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What's an investor to do?

An easy way to determine if an investment is a good deal or not is to compare your forecasted rate of return to a risk free rate such as a 10 year government bond yield.

However sometimes it is hard to come up with an accurate forecasted return because there are so many assumptions that have to be estimated and many have a large impact on the calculation.

Fortunately, **there is an easy answer in the bond market.**

It's easy because there aren't as many assumptions or estimates that need to be made.

By Bennett Woodward
Chief Investment Officer

In the picture below is the option adjusted spread of high yield debt or junk. This is simpler than you might think.

To fairly compare the yield on a bond to a non-callable Treasury bond, calculators are used to strip out the value of embedded options [usually call features.]

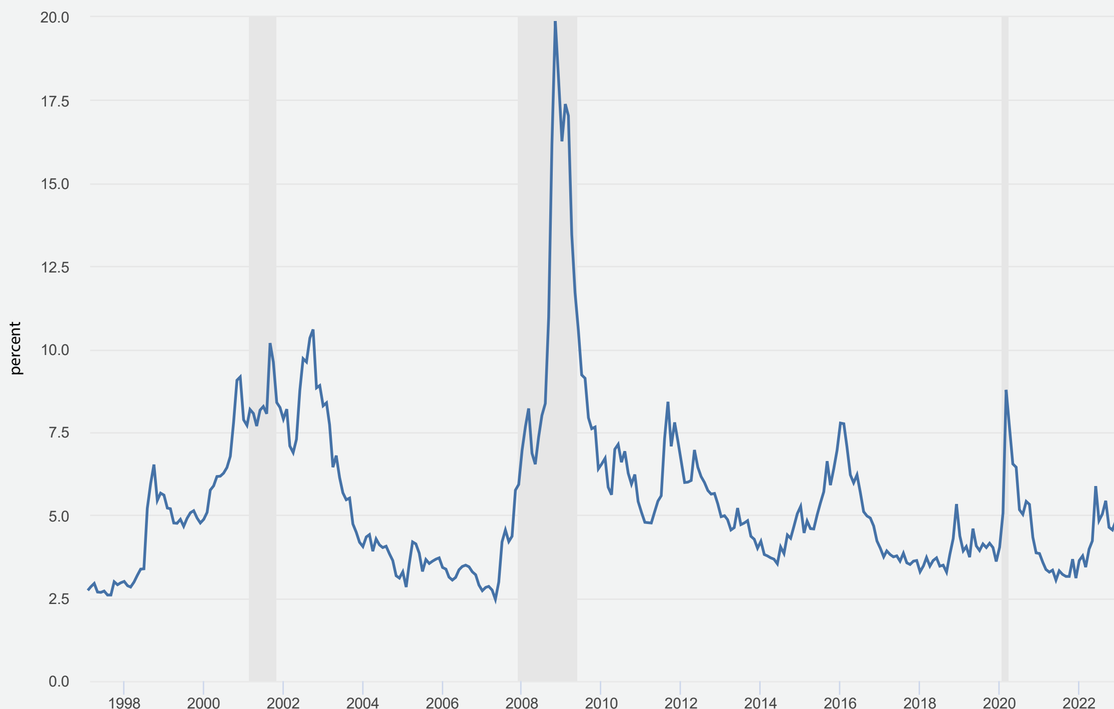
Callable bonds are bonds that can be paid off by the issuer prior to the bonds' maturity date. If a company can refinance at a better rate, they call your bond away from you. Then you will need to reinvest too, likely at a lower rate too. So issuers love call features, but investors hate them. Thus investors are compensated some but often not enough in some extra yield to take on the risk of the bond being called away at an inopportune time.

The option-adjusted spread (OAS) below is the measurement of the high yield or junk bond yield and the risk-free government Treasury yield. Option adjusted means it is adjusted to take into account any embedded option features like calls so the comparison is not apples to oranges so to speak.

Notice that in the middle of the 2008 Global Financial Crisis, you got a whopping 20% more to invest in a junk bond than a risk free government bond. **That, in hindsight, was a great deal.**

Unfortunately, most investors had already bought a lot of junk in 2007, a year of record issuance up to that point, at pitiful spreads of only 2.5% or 250 basis points. When the good deals came, they were way under water on what they owned plus they were very scared to death at the daily financial news so most passed on the good deals.

ICE of BofA US High Yield Index Option Adjusted Spread



Source: Ice Data Indices, fred.stlouisfed.org

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The current latest spread of 4.25% isn't very enticing if you think the Fed can actually get inflation down by causing a recession. On the other hand, obviously investors are willing to buy at 4 to 5% spreads now.

Most of the time, however, the best deals or wide spreads occur right in the middle of a recession, the gray bars in the graph. When the next recession occurs, we probably can get 7 to 8% more yield than a safe government bond. If a recession occurs in 2023, patient investors could be rewarded.

Additionally, a government bond could possibly yield more at that time because the Fed is raising rates to cool the economy to drive unemployment rates up which they hope will stifle inflation.

The takeaway here is chasing yield at the wrong times doesn't improve long term investment results. There is an old Wall Street adage that **more money has been lost reaching for yield [or return] than at the point of a gun.**

So right now, a disciplined investor might be in government bonds or even cash waiting for a better deal. It seems painful to give up yield and return in the short run, but the investment odds should be much better in the future because economic and investment cycles have not been repealed.

