QV Update

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Bond Bull or Bear?

According to Historychannel.com, on this day in history 99 years ago, the first around the world telegram using commercial service was delivered. It was sent from New York and it was relayed through 16 different operators. It took 16.5 minutes to be delivered. We can now send an investment letter from Calgary to people around the world in a nanosecond, at the push of a button. Amazing, isn't it? The communication and technology revolutions of the past hundred years have allowed critical thinkers around the world to debate in real time. One such debate this week was triggered by an article in the Wall Street Journal this Wednesday titled "The Great American Bond Bubble" by Jeremy Siegel and Jeremy Schwartz.

Mr. Siegel and Mr. Schwartz make the arguments that a bubble in bonds, particularly US Treasury bonds is inflating at an explosive rate. Bond fund inflows over the past year and a half have grown to levels well beyond anything we have seen over the past quarter century. They argue that the safest bet for investors looking for income and inflation protection may be stocks, not bonds. This is contrary to what so many investors have become accustomed to during the past 30 years. Mr. Siegel and Mr. Schwartz highlight that they can find many stocks with dividend yields in excess of 4%, trading at reasonable valuations and covering their dividends by more than 2 to 1. They go on to argue that the last time interest rates on Treasury bonds were as low as they are today was in 1955. The following annual return to bonds was 1.9% over a ten year period, just slightly above inflation.

Bearishly tilted economist, David Rosenberg, was quick to take the other side of the debate. Mr. Rosenberg argues that households may be rebalancing their investment portfolios to bonds after being underweight for way too long. They are doing this out of necessity. Baby boomers are no longer in a position where they can speculate over a return <u>on</u> capital. The boomers, which have now reached a median age of 55, need a return <u>of</u> capital.

What we do know with certainty is this: The potential opportunity in the bond bull is waning. That is simple math. An investor in 10 year government bonds back in 1981, when yields were 15.3%, had maximum price appreciation potential (in a scenario of an immediate drop to 0% yield to maturity) of 153%. Today, with 10 year government bonds yielding a meagre 2.6%, maximum price appreciation for a 10 year government bonds is 26%. With 80% less potential upside today as a result of yields grinding lower, the bond bull looks tired. But as Mr. Rosenberg reminds us, a bond bull is not the same beast as an equity bull. Bond's are contractually obligated to repay you your capital.

An equity's only guarantee is that it won't lose you more than your original investment. Hardly comforting, especially when equity land is still full of land mines. Look no further than some of Canada's largest IPO's this year. Athabasca Oil Sands and Smart Technologies, both off in excess of 25% from their IPO prices. Investors in two of this year's hottest IPO's have hardly been compensated for taking on risk.

"Once bitten twice shy" is an understandable mood for many households that are moving out of equities and into bonds today. But households are only part of the picture. According to an August 11th article in the Financial Times "Hedge fund managers now account for one-fifth of all the trading volume in the US Treasury bond market, up from just 3 per cent in 2009" citing consultancy firm Greenwich Associates as their source. With performance fees often reaching 20%, hedge funds appear to us as the least likely candidates in search of simply a return <u>of</u> capital. For those households moving into the bond market now, we must caution that price swings may be volatile, the nominal return may be low and the risks of capital loss high if credit worries re-surface.

Last week we had a meeting with Murray Mullen, CEO of Small Cap Fund holding Mullen Trucking. He summed up the environment best. He described the mid 1990's to 2006 as one which executives were paid to take on risk. Money was cheap. A gambler was rewarded for covering the table with chips. The market even rewarded some companies for taking risks they shouldn't have taken. Today it's different. It is not a gamblers market.

Last year we saw risky activity temporarily back in vogue. This week the chips were back on the table. We saw more merger and acquisition activity than we have at any point this year. BHP bid to buy Potash for approximately US$39.0 billion. Intel announced the purchase of McAfee for US$7.7 billion. Both BHP and Intel are trading sharply down after these announcements. In the short term, their investors don't appear to like the added risk that these acquisitions could bring. Mr Market is being more punitive towards merger activity. Sobriety is entering investor's minds. HP is down approximately 10% since the announcement. BHP is financing their proposed acquisition with short and medium term debt, adding balance sheet risk whereas Intel is paying cash.

The "two Jeremies" and Mr. Rosenberg could all be right but with differing time horizons. Recent economic indicators are hardly inspiring, and bond prices are firm. High quality businesses certainly have better prospects over the long term than anything offered in government backed bonds today. For an investment in a good business, time is one's friend as the power of compounding takes hold.