Hierarchy Of Returns As First Quarter Comes To A Close

It is a conversation I have had many times over the past three decades. The punchline is some variation on how I had to unlearn a lot of textbook finance as I transitioned slowly and somewhat unintentionally from an industry economist to someone involved in the daily analysis of markets for purposes of trading. Essentially, if I was to play in the markets, I had to learn to respect technical analysis, behavioral decision-making and other forms of messiness. When in Rome, you have to do what the Romans do; this held true even in Houston.

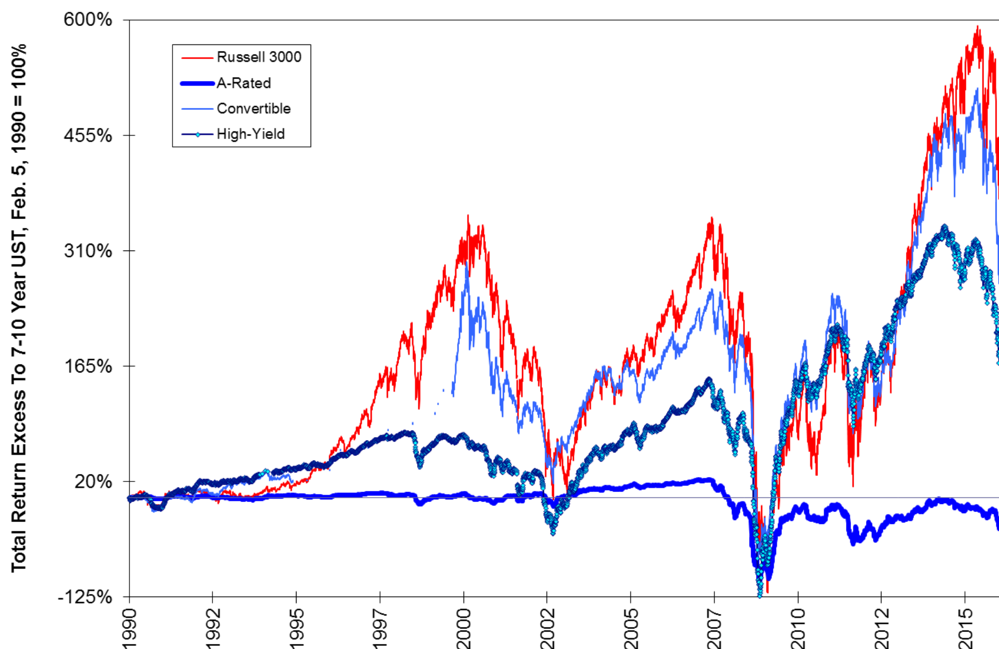
One of those textbook truths was the famous Roger Ibbotson study on the hierarchy of asset returns. This can be summarized as investors get rewarded over time for assuming risk. Stocks would outperform real estate, equity-linked bonds, high-yield bonds, investment-grade bonds, government bonds and then cash. The "over time" part was the fly in the ointment as each successive market downturn seemed to reward flights to safety so that by the end of the 2008-2009 financial crisis investors could look back and marvel at how bank CDs had outperformed equities for years. Back to the drawing board!

Current Hierarchy

Let's take a look at the current hierarchy of selected asset returns relative to 7-10 year Treasuries. These bonds' returns hit a local maximum on February 11, 2016 and have lost 1.76% since then. The Russell 3000's 12.39% return over this period exceeded returns for A-rated+ corporate bonds, convertible bonds and high-yield bonds; these gained 1.31%, 8.54% and 8.46%, respectively.

This return pattern is absolutely consistent with a return to normal risk-seeking behavior. Over the long-term extending back to February 1990, returns have followed this pattern, with one prominent exception. A-rated+ investment-grade bonds have underperformed 7-10 year UST over the past quarter-century and continuously since the start of January 2008. A more proper way of viewing this anomaly may be Treasury returns have been boosted artificially by monetary policies and by regulatory constraints favoring sovereign debt.

