

Bond Risk For The Long Run

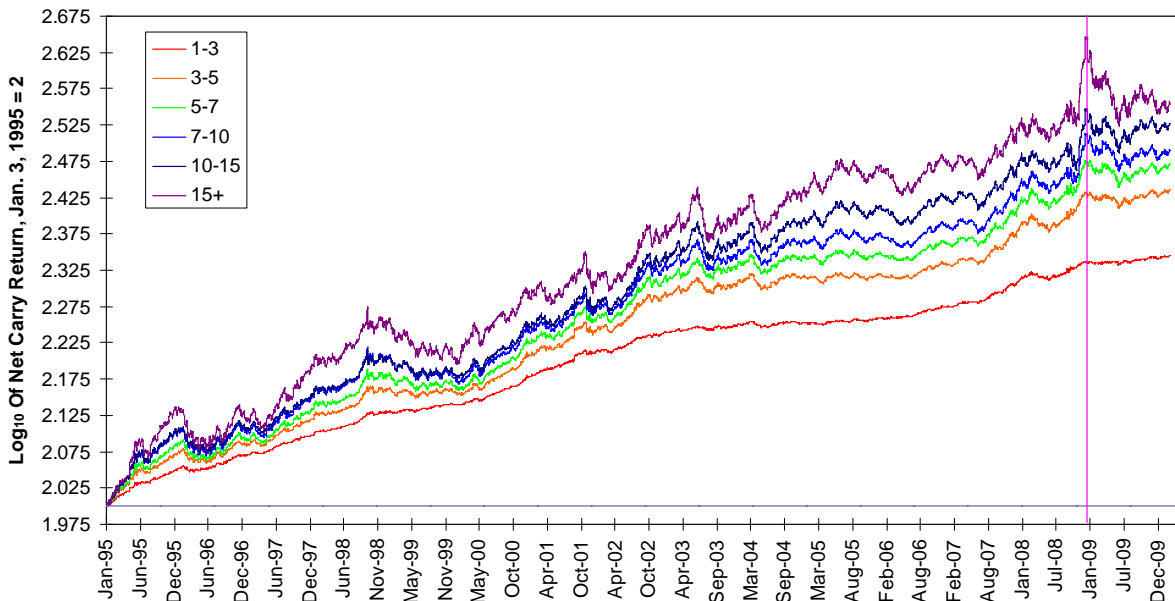
We have raised a generation who has never seen a multi-year bear market in bonds the likes of which occurred during the **high-inflation years** of the 1970s and early 1980s. Maybe this is no worse than raising a generation of students who think they are entitled to an 'A' by virtue of their being in a country full of politicians who see nothing wrong with spending trillions of dollars of money without a thought as to how these debts will be serviced, forget repaid, but it is bad nevertheless. Bear markets are God's way of reminding us investing is a risky business. Who, besides all of us, really wants to see the market rise all of the time?

The incredible thing about the bull market in bonds beginning in September 1981 is the degree to which it remains disbelieved. You would think after three decades, it might get a little respect, but stocks, commodities and real estate grab all of the red-carpet glamour and bonds are the Cinderella of the story. What a shame. What a pointless metaphor.

Lost in the discussion of bond total returns is the opportunity cost of holding a position. Cash does not appear magically on the scene unless you are a central banker; no, you have to surrender the opportunity to have earned the short-term rate of return to have gambled on the long-term rate of return. While short-term interest rates are trivial today, this was not always the case; real people with real names earned real money by holding money market funds, certificates of deposit and similar instruments.

The proper rate of return to subtract from the longer-dated bonds is not the three-month Treasury bill rate; you and I cannot borrow at that rate. A better proxy is three-month LIBOR. If we subtract this total return stream from the total return streams of bond indices at various maturities and plot them on a base-10 logarithmic scale, we can see just how sustained the bull market in bonds has been over the past fifteen years (Note: This is the earliest this particular analysis could begin. It is not an attempt to hide the bond downturns in years such as 1987 or 1994). Yes, 2009 was a horrendous year for long-dated Treasuries, but that is really just an artifact of their end-2008 panic in bonds marked with a vertical line.

Field Of Streams: Net Treasury Carry Returns



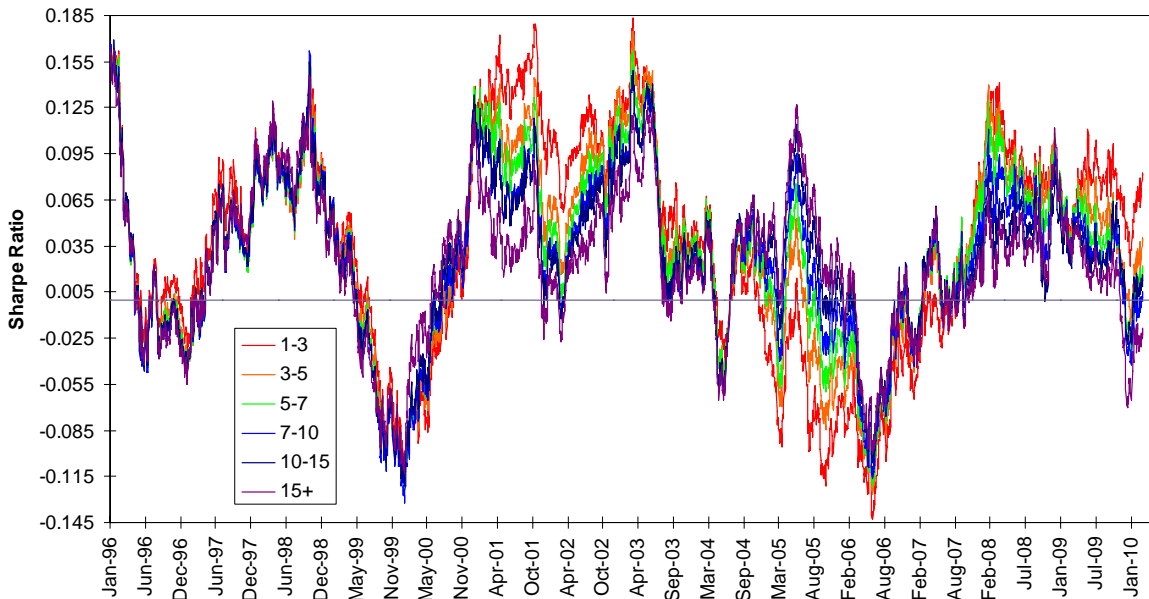
What is even more remarkable in a world where the standard modern portfolio theory about risk and reward going hand-in-hand has proven deficient in practice more often than not, investors have been rewarded for taking on maturity risk in Treasuries. While it may never have seemed worth it to extend duration, it was worth it over time.

The Sharpe-r Image

However, the opposite conclusion can apply if you used the Sharpe ratios of these Treasury indices; the Sharpe ratio is the excess return over the three-month Treasury bill rate divided by the standard deviation of returns for the market being examined. Here the higher-returning longer-dated Treasuries have had higher Sharpe ratios only

during those periods when the yield curve has been flattening. If we look at the periods such as today when the yield curve is steep, the shorter-dated Treasuries have the higher Sharpe ratios.

One-Year Rolling Sharpe Ratios Of Net Carry Returns



As the yield curve is likely to flatten from its present exaggerated level at some point in our lifetimes, keep this relationship in mind. If the move is a bearish flattening, one where long-term rates are rising while short-term rates are rising faster, the higher Sharpe ratio will be of little solace to you.

Over the short-term, look for the bull market in bonds to continue until short-term rates are increased from their current levels. And then be prepared for the final and long-anticipated end of the great bull market in U.S. Treasuries.