

DEBT - No Longer a 4 Letter Word?

November 17, 2008 Newsletter

***When the world is running down
You make the best of what's still around
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When the World is Running Down -The Police

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“The national budget must be balanced. The public debt must be reduced. The arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced. If the nation doesn’t want to go bankrupt, people must learn to work, instead of living on public assistance.”- Cicero, 55 BC.

Is Debt The New Equity?

I have been negative on credit for what seems like an eternity now. I have stated many times that, “if you are not being compensated to take risk, particularly credit risk, do not take credit risk”. And so for a long time we have been void of credit risk and to be frank, remain so. But for those that must take risk, the credit market is starting to seem like a far better bet than do equities.

Before the equity market began its descent this spring, I believed that the credit market was sniffing out something that the equity market was not. Please click the link for more on this ([The Tale of Two Markets](#)). When asked many times why I believe the stock market has corrected so

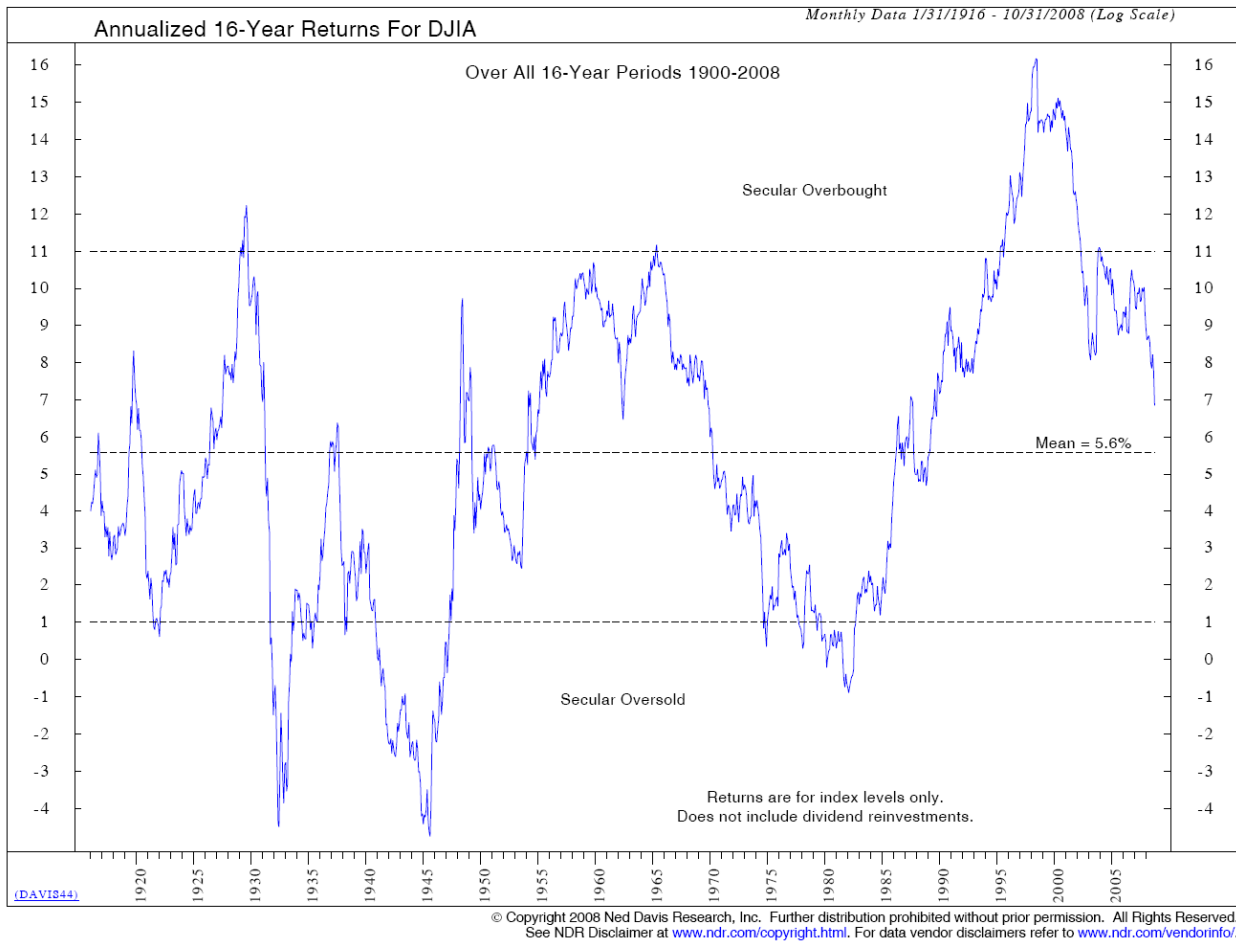
swiftly my answer has been because, “it had a lot of catching up to do”.

