Hierarchy Of Risk And Return Returning To Normal

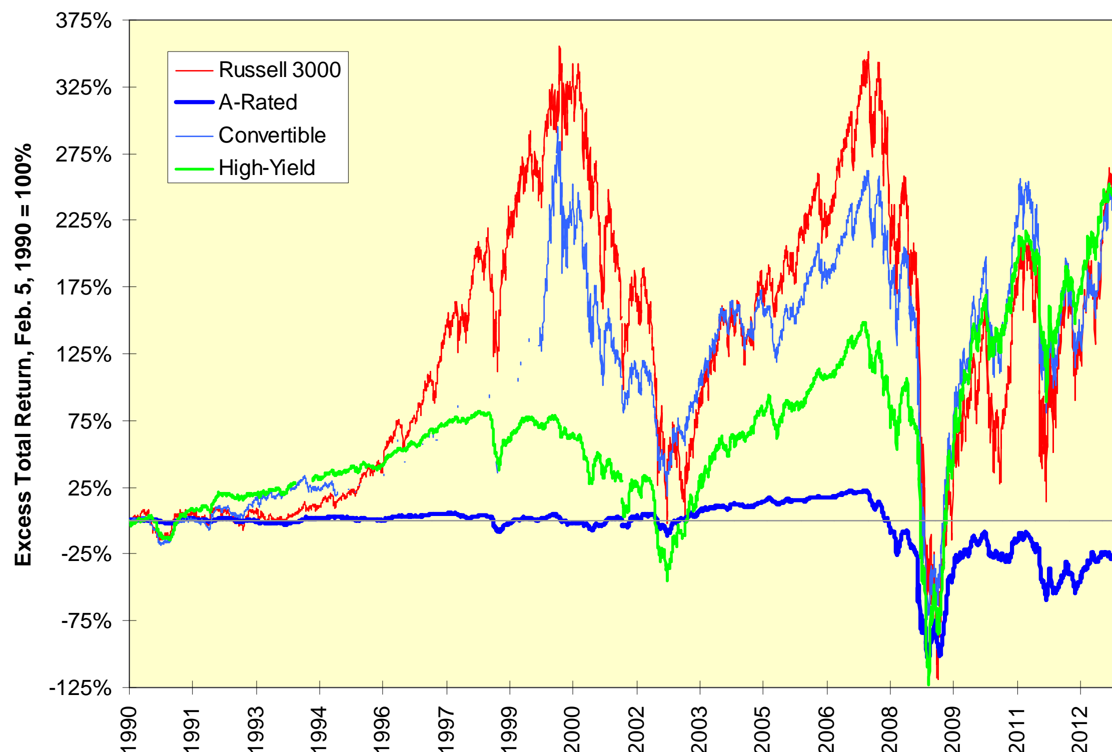
Students are taught risk and reward go hand- in-hand when it comes to investing and, I can tell you from experience, accept this assertion as if it was being downloaded from Mt. Sinai the old-fashioned way. Where else in life do you expect rewards and kudos to flow from taking more risk… driving too fast, drinking 32-ounce sodas, eating fatty foods? Worse, given the ridiculous prevalence of negative real interest rates permeating the supposedly risk-free world of sovereign debt, we cannot even determine any more what is risky and what is safe. While we are at it, the regulatory geniuses in charge of enforcing Dodd-Frank cannot even agree on what a proprietary trade is for a bank.

