



If money never sleeps, what's an investor to do?

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1. Bonds vs. stocks

When it comes to investing, the striking thing today is this: investors prefer bonds or cash over stocks. It seems right now investors also prefer gold. From an asset class perspective, bonds (and cash) are where the herd has been congregating for quite some time.

Over the last 12 months, according to the Investment Company Institute, U.S. investors have nevertheless ploughed an unprecedented U.S. \$388 billion into bonds and income funds to the detriment of equity funds. Canada has followed a similar pattern with, for example, 2010 redemptions from equity funds peaking in July even though the TSX rose 4.6%.

A measure of how stocks are shunned is provided the National Bank in their September report on this very subject: in the past year P/E ratios for S&P 500 listed companies have fallen contrary to historical precedent. This is a significant deviation.

In our own research (July 7, 2010) we have also noted how over-bought bonds are as an asset class by pointing out that 5 year investment-grade corporate and government bonds yields are, very unusually, in the same range as the yield provided by a stock index such as the S&P 500. An investor with a very short investment horizon may not be interested, but a little longer perspective highlights the opportunity: this aberration can only be corrected by a rebound in stocks plus a concomitant drop in bond prices.

Lest we forget, the recession is over, global trade and GDP output has reached pre-recession levels and the financial system, credit spreads and other indicators of market stability are normal. Warren Buffett recently observed: "I am a huge bull on this country. We are not going to have a double-dip recession at all...I see our businesses coming back across the board."

Today's market imbalances are a direct result of the trauma experienced in 2007-2009 (and much lost sleep on account of it), or exactly what Arthur Pigou had in mind when he wrote: "The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant."

2. Government debt

Something else that has been keeping investors up at night is the knowledge that government debt and deficits in many advanced economies are at record levels. The focus has been on outright defaults (remember the PIGS?) but the reality is that governments are hugely motivated to find other ways to minimize the long-term impact on this debt. Greece for one got bailed out.

Morgan Stanley recently completed an analysis of government balance sheets and possible rates of taxation and concluded (not surprisingly) that many advanced economies have an insufficient revenue base to be happy with the ongoing interest payments or to pay off the debt entirely. Rather than outright default, Morgan Stanley's analysts expect (again not surprisingly) that governments will resort to '*financial oppression*' --- that is imposing on bond holders rates of return that are negative by repaying debt in devalued money (known as quantitative easing) or by imposing taxation or other regulatory incentives to distort prices.

This is what has happened in the past, most notably following both World War I and II. Today the U.S. Federal Reserve is openly contemplating further rounds of quantitative easing (buying back bonds with newly minted currency, which it already did in 2009) as are the Bank of England, some Asian countries plus Brazil. Japan and the Swiss recently did exactly that.

So investors (and especially China) with a large exposure to long bonds issued in the U.S. and in other advanced economies, have some reason to worry. Concerns about long-term currency devaluation and inflation is fueling the flight to

gold and other precious metals, though typically it looks like the market has telescoped the event as if the danger is immediate.

3. Buy gold or short bonds?

Here's what Doug Kass, general partner in Seabreeze Partners, a Florida hedge fund, recently said about bonds (with typical hedge fund manager gusto):

"I personally believe that the trade of the decade will be to short bonds ... the 10-year Treasury yield is too low now given inflation expectations. The benchmark note historically has been 3% points above inflation and 3.6% above real GDP, which was 1.6 percent in Q2. The 10-year note was [only] yielding 2.55 percent in early Friday trading. To me the fund flows into fixed income—\$500 billion in the last two years—is eerily reminiscent of the movement into domestic stock equities in '99 and 2000, and we know that outcome ... the disparity between the 10-year note and inflation expectations means that the bond market is extremely vulnerable."

Given everything we've said about bonds, we are cautious about our bond allocation --- that is, the exposure to long term government debt is reduced and mitigated with cash, corporate bonds, stocks, gold and REITS, and we may (in some portfolios) short long bonds. There is more than just one trade.

3. If money never sleeps, what's an investor to do? Find balance! Don't go boom to bust to boom to bust ...

The very reason investors are so wary of stocks today is that they have gone from boom to bust to boom to bust and thus from extreme to extreme and always with far too short an investment horizon and a focus on just this or that stock and rarely the asset class and a 2-3 year strategy. It's no wonder investors cannot get any restful sleep.

But by thinking about asset classes and using a balanced (this means that no matter what happens, there is never a zero allocation to any asset class) and multi-faceted approach with a longer investment horizon, an investor is better equipped to resist the temptation to chase markets or end up in an extreme position (100% bonds or cash or too much riding on gold or shorting the market) where the timing of every trade is fraught with danger.

Now, sleep on that.

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