

Thought for the Week: Monday, December 13th, 2010

Is “Risk Free” really without Risk?

Investment disclosure regulation allows financial advisors to describe the income paid by short-term U.S. Treasuries as **the Risk Free Rate of Return**. Although nothing is totally risk free, the fact that this debt is short term and backed by the U.S. Government means it's pretty safe.

If we consider this income as **the rate of return (income) an investor can expect for taking virtually no risk**, the additional income produced by a different investment is commonly called the “**Spread**”. Spread is considered a measure of the additional risk you are taking.

Riskier bonds are priced to pay a spread over less risky debt in order to tempt buyers.

As a hypothetical example, assume the risk free rate of return is 1% when a different bond would pay 5%. Investors should ask themselves: “is the additional risk I incur by owning the 5% bond worth the 4% spread”. If two bonds pay the same income but one is rated lower than the other, why buy the lower rated bond? To sell this bond, the price has to fall thereby raising the yield spread to a level which attracts buyers.

One reason why U.S. Treasuries have been in such high demand over the last few years is investors wanted to park their money somewhere safe because they thought all companies or smaller countries had a high risk of default. The excessive demand for Treasuries has created **exceptionally high “Spreads” between Treasuries and high-yield Corporates**.

So how has Risk Free Capital been doing recently?

During the last month or so, normally benign Treasury markets have been exceptionally volatile:

- **If you bought a 10 year U.S. Treasury on Nov 1st 2010 the annual yield (coupon) was 2.6%. By Dec 17th it had lost approximately 8% of its value!**
- **If you bought a 30 year U.S. Treasury on Nov 1st 2010 the annual yield (coupon) was 4.0%. By Dec 17th it had lost approximately 9% of its value!**

We have been warning for months that asset classes with historically low risk are exposing clients to higher price decreases than asset classes traditionally thought of as more volatile, such as equities.

Risk Inversion (not aversion!)

For many areas of investing **risk has become inverted**; what used to be dull and boring (e.g. U.S. Treasuries) is now an exciting and dangerous roller coaster. What used to be highly risky (e.g. Emerging market Debt) has become fundamentally dreary.

Maybe this was to be expected – can you remember when the expression “**Safe as Houses**” was a fashionable statement?



For the next year or two, **Corporate Bonds may do better than Government Bonds**. Controversial Statement or Risk Inversion?

When everyone thought the world was about to end they stampeded to 'safer' assets, thereby bidding up prices. This **'risk trade'** was so long and deep that prolonged, excessive demand inflated the prices of many traditionally less volatile asset classes to bubble levels. From a common sense perspective, **what goes up normally comes down**.

In the case of bonds, **as the world recovers, the risk trade will unwind** and prices should deflate to previously boring levels. This is irrespective of the effect of real interest rate movements. The November correction was the first stage of the risk trade unwinding.

So what Happened to Conservative Income (CI)?

While we would not suggest CI is a safer investment than a U.S. Treasury:

- **From Nov 1, 2010 to Dec 17, 2010, Conservative Income yielded 5.7% and dropped in value by less than 1%.**

Although **we expect Conservative Income to recover these losses and continue paying higher levels of income**, the portfolio lost a great deal less than one of the lowest risk investments it is possible to make.

Portfolio Protection

An actively managed, diversified portfolio will always have more chance of lowering volatility compared to a single security or asset class. This is one of the features of the DIAS range of portfolios.

It is important to understand, **Diversification doesn't mean that every selection is picked to always appreciate**. Some portfolio holdings are selected to rise in price if others drop, therefore they will probably fall when others rise. **Please resist the temptation to critique every holding in a properly diversified portfolio**.

Conservative Income attempts to diversify the risk of falling fixed income prices so the recent correction was a test of how well the protection worked. We are pleased with the above result.

DIAS attempts to 'Tilt-the-Odds'; it does not make wild, risky allocation swings and chase sort term curveballs in long term trends. Conservative Income already has a number of holdings which protect against bond and interest rate volatility while maintaining income. These include:

- Short duration bonds and bond funds
- Floating Rate Loans
- TIPS, TBTs & PSTs
- Dividend-paying Equities and MLPs

Therefore, any short term losses experienced in Conservative Income were minimized by these holdings. Moreover, **Conservative Income pays approximately 6% per year of income**, separate from any price gain/loss.

During November, we were well protected when the Risk Trade unwound.