ADVISOR PERSPECTIVES

Why Three Top Bond Managers Like Equities

By Robert Huebscher
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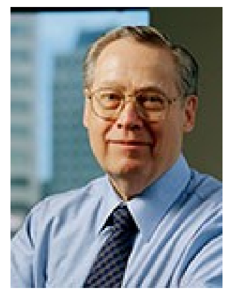
You'll rarely – perhaps never – hear a fund manager say that market conditions do not favor investing in their chosen asset class. That's why it was so remarkable when several prominent managers recently admitted that they favored equities over their own discipline – fixed income.


Dan Fuss

Participating in a panel discussion at the Advisors' Money Show in Orlando last week were Dan Fuss, Loomis Sayles' Vice Chairman and manager of its Bond Fund; Margie Patel, a Managing Director and the senior portfolio manager of the Wells Fargo Advantage Funds; and Anthony Crescenzi, a senior portfolio manager with PIMCO.

"I've never seen it look this good in half a century," the venerable Fuss said of the opportunities in equities, which he called "statistically cheap." Fuss said the earnings and cash flows underpinning US and global stocks were very good historically.


Margie Patel

Patel went further. "By any measure you want to look at," she said, "free cash flow, dividend yield, P/E ratio – stocks look relatively cheap for the level of interest rates." The Fed's quantitative easing policy aims for higher equity prices, and "they will succeed," she said.

The high price paid for GM's IPO, Patel said, served as evidence of investors' appetite for equities. Stocks right now, she said, offer a "once-in-a-decade opportunity to buy and make some real capital appreciation."


Anthony Crescenzi

Even Crescenzi, whose firm is the world's largest bond manager, endorsed equities. "Valuations are not risky," he said. "P/E ratios have been fine for a decade, in part because of the two shocks that drove investors away from equities and compressed P/E ratios." The shocks he referred to where the dot-com crash and the more recent financial crisis. "The Fed has helped to lower the equity risk premium and allowed investors to take risk," he said, "but not undue risk."

QE2, Inflation, and Bond Risks

While all three agreed that expansionary monetary policy was good for stocks, none of the panelists said it posed a danger to bonds, at least in the short run.

“Money supply is not expanding,” Crescenzi said. The funds generated by the Fed’s bond purchases through QE2, he explained, are being re-deposited at the Fed as excess reserves. Until the velocity of money picks up, he said, and M2 expands, inflation is unlikely.

Patel said QE2 was a “mild positive” in the short term, as it will stimulate home refinancing and aid the housing industry. It will also help reposition the federal debt structure, shortening the average maturity, since the Fed is buying mostly medium-term notes.

The long bond may be a victim of QE2, Fuss said, since very few purchases are targeted to 30-year maturities. Yields will rise at the long end, he said, and the yield curve will steepen.

Every bond investor fears inflation. While some consider it to be an inevitable consequence of QE2, the panelists disagree. PIMCO’s stance, Crescenzi noted, is that inflation will stay near its current rate of less than 1% for the next few years, gradually normalizing to 2% or 3%. One needn’t worry until at least 2013, which he said was a critical year, citing the work of Carmen Reinhart and Ken Rogoff. In their widely publicized studies of financial crises throughout history, the two have found that the deleveraging process takes about seven years, which in this case gives us 2013.

Fuss shares the hope that inflation will remain in the 2% to 3% range, but he worries about the role of demographics. With an aging population, fewer skilled workers are entering the workforce, he said. While the trend is most pronounced in northern Europe and other developed countries, this reality is becoming a factor in the US and will drive up labor prices.

Crescenzi agreed that labor drives 70% of the CPI and jobs – not commodities – are the dominant factor underlying inflation. Again repeating PIMCO’s party line, he said that economic growth will be at “new normal” levels of approximately 3% – enough for a “sustainable and self-reinforcing recovery,” but not enough to materially reduce unemployment.

Reversing course

Over the longer term, Fuss was less confident the Fed could successfully keep inflation under control, especially when it comes time to withdraw excess reserves from the monetary system. That said, Fuss said he is confident in the skill set, good intentions, and integrity of the people at the Fed.

Politics concern him. “I am not confident that the Fed will have to bend to the political will of the people as expressed through Congress,” he said. “Pressure will delay – but not deny – how they take reserves out.”

"Odds are at least 50-50 the Fed will let it run a bit long," Fuss said, implying that the Fed might not tighten monetary policy quickly enough to stem rising inflation.

Fuss' warning has historical precedent – at least for inflation striking quickly and uncontrollably. The October 29 issue of *Grant's Interest Rate Observer* recounts a talk by Frank Byrd, director of research at Fielder Research and Management. In late 1971, Byrd said, CPI was decelerating, capacity utilization was falling, interest rates were dropping, and other economic indicators eerily paralleled today's movements. Within 18 months, Byrd noted, "a tremendous inflation emerged" and, despite the Fed's aggressive tightening, the CPI tripled from 4% to 12%.

Crescenzi conceded that the "30-year journey on rates is near its ending point" and that "we are at the end of the duration tailwind." He was entirely confident, however, that PIMCO could successfully navigate a regime of rising interest rates by controlling its positioning on the yield curve (i.e., shortening maturities), exploiting exposure to certain risk factors, and investing in certain countries.

Brazil was a county Crescenzi cited as offering attractive nominal bond yields, relatively low inflation, and a stable currency. Patel, however, disagreed, saying that emerging market bond yields "are not exceptional" and, in those markets, "stocks are a much better buy than bonds at this point." Fuss added that he thinks Brazil's currency is overpriced.

Bonds for the long run?

"Longer-term, I think rates will go up, for a long time," Fuss said.

Coming from one of the most successful and well respected bond investors of the last half century, only a fool could ignore those words.

Asked when rates may rise, Fuss had an ominous response. "You don't want to read about it," Fuss said. "You want to adjust now."

Bonds certainly have a role in virtually any portfolio, if for no other reason than it is beyond the skill set of even to most seasoned and accomplished investor to accurately predict the timing and direction of interest rate movements.

To believe, however, that bond funds will continue to earn the outsize returns many have garnered over the last several decades requires more than a modest a leap of faith.

That leap was articulated by Crescenzi, whose words will be familiar to any advisor who has listened to an active fund manager defend his or her chosen asset class.

"Good money managers know how to play the game," Crescenzi said, and that means knowing how to invest new money at higher rates.

The ability to "duck and weave" and to "go into other areas of the market" will be critical, Crescenzi said. "Flexibility is the key thing. You can't be a passive investor now," he said, and that means you can't be "tied to an index."

That is unless, perhaps, you heed the implied message of these experts and reallocate from fixed income to equities.