Back To Normal

Warren G. Harding, considered a failure as President but world-class as a philanderer, campaigned in 1920 for "not nostrums, but normalcy." Sounds good; who, really, campaigns intentionally on behalf of nonsense; it just seems to show up on its own. I concluded a discussion of risk and return last February:

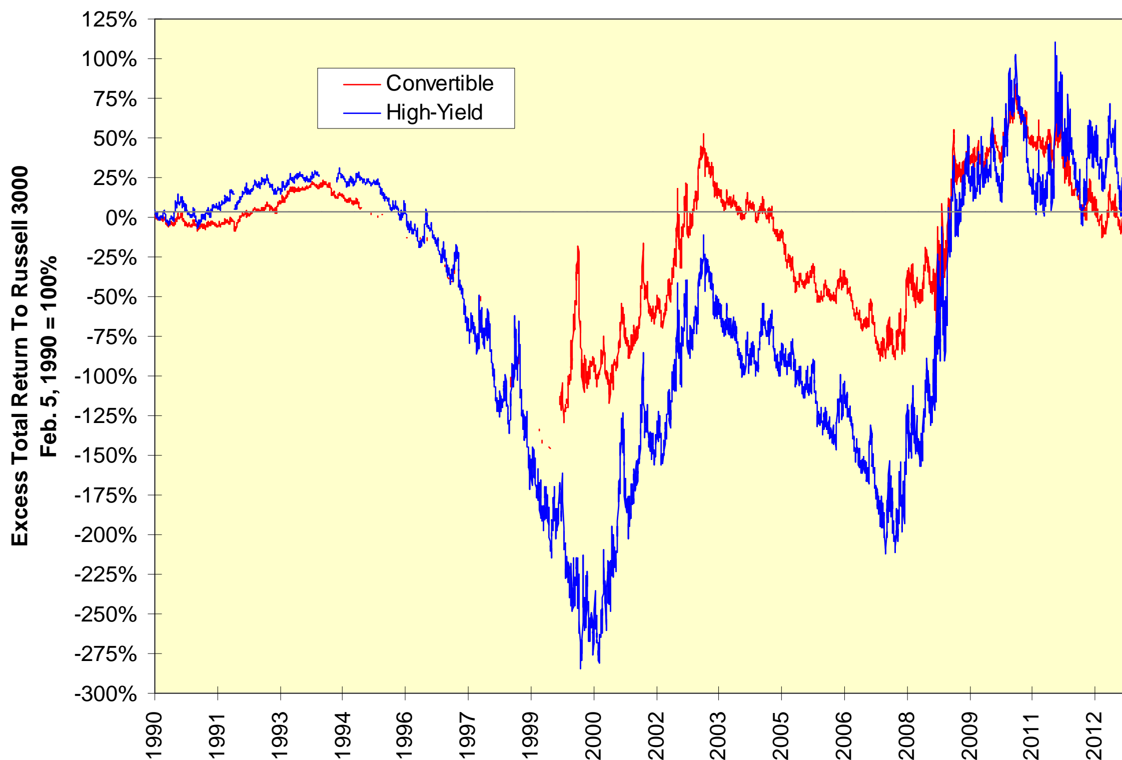
> *I expect this realignment of risk and return to continue until we return to the Ibbotson world of stocks having the highest risk and return and Treasuries the lowest on this scale. What is going to be interesting is how distorted the 7-10 year Treasury baseline is going to be if and when the Federal 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).*

We are almost back to the full normal in our New Normal era. 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. Stocks finally have pulled ahead of high-yield and convertible bonds. The Earth revolves around the sun again, or whatever it was Copernicus said it did.



That last point can be reinforced by comparing the two equity-like bonds' total returns to those of the Russell 3000. Stocks pulled ahead of convertibles in January and high-yield bonds in March. The long hate-fest for equities reached its peak back in August 2011, right at the time when the federal government was talking about defaulting

and the U.S.' credit was downgraded. It also was the time when Operation Twist began and started making stocks, with the long effective durations, attractive relative to long-dated Treasuries.



Stocks should be able to continue this outperformance, even against convertibles; here the bonds suffer from low volatility and a concomitant decline in the gamma of their embedded call options. High-yield bonds' yields and credit spreads have declined to the point where they are attractive only in relation to Treasuries with their negative real yields for maturities of ten years or less.

When Ben Bernanke hopes into his Chairman's helicopter, Ink-Spray One, for his final ride into the sunset, he will turn to his biographer and say, "My proudest achievement was making reality conform to at least one financial theory." Everyone will nod; they always do.