The big question on my mind these days is whether or not the equity market has corrected enough in order to make them cheap relative to other asset classes, particularly credit. In short, my answer is a resounding NO!

I have stated and still believe that we are in a secular bear market in equities that will not end until 16 year trailing returns for the Dow Jones Industrial Average and S&P 500 is in negative territory. In other words, this would mean that when we marked the high for the S&P in March of 2000 at approximately 1500, a secular bear low assuming a -4% annualized trailing return for 16 years would place us at around 795 in 2016. Pretty sobering, right?

Looking at the graph below, courtesy of Ned Davis research, we can see that secular lows have been established in the DJIA when the 16 year trailing return range is between -4% and 0%. Considering that the secular bull market party that went from 1982-2000 was the greatest on record, one must expect the secular bear to accompany it to be the nastiest on record as well.

Annualized 16 Year Trailing Returns for DJIA since 1916



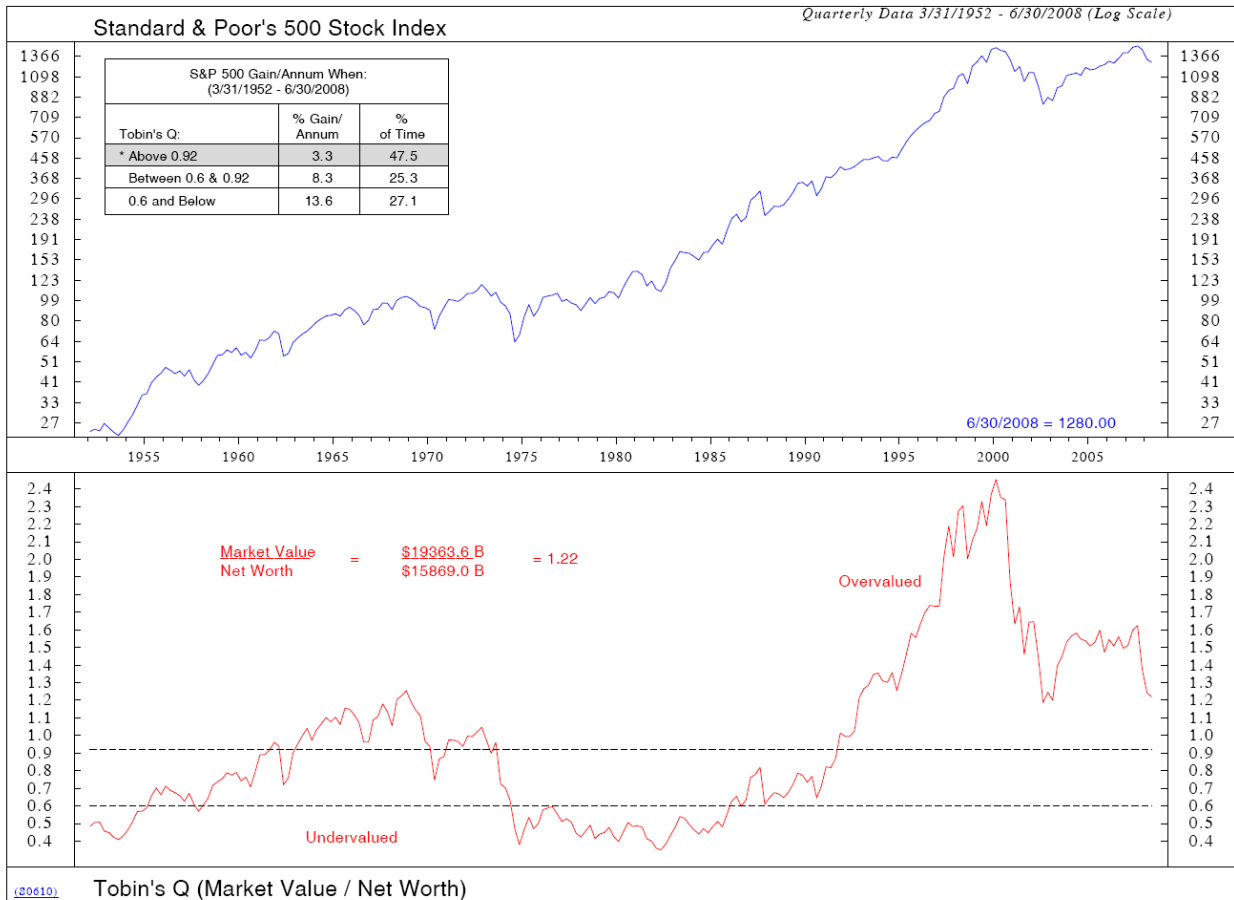
Notably, in the secular bear market, lows stemming from the Great Depression (the most similar pattern I can come up with for the mess we face today) and the 16 year annualized trailing returns in the range of -4% seem to be the most appropriate level to use. Since this credit Unwind may actually be more painful this time around, I think that is the best we can hope for. So while equities may seem 'cheap' to most, I can accept that they will rally from time to time, perhaps fiercely, but the sad truth is that the 'buy and hold' approach that has scorched so many the past eight years is still not the best risk/reward proposition. This leads me to ask, "what is the better proposition?" Debt. Yes, that 4-letter word I have been avoiding for so long.

