Risk and Return Go Back to the Future

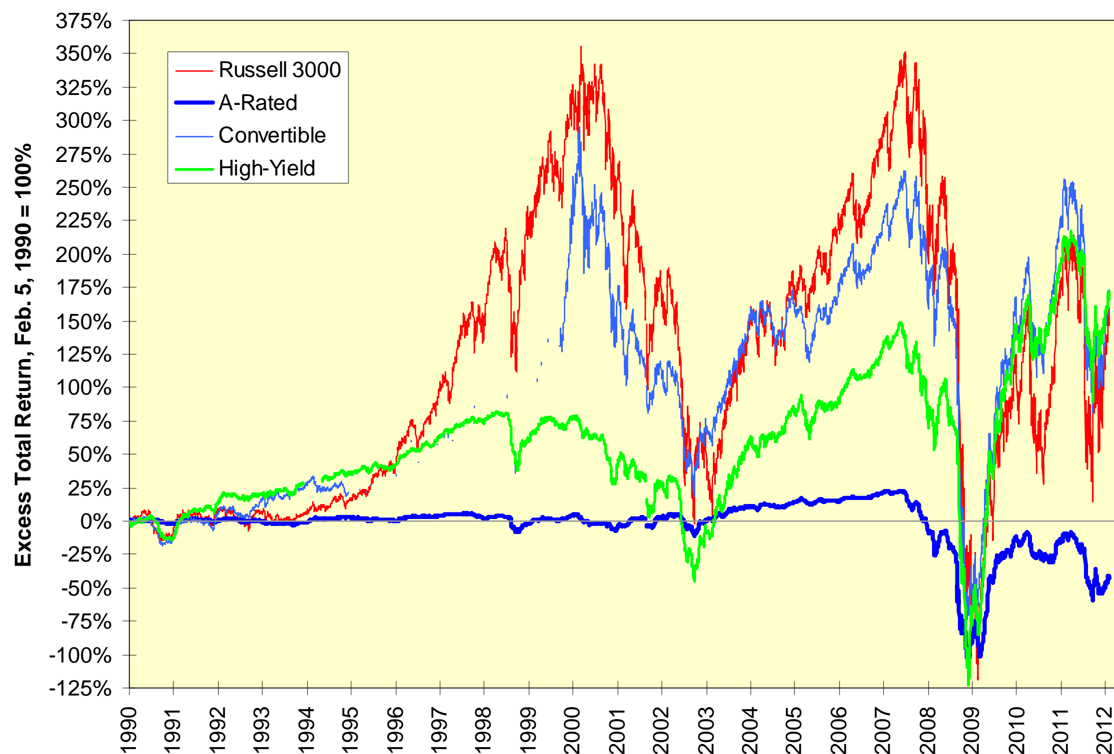
The Jumbled Hierarchy Created During the Financial Crisis Is Disappearing

When Lord Cornwallis surrendered to the combined French and American forces at Yorktown, Virginia, in 1781, the British military band played "The World Turned Upside Down." It is not a particularly catchy tune, and hardly conveys the agony of surrendering to a French force. I personally think it would have been more appropriate for investment committee meetings over the last few years when supposedly low-risk / low-return Treasuries were duplicating the French tour de force by running roughshod over supposedly high-risk / high-return stocks.