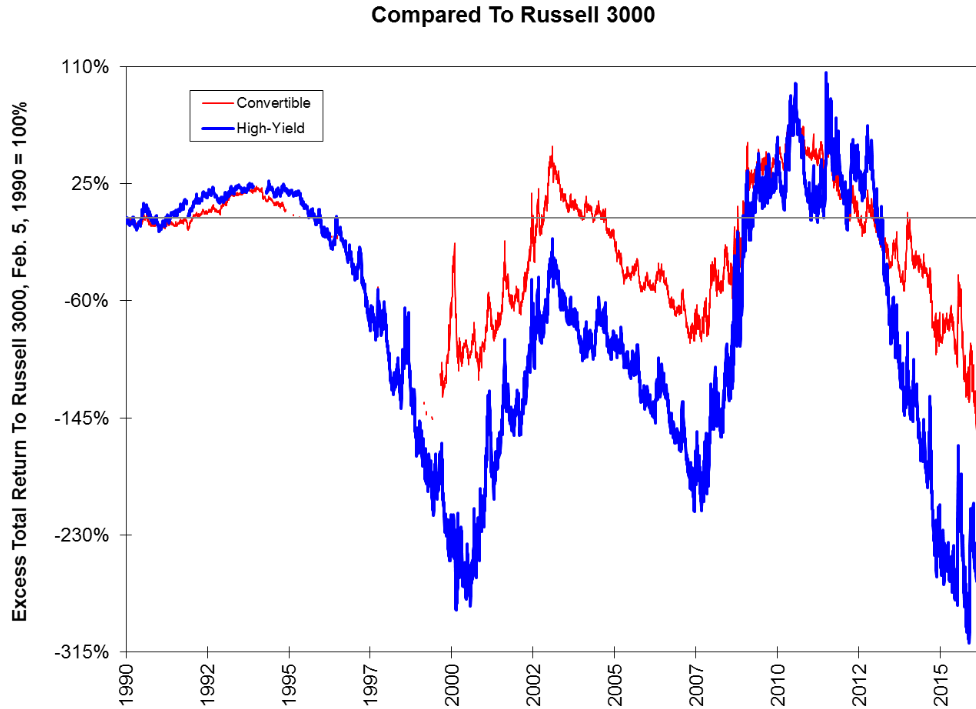
Compared To 7-10 Year UST



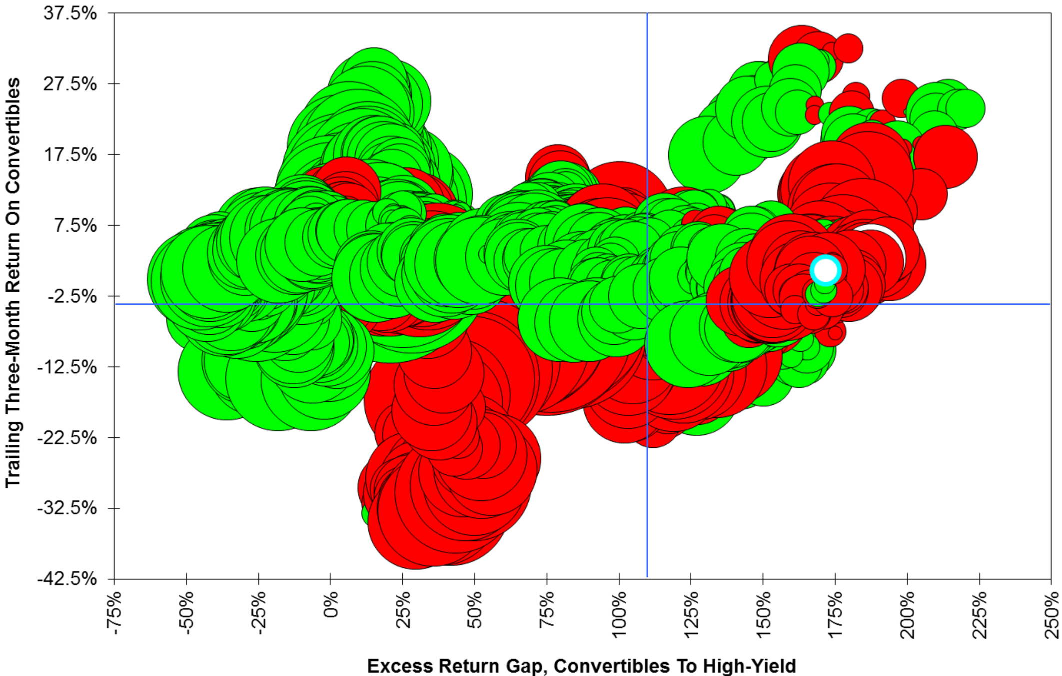
Now let's map the excess total returns of both convertible and high-yield bonds to the Russell 3000. High-yield continues to underperform equities strongly, but the gap is narrowing. It reached its post-2000 level of maximum underperformance, -308.6%, on December 29, 2015; that gap is now -260.7%. The performance gap between

convertible bonds and the Russell 3000 reached its post-2000 level of maximum underperformance of -155.0% on March 18, 2016 and stands at -151.1%.

The relative performance gap between convertibles' and high-yield's excess returns reached its post-2000 widest level of 193.8% on June 18, 2015. It narrowed to 97.0% on February 10, 2016 and now stands at 109.6%.



Does this excess return gap imply anything for prospective equity returns? Let's map three month-ahead returns for the Russell 3000 as a function of the excess return gap and trailing three-month returns on convertibles. Positive prospective returns are depicted with green bubbles, negative prospective returns with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the return. The last datum used, December 28, 2015, is highlighted and the current environment is marked with a bombsight.



The west-southwestward shift has pushed prospective equity returns into a zone of prospective positive performance. We would need to see a strong decline in both the absolute and relative performance of convertible bonds for this to change.