Why Debt is Now the Best Proposition

Most market players, present company included, are faced daily with the choice of which asset class possesses the best risk/reward characteristics. Considering that I believe that earnings estimates for stocks are at best, optimistic, or at worst, impossible to predict. This leads us to more 'traditional' valuation measure like 'Graham and Dodd' analysis or the 'Tobin Q Ratio' (Market Value/Net Worth).

As you can see in the chart below, the market would need to be carved in half yet again to reach the secular bear lows of the early 1980's, a number (S&P 400-500) that is actually my ultimate goal for this bear market before rallying back to 800 or so.

Tobin's Q for S&P 500



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Got Debt?

While I have highlighted the over-leveraging of the world over the past 10 years or so, we do get to a point when markets fully price in bad news, or for that matter, overshoot to the upside or downside. I believe that long-term investors (folks that can actually withstand interim volatility) are now being properly compensated for taking credit risk. Spreads could blow out further, but the yield along the way is an excellent proposition, particularly when compared to stocks.

Agency Mortgage Backed Securities (in general) are appearing to be a good risk/reward proposition based on an OAS (Option Adjusted Spread) basis, and even high grade corporate bonds and yes, even junk bonds are a good proposition. Please note that while we are significant players in the MBS market, we have

no position in corporate bonds, nor are we likely to in the near future. We are completely avoiding the preferred and hybrid (perpetual 'fixed-to-floating) markets as I would not be stunned to see uncle Sam tell banks and finance companies that they aren't allowed to pay dividends in the not-too-distant future (let's face it, banks are now socialized utilities). Considering that nearly 90% of issuance has been in financials, I would stay away—in fact very far away. Municipals are tempting but lack liquidity and the housing market has yet to be completely felt in that arena nor do I feel capable of doing credit research on the nearly 50,000 issuers with municipal debt outstanding.

