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INVESTMENT UPDATE

US interest rates are low—as low as any of us have ever seen—and that's making investors re-think their fixed income allocation. After all, it is pointed out, with interest rates this low, they have only one way to go: up. And when rates go up, bond prices go down. When bond prices go down you get poor performance in your bond portfolio. Poor performance in your bond portfolio is unacceptable, so we must take action to prevent that from happening.

The logic seems unassailable. And it is. Except for the thorny issue of how best to "take action" and, perhaps even more importantly, when to take action. Turns out that taking action itself involves risk, and may, in fact, add risk to a portfolio even when you think you're reducing the risk of the portfolio.

Come again? Reducing risk can actually increase the risk? Maybe we need to define some terms.

Risk can be defined many ways. Clients often define risk as "losing money," while money managers may use the word when they're really talking about volatility—as in "We're reducing the risk in your bond portfolio by shortening maturities." Both of these really miss the point. Risk and volatility are just ways of saying that your results may vary. A high-risk investment (one with a lot of volatility) may produce results that are very bad, or very good. But nobody really minds when a high-risk investment pays off big; risk is only a problem when the results are ugly. And that's the point. When it gets down to it, what we are all trying to do is maximize the upside risk and eliminate the downside risk. Or, at a minimum, tilt the table to the upside on the risk scale.

But it's not that simple. Our estimates of risk tend to be based largely on history, and history has a way of changing its outcome at the most inopportune time. An example is in order. When you put a quarter in a slot machine, you already know there's an uncertain payback. Chances are, you won't win anything and the machine will eat your quarter. You may get lucky and win a few quarters back, you may get really, really lucky and hit the proverbial jackpot; but the expectation is that you will take a modest loss. It's hard, after all, to beat "the house."

But what if you put a quarter into the slot and the machine reached into your pocket and stole your wallet? It may be a silly example, but that's an outcome that's much worse than what you anticipated. And it's the kind of unforeseen risk that investors often stumble over. It's a sore spot for us, but the Lehman bankruptcy in 2008 was an example of just this type of risk; unlike previously failed big investment banks, Lehman wasn't acquired, or put into receivership, and their bonds didn't get assumed by the acquiring firm, as had happened to other major financial firms in the months leading up to Lehman's demise. Instead, Lehman was taken out behind the barn and unceremoniously shot, sending the world's financial markets into a state of utter shock.

When investors are attuned to risk, they tend to adjust their behavior accordingly. But not always in the way you might imagine, and often in exactly the wrong direction. Take the US housing market. By 2006, US home prices had risen by more than 9% per year for more than a decade, and residential real estate was still widely believed to be a safe place to invest. But prices had become so inflated, and credit had become so freely available, that risk—the chance of a truly awful outcome—had risen considerably. Of course, potential homebuyers weren't thinking about the risk of prices going down, they were afraid that prices would continue to rise, and they would miss out on further appreciation. It's estimated that in the final throes of the housing bubble, 1/3 of all new mortgages were written for investors and speculators, not for primary residences.

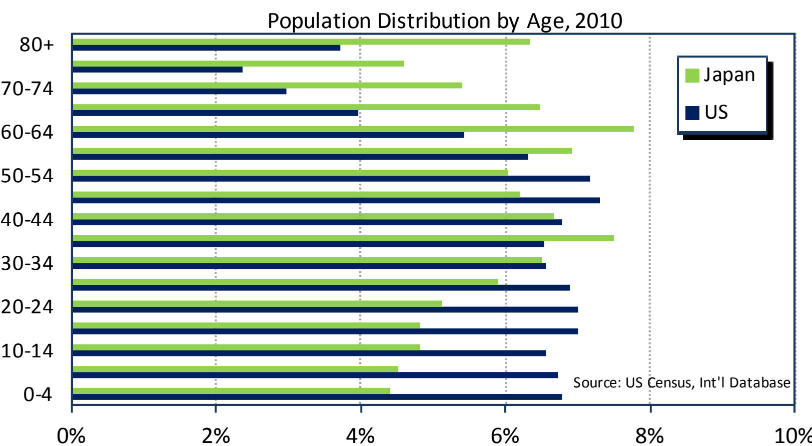
But there's nothing like a popped investment bubble to really change people's behavior. Today, residential real estate prices are down 30% or more in most areas of the country, and mortgage rates are at their lowest levels in at least 50 years. Yet, there are precious few buyers; even after accounting for the weak economy and more stringent underwriting standards, home sales are a fraction of their peak levels of five or six years ago. The risk is lower today, much lower, but there are fewer willing to take on that risk, having been burned so badly. Likewise with lenders—they were all too happy to lend at generous terms at the top of the market; now with capital appreciation much more likely (and their loans, therefore, much safer), they are reluctant to make new loans.

