame in the age of MTV. If we were to relate that tune to the investment climate of the last ten years or so we would slightly modify the ending: "…and your risk for free". There has been something very unusual going on in the relationship between risk and return in financial markets for quite awhile now, and we think the time may be at hand for this unusual thing to have run its course.

In the world of investments, as with life in general, we expect that if we want to achieve more of one thing we have to sacrifice something else. Getting that coveted promotion at work means staying in the office late to finish a major project rather than hanging out with friends in the local pub. As for investments, achieving more return means giving up peace of mind. If we want to earn double-digit returns on our portfolios over the long term we have to be willing to deal with the likelihood of stomach-churning volatility in the short term – that's the essential risk-return tradeoff. Long term outperformance is earned on the backs of asset classes like emerging markets stocks and global real estate trusts, not US Treasury securities.

Or so we would think, right? But the world of the last 15 years tells us something quite different. Consider the following table:

Ending 10/31/10	**15 years**		**10 years**		**5 years**	
	TR	**SD**	**TR**	**SD**	**TR**	**SD**
S&P 500	**6.7%**	**16.3%**	**-0.02%**	**16.45%**	**1.7%**	**17.7%**
Barclays US Aggregate Bond	**6.4%**	**3.7%**	**6.4%**	**3.7%**	**6.5%**	**3.5%**
TR=Total Return; SD=Standard Deviation					*Source: Zephyr StyleAdvisor*	

In considering what this table tells us, we should explain that standard deviation ("SD") is a standard measure of risk – basically, it tells you the extent to which the return of an asset can be expected to deviate from its statistical average. In other words the higher the standard deviation, the more butterflies in your stomach with the roller-coaster ups and downs. When you make an investment decision the first thing you think about is how many butterflies in your stomach you are willing to deal with. Then you go out and try to find the assets that offer the best available return for that amount of butterflies.

Now consider what is so amazing about this table: for the last 15 years, when looking at the broad-based markets for stocks and bonds, you got *no benefit whatsoever* from taking on more risk by going into equities. None. The 15 year average annual return for the S&P 500 and that for the Barclays US Aggregate Bond Index are virtually identical at 6.7% and 6.4% respectively, while the risk for equities is *more than four times higher* than that for bonds.

Mind you, this is not a short-term fluctuation. We are talking about 15 years, going all the way back to the dawn of the Internet boom in the mid-1990s. The story is even more eye-popping when we look at shorter time periods. For the entire first decade of the 21st century, bonds outperformed stocks by 6.4% to -0.02%, and by similar margins in the last five years. In each case the return on bonds has been as predictable as the sun rising in the east, and while fixed income risk largely stayed the same over this period, equities became even more volatile – from 16.3% standard deviation for the whole 15 year period to 17.7% in the last five years. In fact volatility for the S&P 500 has been over 20% throughout the last couple years.

Now, if someone tells you that you can have money for nothing, what do you do? Your first impulse probably is to reach out and grab it without a moment's pause. And that is precisely what investors have been doing for the last several years, as hundreds of millions of dollars have poured into fixed income funds and out of equities. But after awhile you probably say to yourself – hey, wait, there really is no such thing as a free lunch, right? Isn't that what my parents always used to tell me when I complained about doing my homework?

And that brings us to this auspicious present moment. We live in a world where short term interest rates are effectively at zero percent, yields on US Treasury bonds for most of 2010 have been at historic lows, and European markets have been grappling with the instability in the national debt markets of a handful of countries – not only the likes of Greece and Ireland but also larger economies like Spain and Italy. The US Fed has been resorting to the non-traditional practice of quantitative easing to pour money into long term debt securities to add more economic stimulus to the US economy. The US dollar is weak and the pace of recovery, while seemingly on the right track, is too slow to help jolt unemployment numbers down from their persistence around 10%.

This world does not paint an attractive picture for bonds, and we see significantly higher than average risks ahead. In considering our asset allocation decisions for 2011 we have looked very carefully at the role fixed income should play in our portfolios. Mind you there is always a role for fixed income – it would be practically impossible to achieve the kind of risk-return positioning that more conservative, capital preservation and income-oriented strategies require without having a substantial fixed income presence. But this year we have looked for ways to complement the fixed income component with other types of assets that can also offer lower volatility and low correlation with other assets.

And what about equities? After all, even if the fixed income side of the equation is due for a correction, investors will still need reasons to be willing to wade back into the waters that have been so choppy for so many years. We do believe there are risks, but with global fortunes turning largely on the backs of high-growth economies in Asia and Latin America, and with US and European corporate earnings reflecting the opportunities for the companies that populate the S&P 500 and the FTSE 100 to benefit from emerging market growth, we see opportunities for strong equities performance even with the likely persistence of anemic growth conditions in the more mature economies. We will have much more to say about this in our upcoming 2011 Market Outlook.

2010 has certainly lived up to the "interesting times" of the timeless Chinese adage. And no doubt more interesting times await us in the New Year. In the meantime, though, as the year draws to an end we extend our warmest wishes to each and every one of you for a holiday season filled with health, happiness and the company of loved ones and friends. Happy Holidays!

With warm regards,

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