

Thought for the Week: Monday, March 22nd, 2010

How are Bubbles Made?

Following the Money...

Tracking the level of investor dollars flowing into an asset class is a very important part of understanding the fair valuation of that asset class and its current market cycle position. Just like the Supply and Demand basics for any retail product, the higher the demand for an investment, the higher the price tends to move.

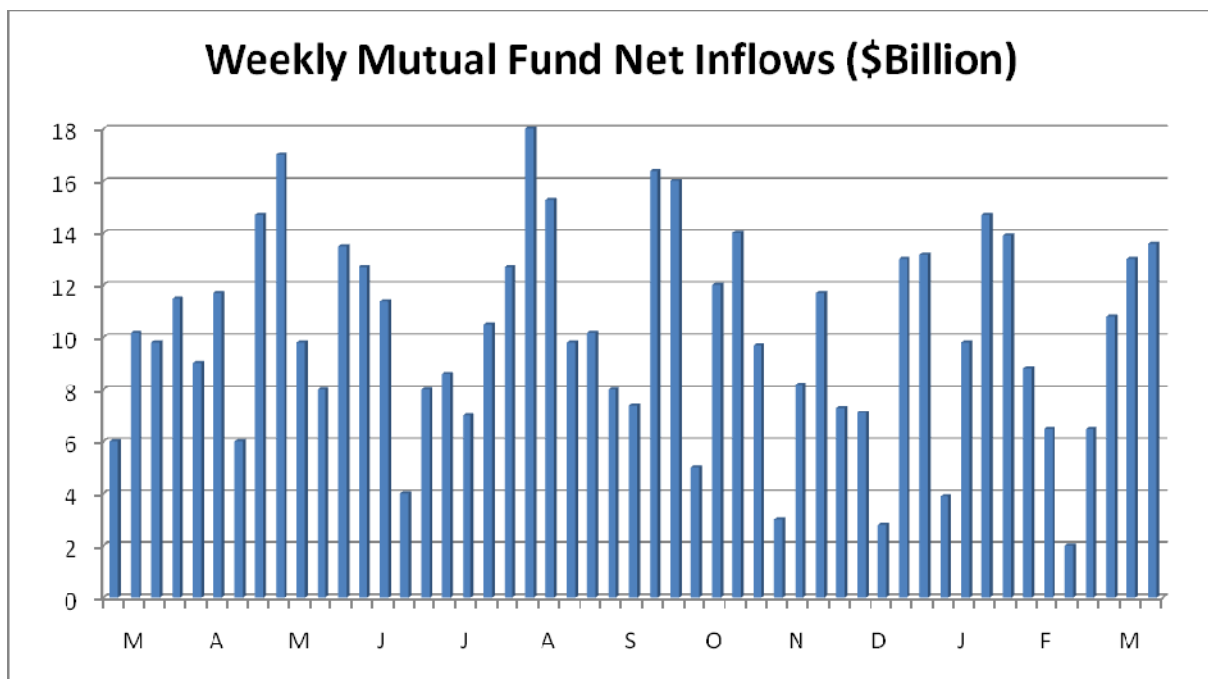
Now, there's nothing wrong with investor interest coinciding with price appreciation - providing it can be supported by fundamental data showing the investment is currently worth what is being paid, or data suggesting the valuation might be justified at some future time.

Unfortunately, **herd-mentality and/or professional speculation can cause asset valuations to climb** to levels beyond that readily supported by fundamental information. This is how Asset Bubbles can form – **money flowing into an asset class for reasons not supported by fundamentals and investor psychology finding ways to justify the situation.**

Where is the Money Going?

At a time when most people think interest rates may rise, causing Bond values to drop; new money has constantly flowed into Long-term Bond-based Mutual Funds. Investors are putting money into an asset class and driving up prices to a level that may not be justified by the current economic outlook.

The chart below shows consistent weekly net inflows throughout last year totaling \$507 billion, of which \$409 billion was invested in long-term Bond funds.





We feel this is because **investors are tired of the exceptionally low interest** rates paid by CDs and low risk income investments. They are therefore searching out different ways to generate income. This is evidenced by the net investor money flowing out of Money Market Funds (over \$250 billion Year to date).

It also seems to be the result of the mass market financial system recommending that clients buy this type of fund. These advisors are motivated to move money out of cash, on which they make very little, and into something they can make money on – **Bonds seem like an easy sell** at a time when Stocks are still a tough recommendation.

One conclusion: **Many Bonds Sectors are starting to look over valued.**

What is Global doing about this?

Reducing Duration: Duration is the approximate amount a bond may **drop in value for every 1% rise in interest rates**. It is closely related to a bond's Maturity, but there are other factors involved.

Moving capital into bonds with lower duration will reduce the sensitivity of bond-based portfolios to interest rate increases. The bond components of DIAS Conservative Portfolios currently have a duration of just below 4.

Generating Diversified Income: Most of the brokers in the aforementioned mass-market financial distribution system (aka The Wirehouse) tend to focus on the allocation of capital between Stocks and Bonds and their immediate derivatives. Moreover, most **Mutual Funds have investment constraints imposed by their prospectuses**.

DIAS has the flexibility to diversify into areas other than Stocks and Bonds. It is free to **analyze many asset classes and regions in search of bond-like income and risk characteristics**.

Master Limited Partnerships (MLPs) and Treasury Inflation Protected Securities (TIPS) are examples of investments which DIAS is using in an attempt to protect conservative, income-led investors from a dramatic rise in interest rates. Preferred Stock and Common Stock which pays excellent dividends are two additional examples.

As we become more and more concerned that **temporary factors are keeping the lid on bond depreciation**, investments such as TBTs and PSTs (Ultra short Treasury ETFs) may become an increasing part of DIAS portfolios in an attempt to protect investors from losing money in bonds.