But let's get back to the bond market. With interest rates low, the general consensus is that one must shorten maturities in order to protect against rising rates; in bond-speak, "reduce duration risk." And in a normal interest rate cycle, this might make sense. But there's not much that's normal about this cycle—we have short-term rates yielding essentially zero. In the Treasury market, any bond with a maturity less than five years yields less than 1%. Shortening maturities means ac-

cepting little to no income—not a very attractive choice.

And this is the quandary that bond investors face right now: Many think that by "reducing risk" (shortening the duration and maturity of their holdings) they are protecting themselves. But shortening means giving up yield, and yield is, over time, the predominant source of return in a bond portfolio. Yield helps cushion against rising rates by providing income to the bond holder. Further, the bonds with the least credit risk (despite what S&P might think), Treasury securities, have the least yield of practically any bond the whole world over! With little or no yield, a portfolio of very short bonds—especially *low risk Treasury bonds* (there's a misnomer if ever there was one) will provide a return of essentially zero, at best.

And that is exactly how a risk-averse investor, intending to protect himself and do the right thing, ends up *adding* risk to his portfolio—adding risk because he's likely to get an outcome that's worse than what he thought he was going to get. What's the alternative? Going back to our mantra that "yield wins over time," a risk-averse investor should focus, in this environment, on high quality bonds that possess good yield, among intermediate-maturity bonds. Translated into English, that means purchasing a fully diversified basket of corporate bonds issued by solid, profitable companies—bonds that will generate consistent and ample cash flow (yield) during an uncertain economic period.



As always, any specific recommendation comes with caveats. If the US and global economies catch fire, with the labor markets firming up, consumer spending rising strongly, and inflation taking a strong hike northward, then a zero percent return may be the best you can hope for in a bond portfolio; in that environment, most bonds will fall in price, even intermediate maturity bonds. But we think it's far more likely that the impediments to US growth that have been in place for the past few years—households still more interested in saving than spending, and both businesses and consumers reluctant to borrow money, even at ultra-low rates—these factors will keep capital investment and economic growth suppressed. To make things worse (from a growth standpoint), public policies are likely to become far more restrictive in coming years, as the US and other Western countries throttle back on spending, with tax reform (read "higher effective taxes") a near-certainty. The stimulus programs of the past three or four years will be replaced by fiscal austerity programs, which will, all else equal, suppress economic growth and help keep interest rates low.

There's an old adage in the investment world, "If you want to surf, get off the beach." Waiting for the perfect wave isn't going to win you any tournaments, and it's the same in the investment world. Obviously, there are times to be cautious, times to take risk off the table. But there is risk even in "de-risking" your portfolio, especially when de-risking means sacrificing any real possibility of decent returns. Sometimes the riskiest thing to do is to get caught up in the popular consensus and take the "risk-free" approach—this is exactly what happened in 2011, when most investors were convinced that interest rates were going to rise, but the best performing asset ended up being long-maturity (and thus, high duration risk) Treasury bonds, which returned more than 30% for the calendar year.

One last thought before we close: What if interest rates in the US remain at these levels for an extended period of time? For those doubting that it could happen, we need only look to Japan, whose ten-year government bonds have been trading below 2%, and most often around the 1% mark, since 1997. Now, there are clear and distinct differences between the US and Japan, most notably in demographics; Japan's aging population and penchant for savings mean that their economy is on a long-term disinflationary path, with little push from consumer spending, and heavy demand for fixed income investments. The chart shows the differences currently between Japan's and the US's population distribution by age group. And things get even more "top heavy" for Japan over the coming decades: With their very low birth rate, Japan's population will decrease by six million people over the next 20 years (equal to approximately 5% of the population), while the US's population is expected to grow from approximately 308 to 365 million over the same time frame. The average US citizen is expected to be approximately 40 years old in 2030, compared to 37 today, while the age of the average Japanese citizen is expected to rise from 44 to 50 years old.

The demographic differences between Japan and the US are significant, and most likely wide enough to lead us to conclude that US interest rates will not remain at these low levels forever. But stranger things have happened, and with the US and other major global economies looking to reduce public debt in the aftermath of a multi-decade borrowing binge, we don't dismiss the possibility of low rates hanging around for a while longer.