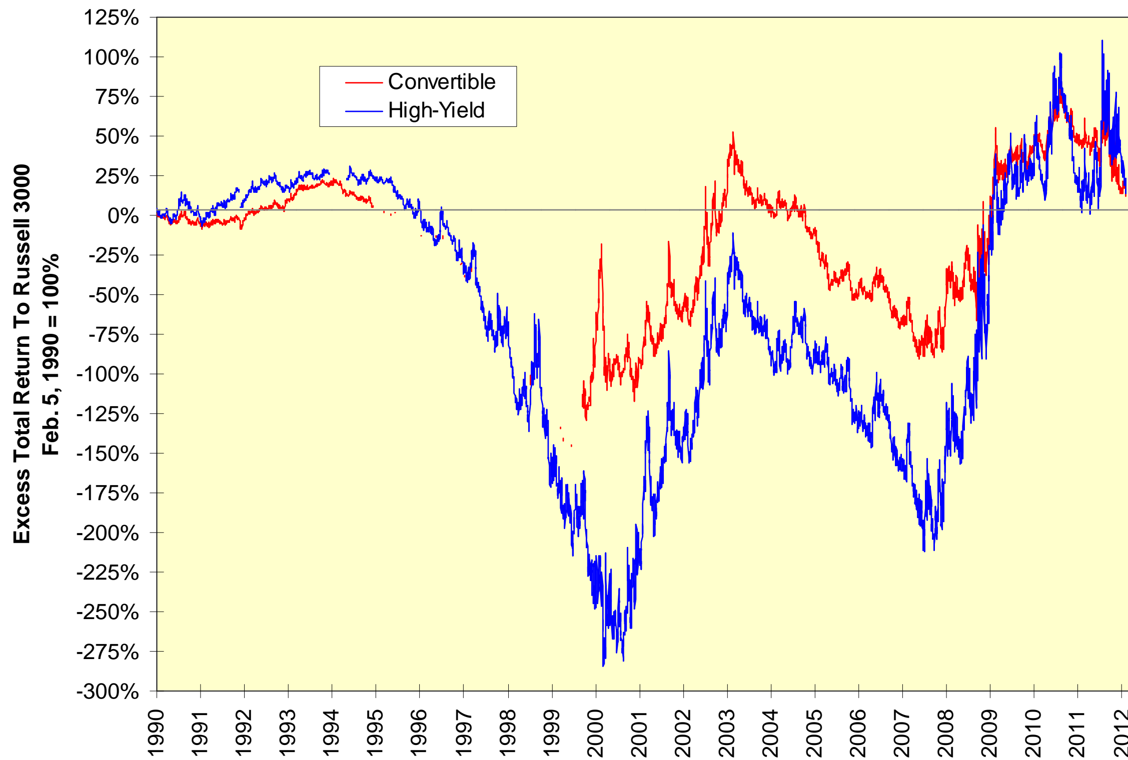
While we are at it, both convertible bonds and high-yield bonds, not to mention high-yield convertibles available in closed-end funds such as the Calamos Convertible and High-Income Fund (CHY), put the hurt on the U.S. stocks, too. So much for the orderly Newtonian universe described way back in 1976 by Roger Ibbotson in *Stocks, Bonds, Bills and Inflation*; that world was turned upside-down.

Returning To Normal

However, the universe can be self-correcting after a fashion. If we map the excess total returns of the Russell 3000 index (accessible via the IWV ETF), and the Bank of America-Merrill Lynch series for convertible bonds, high-yield bonds and A-rated bonds to the total returns for 7-10 year Treasuries since February 1990, we see only investment-grade bonds are underperforming Treasuries and stocks are converging to the two high-risk bond markets.



Now let's isolate the excess total returns of the convertible and high-yield bonds to the Russell 3000. The excess return gap of the convertible index peaked in August 2010; for the high-yield index, the excess return peaked in August 2011. Both relative performance gaps are closing rapidly. As all three measures are rising, the conclusion is quite clear: Stocks are gaining on risky bonds.



I expect this realignment of risk and return to continue until we return to the Ibbotson world of stocks having the highest risk and return and Treasuries the lowest on this scale. What is going to be interesting is how distorted the 7-10 year Treasury baseline is going to be if and when the Federal Reserve stops suppressing interest rates and buying longer-term Treasuries. When that point arrives, something I still have to classify as a statement and not a forecast, you will seen some sustained negative returns and very high volatility on this segment of the Treasury market, which you can trade on the long side with the iShares Barclay 7-10 year Treasury Bond Fund (IEF) and from the short side with the ProShares UltraShort Lehman 7-10 year Treasury ETF (PST).

After all, we had to go through a lot of pain en route from normal to the New Normal; why should you expect the return trip to be without what economists drily describe as frictional costs?