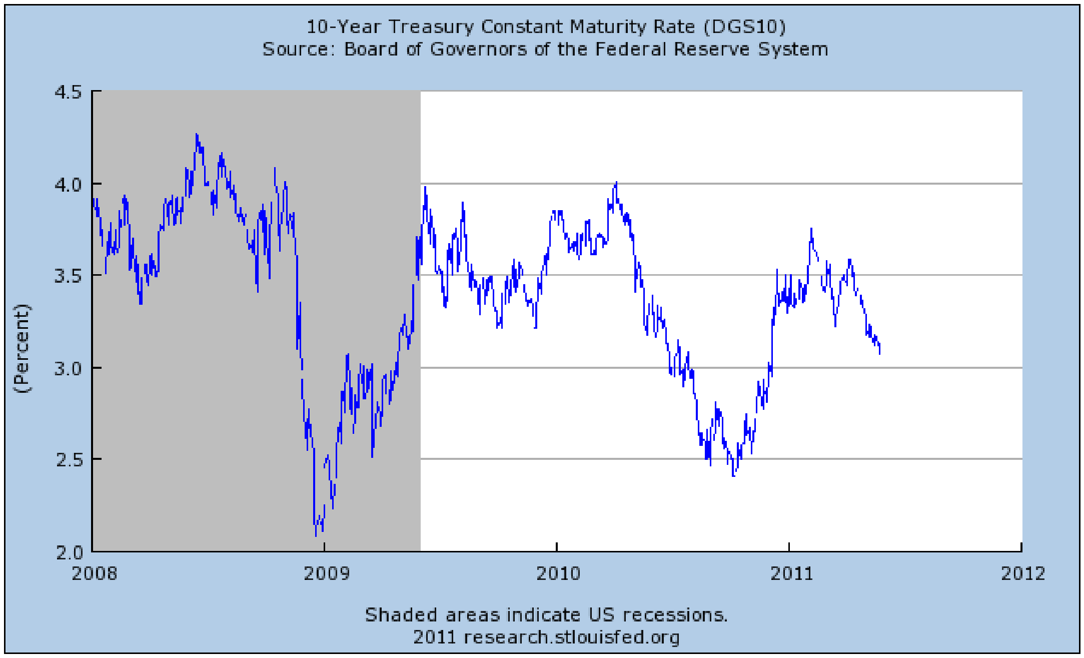
Interest Rates and Asset Prices

June 2011

Michael D. Axel, CFA
Jacob D. Benedict
David J. Manger

For several years now, we have placed ourselves in the minority by rejecting the edict that a rise in interest rates was imminent. Despite generational lows, interest rates have "stayed put":



Our calls on interest rates have been based on research into previous financial crises that exhibited similar underpinnings, most notably Japan in the 1990's. The basis for such calls is not complicated. Interest rates are simply the price of money. That price is set, like any other price, by supply and demand. During a crisis caused by overleveraged borrowers, the demand for money (i.e. the demand for new loans) disappears. While financial journalists often like to focus on the small business owner who can't get a loan, the real problem for the economy is that the larger, more credit-worthy borrowers *don't want loans*. We have stated previously that perhaps the best gauge for the health of our economy going forward is the demand for new borrowing, especially borrowing to support purchases of durable goods like housing and capital investments.

If we had to make a bet one way or the other, we would still probably wager on depressed rates for a while longer. Despite the fact that the Federal Government becomes a more risky borrower by the day, we haven't seen the kind of improvement in the real economy that would support healthy loan demand. Witnessing the same phenomenon last fall, the Federal Reserve embarked on its second round of quantitative easing (QE II). The Fed's key policy tool manifests itself through short-term interest rates. For the past several years, the Fed has kept short-term rates near 0% (this is why most bank accounts pay little interest). Once those short-term rates fell to 0%, the Fed had to resort to other means to stimulate the economy. Quantitative easing consists of the Fed buying longer-dated bonds in the open market, thereby pushing down *long-term* interest rates (increased demand for bonds pushes up bond prices, thereby reducing interest rates).

By lowering both short- and long-term interest rates (i.e. lowering the price of money), the Fed hopes to encourage increased borrowing, thereby supporting the economy (while simultaneously repairing bank balance sheets with low-cost sources of funding).

QE II, pegged at $600 billion, is scheduled to end soon. There is much debate as to whether the exit of such a large buyer from bond markets will cause a jump in interest rates. We don't know. Interest rates are incredibly hard to forecast, so we haven't patted ourselves on the back for past calls nor put too much confidence in future calls. But given the fact that the Fed's exit has been clearly signaled, the economic recovery appears to be slowing and the country still appears to be in a liquidity trap, we wouldn't be surprised to see interest rates remain within a depressed band for some time longer (eventually, one would think, interest rates have to rise).