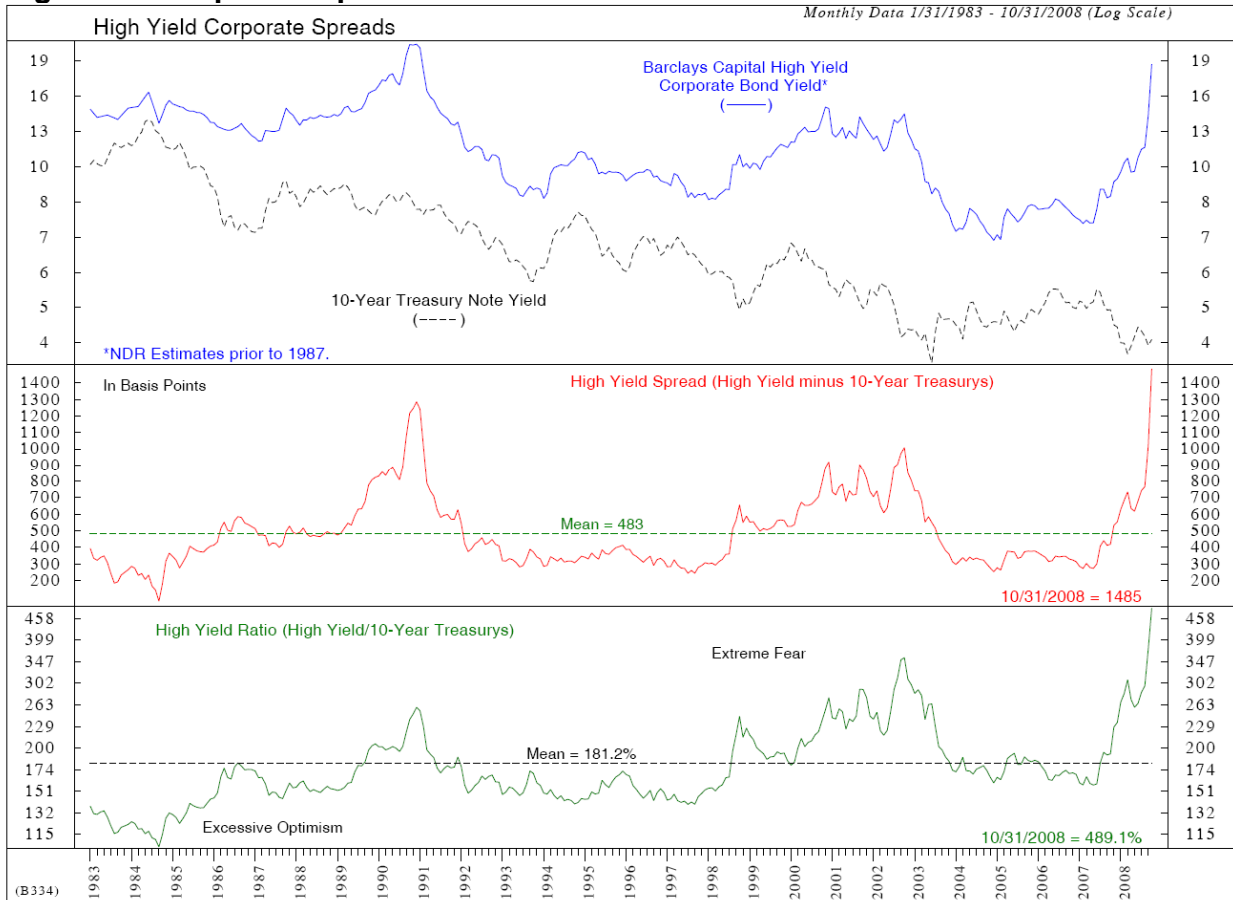
That said, for those capable of doing credit risk in the municipal market, particularly with tax increases likely on the way, municipals make

sense so long as you can withstand the interim volatility. Below, I will highlight the asset classes that I have mentioned before, and you should be able to see for yourself that finally, folks are being compensated to take credit risk.

Whether or not they are cheap and getting cheaper, I will say this; the stock market will have

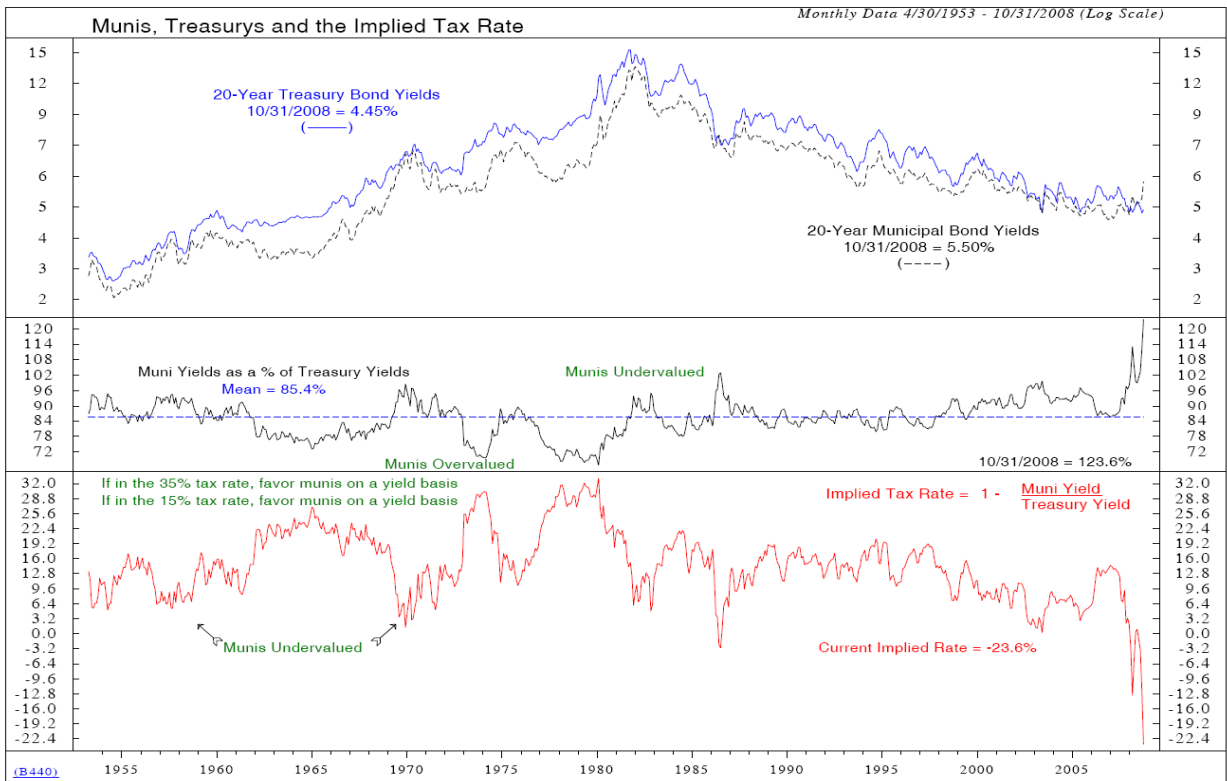
great difficulty performing unless spreads tighten. So equities are out of the question, except for a trade here or there, until the credit markets thaw. One other problem for equities is that since bonds now offer 'equity like' returns or higher, cash may be siphoned away from equities into fixed income. Ultimately, this could lead to even more relative pressure on equities.