This leads to a discussion of equity risk premiums, a more complex financial calculation. **The interesting thing to me is that equity risk premiums and high yield bond spreads correlate a lot.** In statistical terms we use correlation to denote linear strength between two variables. Equity risk premia and junk bond spreads track each other and thus are called highly correlated.

The term equity risk premium refers to an excess return that investing in the stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of equity investing just like higher spreads compensate for the higher risk of investing in lower credit quality bonds.

When the premiums are high, or spreads are high, the risk of investment actually can go down because of adequate compensation for taking the risk. Michael Milken who basically invented the junk bond market back in the 1980s successfully pitched to investors that junk wasn't as risky as they thought. Back then spreads were often over 10% routinely and early investors in the asset class were well compensated because 10% more was very adequate compensation.

However as interest rates have fallen due to monetary policy like zero interest rate policy (ZIRP) and quantitative easing (QE), another acronym appeared on the investment scene, (TINA) or there is no alternative. The risk free rate got so low recently, investors decided en masse to take more risk and earn lower spreads or invest more heavily in stocks at higher valuations and lower risk premia. This is a valuation driven bull market. They are fun until the party is over, aka the bubble pops.

However, all cycles come to an end especially when inflation rears its ugly head. Inflation may be the culprit for the latest bubble popping.

The following is a picture of current equity risk premia according to a Bloomberg model. According to this model, equity investments are very richly priced. Some think they could become even richer but this model suggests that it is a very bad risk/reward right now.

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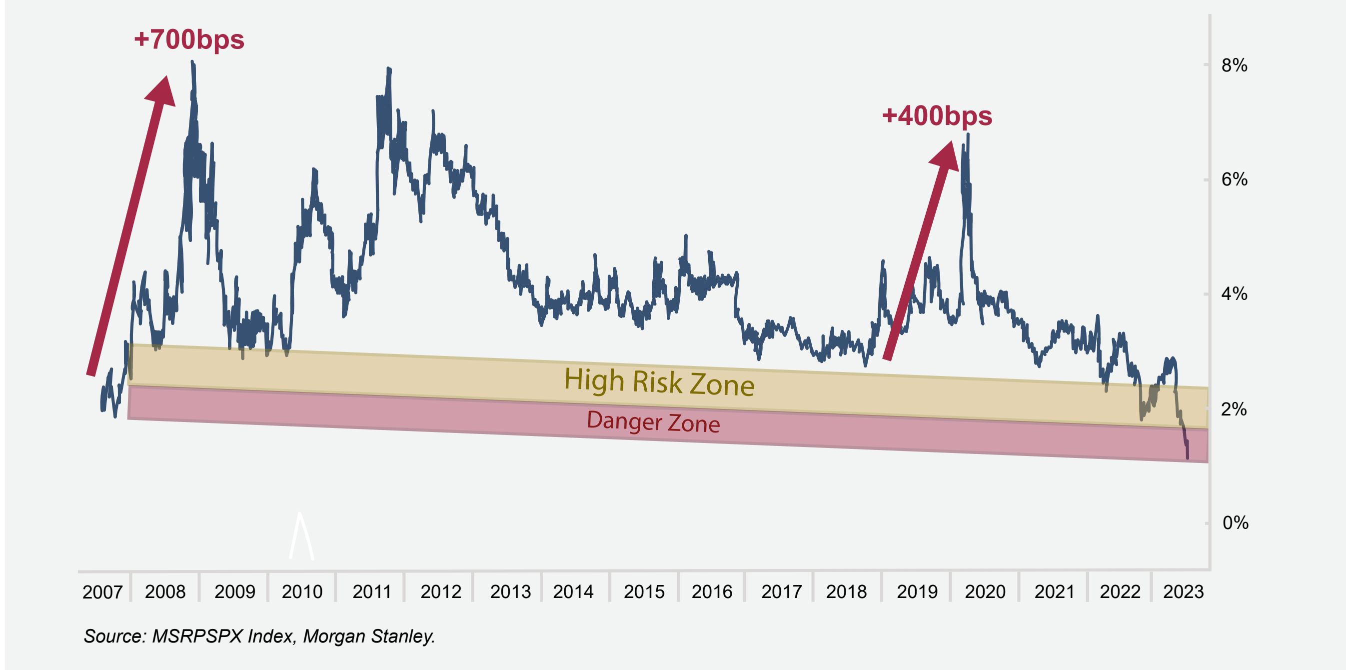

[A Bloomberg Terminal is a computer software system provided by the financial data vendor Bloomberg L.P. owned by Michael Bloomberg that enables professionals to access, monitor and analyze real-time financial market data. BTW I did a private placement with Bloomberg back when they were just getting started at a 15% Yield to Maturity...the good old days. I asked Michael why they didn't go public and he basically said he didn't want to deal with them and he knew he wanted complete control of his empire. I guess he was right!]

So what can investors do?

1. **You can invest as you previously have, but accept that risk will be higher and your returns will be lower than they used to be;**
2. **You can reduce risk a small amount to prepare for a market correction and accept a return that is lower still.**
3. **You can go to cash and anticipate that the market will decline a lot and thus offer much higher returns in the future, or**
4. **You can ramp up your risk in pursuit of higher returns; most pensions are doing this by huge allocations in alternative asset classes like private equity.**

I'm picking a mix of 2, 3 and 4 for myself.

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2700 Via Fortuna #100, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com

5555 Glenridge Connector, Suite 200 Atlanta, GA 30432 • (470) 552-5902 • www.WaterlooCap.com/IWS

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