Each time we make any sort of investment decision, however, we study in detail not only the potential return but also what is at risk. In the case of interest rates, a belief in low rates persisting may lead one to invest in longer-dated bonds. But that leads to only modestly higher yields – the current 20-year Treasury yields just 3.92%, only *0.88% above the 10-year Treasury* (at 3.04%). For the downside risk that one is accepting (high interest rates, higher inflation), that hardly seems to be fair compensation (in spite of the extra deflation protection provided).

Most investors have firmly grasped this concept – interest rates are low and there is risk in longer-dated bonds. What is less understood is the role that interest rates play in influencing the prices of other investment assets. Indeed, when Federal Reserve Chairman Ben Bernanke instituted QE II last fall, he explicitly stated that the Fed was hoping to boost stock prices in order to improve consumer confidence and purchasing power (an incredibly dangerous rationale in our opinion). Low interest rates, like too much liquor, often lead to poor decisions on the part of investors. The reason is that to some degree, all investment assets – whether they are stocks, bonds, real estate, etc. – compete with one another for investor dollars. Howard Marks, Chairman of Oaktree Capital Management, writes in his recent letter to investors:

> Today, pension funds and endowments simply can't achieve their goal of nominal returns in the vicinity of eight percent if they keep much money in Treasurys or high grade bonds, and they may not even expect public equities to be much help. They've moved into high yield bonds, private equity and hedge funds . . . not because they want to, but because they feel they have to. They just can't settle for the returns available on more traditional investments. Thus their risk taking is in large part involuntary and perhaps unenthusiastic.

Relative merit is just one piece of the investment equation; successful investors pay much more attention to absolute merit.

So it may be easy to say "I don't want to buy bonds because interest rates are too low and the risks too high." It is much harder to say, "Instead of bonds I will buy XYZ." But many investors do just that – purchasing investment securities based on *relative merit* alone, i.e. "Stocks will do better than bonds, so I will buy stocks." Relative merit is just one piece of the investment equation; successful investors pay much more attention to *absolute merit*. (Relative merit is not very comforting when your portfolio is down just -20% relative to the benchmark portfolio at -24%.) It seems true that stocks will likely do better than bonds over an extended period of time (this should *usually* be true), but that in and of itself does not mean that investors should favor stocks.

Low interest rates have pushed investors into higher-risk investments and driven up prices, thereby lowering future prospective returns. The best way to win both absolutely and relatively is to insist on cheap prices; Marks writes:

> If I had to identify a single key to consistently successful investing, I'd say it's "cheapness." Buying at low prices relative to intrinsic value (rigorously and conservatively derived) holds the key to earning dependably high returns, limiting risk and minimizing losses.

We are not finding a lot of "cheap stuff" right now. That's not to say that markets are overheated like 2000 or 2007, though there are some corners of the market where things appear extreme (on its first day of trading post-IPO, LinkedIn nearly reached a $10 billion market capitalization, despite earning just ~$200 million in revenue and barely breaking even). Marks observes: "In general, I would describe most security prices as falling somewhere between fair and full. Not necessarily bubbly, but also not cheap."

So how do we respond? We get cautious and creative. Caution means holding an above average cash balance, limiting our exposure to assets that we believe have the most downside and being patient despite a market with a lot of momentum. Creativity means working hard to source both investments and investment managers that reside or operate in inefficient parts of the investment markets, i.e. places where perhaps other investors don't look.

We try to avoid rash decisions and the current period is no different. You won't see us flip to cash one week and back to stocks the next week. Instead, our decisions are deliberate and well researched, taking effect gradually as we seek to take advantage of market movements. So over the next year, if current market conditions persist, one would likely see our:

- Cash balances rise
- Bond portfolios run-off (both a reduction in dollar exposure and interest rate exposure)
- Stock portfolios turnover a bit (meaning we sell stocks that have appreciated beyond our fair value and purchase new stocks that we believe are mispriced for a given reason)
- Partnerships with creative, absolute-return oriented investment managers expand and develop.

Marks, like us, finds wisdom in Warren Buffett's advice:

> The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs.

Looking back, it becomes clear that it was actually harder to make investment mistakes in March of 2009 than now because asset prices were so *cheap*. Though it feels paradoxical to many investors, risk is often the lowest when investors perceive it to be the highest. Likewise, risk is often the highest when investors perceive it to be the lowest. The current state of markets, by our estimates, doesn't call for comparisons to recent investment peaks (at least not yet). But the downside risks do seem to outweigh the upside potential, so we are acting accordingly.