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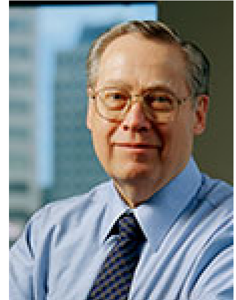
Dan Fuss: What Keeps Bond Managers Up at Night

By Dan Richards
June 8, 2010



Dan Fuss has 50 years of experience in the investment management industry and has been with Loomis, Sayles & Company since 1976. He is vice chairman of the firm and manages numerous institutional accounts for its fixed income group. Dan also manages a variety of mutual funds, including the flagship Loomis Sayles Bond Fund. In 2000, he was named to the Fixed Income Analysts Society's Hall of Fame in recognition of his lifetime of contributions to advancing the analysis of fixed income securities and portfolios.

Dan Richards interviewed Dan Fuss at the CFA Institute Annual Conference in Boston on May 24. A video of this interview is available here.

Dan, you are participating in a panel on the questions that trouble bond managers. What is the number one question that keeps bond managers awake at night?

To be straightforward, I sleep very well no matter what.

All right, so what keeps other bond managers awake at night?

If I was prone to stay awake at night, the one thing that would keep me awake would be market liquidity.

The fundamental difference between the stock market and the bond market is that the stock market, by and large, tends to be an auction market. There is a regular meeting spot, and there are predetermined people, at least on the exchanges, who maintain a semblance of order called the market. And the other non-exchange markets feed off that, so you have a rough idea of what the going price is as the day goes along.

That does not exist in the bond market. You come close with Treasury debt, but as you get away from that you can have difficulty with price discovery. Last Thursday night, for example, the pricing tape on single-A paper had price discrepancies, by our calculations, of five to six price points. However, that was extreme.

When you think back to 2008, for corporate issues there was virtually no bid at various points in time.

That's right. There was no bid on some AAA paper that would normally trade $50 million in an instant.

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So the first issue you worry about is liquidity. What would be next on your list, if you were prone to worry?

If I was prone to worry, I would be concerned with credit.

Today, the corporate sector in North America doesn't seem to be a major worry – quite the reverse. Credit trends right now, in my estimation, are as good short-term as I've ever seen them. And I've been doing this for 52 years now.

The public sector is another matter.

Credit trends at the margin are widening, and the most obvious example would be Greece, but the same is true for other large issuers like the United States government.

And certainly in our state and local area there are exceptions where you are not nearly as worried, and things look rather good looking forward. One of them happens to be where you live. The Canadian government budget balance looking forward under reasonable expectations looks a whole lot better than the US. Either that, or you Canadians are fooling us.

As we learned from Greece, you can absolutely believe all the public record numbers and take them at face value.

Yes, sure.

I also want to talk about the key lessons that the fixed income industry and the bond market have learned from the financial crisis. What would be the number one lesson?

The number one lesson is to be sensitive to potential volatility and what that can do to your liquidity.

People like us are not leveraged, so why should we worry about that?

If I worried, I wouldn't worry about us. I would worry about the intermediary function, the dealer function. Because when the bid goes away from the bond market, the prices can be anywhere, as you recall from the fall of 2008. You just mark them to market. How do you mark-to-market if there is no market? So anybody who is sensitive to short-term valuation is now far more sensitive than they were just two years ago.

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So that's a big issue around risk management. What about portfolio construction? What would be a big lesson from the financial crisis about that?

The big lesson I re-learned was the importance of having some sort of reserve, so that if the market does not have a bid you can bring a bid to an illiquid market.

You might say that's a good social mission. Yes, but it is also very profitable, because you can set a bid, and chances are it will be hit in an illiquid market. So, within reason, you set the price. Now, to do that, you have to have some liquidity. Well, what goes up when other things go down or don't have a bid? It tends to be, although not always, government debt. You better be careful, though, *which* government.

As long as it's the US government you're okay.

Well, I think Canadian government is the same thing.

On the topic of Government debt, I was talking to a long-time veteran of the business, and he talked about a couple of occasions when you actually had negative over-night interest rates on US Treasuries. And he said they'd never thought that they would see that in their career — people actually paid the government to take their money overnight. What were you thinking as that was happening?

Well, the first thing you do is doubt your information source. You say that must be an error. The minus should be a plus, but it's not, or that's "balance sheet dressing." In other words, they need a certain amount of Treasuries in there. It's an extraordinary event, and it won't last.

That's what I was thinking, but it certainly showed an extreme. When markets go to extremes, you have mischief. It's just is another sign of a crazy market without a bid. What's interesting today is the same thing happened with Greek government bonds, but they couldn't print the money.

So you are seeing the same thing potentially happening in Greece, and Portugal — in some of the other sovereign debt that we've been reading about in the paper?

That scared the market. And hopefully the worst doesn't happen, because for other reasons you want to see the euro survive, and you can't have it breaking apart. But you can run into that with other governments where their currency is not a reserve currency.

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