High Yield Corporate Spreads



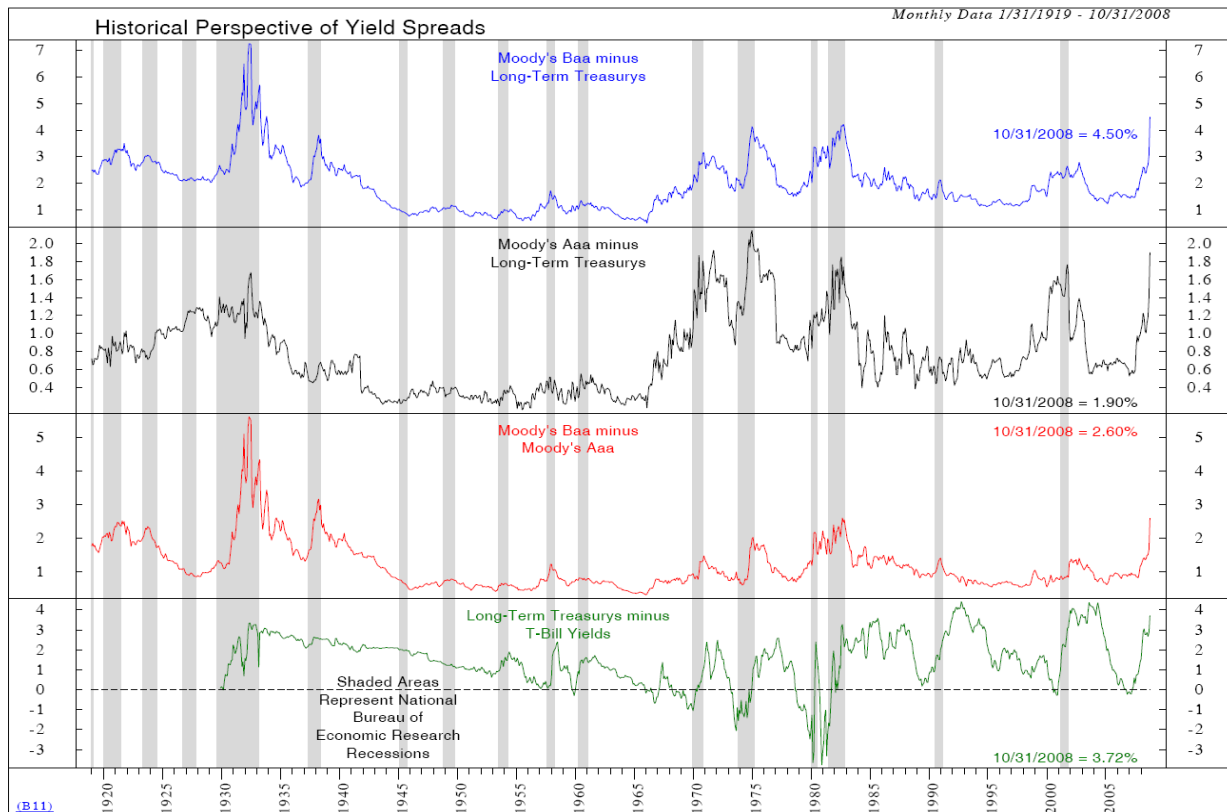
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Municipals versus Treasuries (now 123.6% of Treasuries)



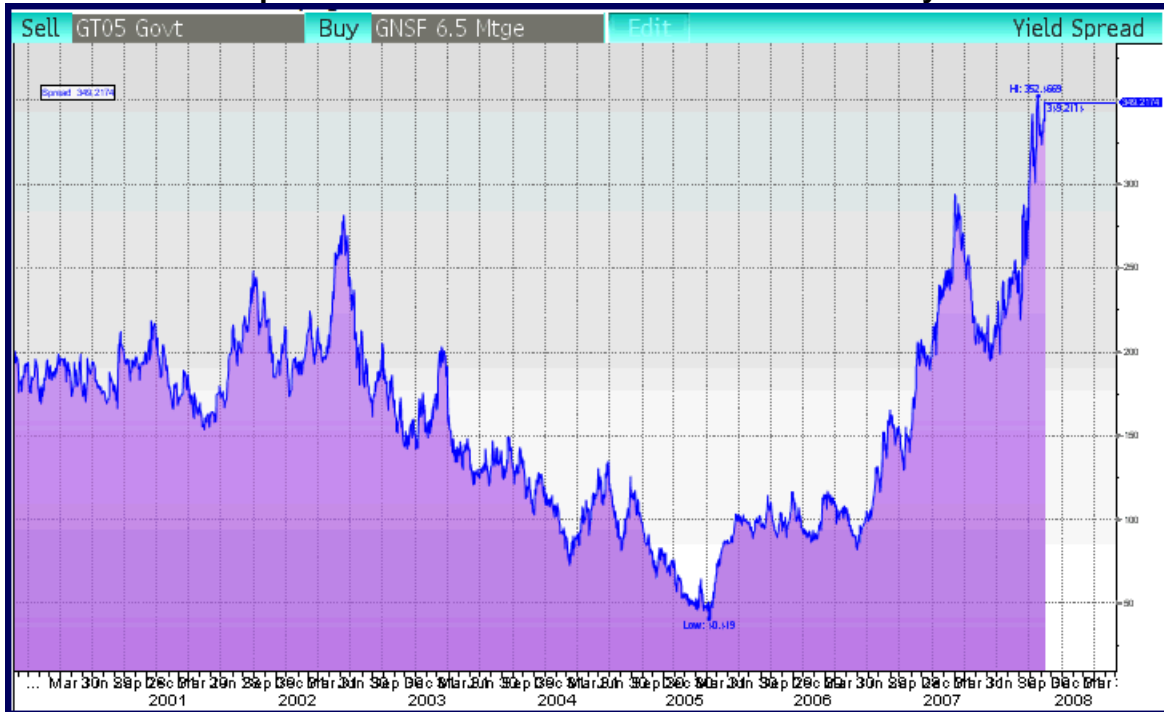
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Historical Perspective of Corporate Yield Spreads



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Historical Yield Spread between 30 Year GNMA 6 1/2% versus 5 year Treasuries



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I am fortunate to be an absolute return investor. I am not tied down to performing in line with any particular benchmark like so many investors. In fact, we ask ourselves daily, "in the absence of a benchmark, what would you buy?" I hope that this short analysis drives the point that, as absolute return investors, we have chosen Mortgage Backed Securities over stocks and Treasuries as I feel they possess the best absolute return risk/reward characteristics. Corporates are cheaper than equities and I doubt that neither economy nor stocks can recover meaningfully until credit spreads begin to behave. So for investors with benchmarks, corporate, junk and municipals make a ton more

sense to me than stocks. This clearly beats a market of stocks when we are grasping for what the 'E' in P/E is and a dividend yield of 3% that will likely drop as either prices fall, dividends are cut, or likely a bit of both.

As always, if we are wrong we will still make 6-7% with no credit risk and loads of liquidity relatively speaking. And above all, if we are wrong, we will have lost opportunity, not precious, hard-earned capital.

Bennet Sedacca,
President

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