



investment styles ebb and flow . . . fundamentals never go out of favor

The Risk in Safety

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The “risk on/risk off” sound bite is routinely applied by financial commentators when attempting to explain inexplicable market fluctuations. As the pendulum oscillates between greed (risk on) and fear (risk off), the fulcrum – the pivot point where the scale rests in perfect balance – can best be characterized as safety. It is from that state of equilibrium that the market begins each trading day; the outcome that financial officers, clients, consultants, advisors and investment managers seek to realize is one where an acceptable rate of return derived from current and future cash flows is balanced against the reasoned probability of principal loss and attendant risk.

The reality for stewards of capital is that the investment holy grail – motionless equilibrium – is not a destination though a journey. And the journey comes with a price: valuation is core to any assessment of risk and reward. While each asset class has a unique set of valuation metrics, the shared objective among investors is a determination of the intrinsic value of a security given risk and reward prospects known in the market at any given moment.

Among the lasting legacies of the 2008 financial market crisis is that the social contract between fiduciaries and plan beneficiaries has in many cases been compromised as discount rate and rate of return assumptions have yielded more measured expectations. And behind the ongoing price/valuation assessments are real people making real decisions that will profoundly influence those for whom the outcomes are decidedly real: parents, retirees, pensioners, endowments/foundations and an endless list of individuals and institutions with hopes, dreams, commitments and missions that, notwithstanding financial market turbulence, they do not want to go unfulfilled.

The Gap: Hopes and Dreams in the Balance

In a relentless pursuit to stave off systemic risk, policymakers in the U.S. and abroad have engaged in coordinated efforts to inject liquidity into the global financial system while signaling to the markets that an extended period of low interest rates would be tolerated, even encouraged. And a not so funny thing happened on the way to the easy money forum: the extension of the 30 year rally in Treasury bonds has led to dramatic reductions in the assumed discount rate applied to plan liabilities. Tomorrow’s liabilities are much closer to today’s stated balance sheet amounts; indeed, the difference between net present value and present value is much lower than this generation of investors has ever known. The confluence of heightened liabilities and a tempering in rate of return assumptions across a number of different asset classes has produced a dilemma for financial decisions makers: The Gap. And the common theme of lower rates of return and higher levels of assumed liability is producing a shared, collective anxiety.

Blackrock CEO Larry Fink effectively articulated the nature of the dilemma in a recent presentation:

This low rate environment is destroying the valuations of pension funds.... And I believe this low rate is reflective of the lackluster investor confidence. The P/E ratio is another example of the lackluster investor confidence. All this is causing greater pension fund and retirement gaps, which I believe will become the largest problem in our country in the next 10 years. This will be much greater than our healthcare problems of today. And this will become one of the dominant themes – the gaps that pension funds have. But, more importantly, the gaps that individuals have with their IRAs and with their defined-contribution plans.

So this gap is going to get more aggravated as longevity increases as we live longer. The gap is going to get greater and greater.

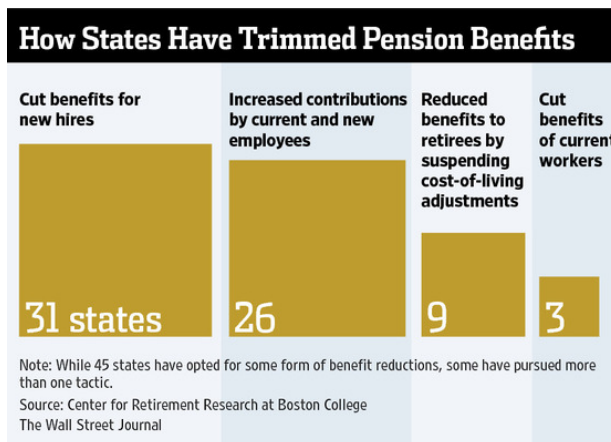
Austerity has become a universal language, a standard government prescription manifest in belt tightening measures among policymakers around the world, and visible in social unrest in Greece and Spain, among other locales. Within our borders, the fraying of the social contract between workers and employers has been predictably contentious, shaping political races including the forthcoming Presidential election, while causing angst at the kitchen table.

A recent *Wall Street Journal* article addressed the measures taken to date, and the still harrowing gap that exists between what retirees expected many years ago and the reality of what to anticipate now.

Almost every state in the U.S. has made cuts to its public-employee pensions, seeking to dig out from the economic downturn, but so far the measures have fallen well short of bridging a nearly \$1 trillion funding gap.

Since 2009, 45 states have rolled back pension benefits for teachers, police, firefighters and other public workers, including cuts by Michigan and California this month....

The state measures show how economic forces are reshaping traditional rivalries, convincing lawmakers and labor leaders that past public pension plans are unsustainable. In Ohio and elsewhere, politically potent unions have locked arms with state officials over the pension cuts.



But the new laws have trimmed just \$100 billion out of the \$900 billion gap between what the states and their workers put into their retirement plans and what the states owe in retirement benefits, according to estimates prepared for The Wall Street Journal by researchers at Boston College.

Unfunded liabilities in many states grew to troubling levels after investment losses in the 2008 financial crisis depleted pension assets. While most states have approved some form of pension cuts, many have opted to apply those changes only to workers who have yet to be hired.

...The lower the expected return, the more the pension's unfunded liabilities grow—unless the state fills the gap with higher contributions from employees or taxpayers, or tries to cut benefits.

Amidst such challenges, the pendulum is anchored on prudently managing assets to optimize return for a given level of acceptable risk. And while austerity measures help to close the gap from a spending perspective, the solution must also be found in responsibly managing associated plan assets with an eye toward realizing a reasonable rate of return. Outcomes ranging from risk off – preserving capital and minimizing risk while accepting abysmally low rates of return – and risk on – earning a return on capital and preserving purchasing power while effectively managing associated risks – define the spectrum.

The Return of Capital: Safely at Risk

The manifestation of safety in financial markets can be seen in the outperformance of select asset classes broadly viewed by investors as safe havens. And while gold, the Swiss franc, German Bunds and U.S. Treasuries have occasionally underperformed, another legacy of financial Armageddon circa 2008 is that these so called “safe” investments have consistently outperformed other asset classes. When fear prevails, the return of principal takes center stage, and little regard is given to the return that one normally demands for the application of such capital. Also ignored is the destruction of purchasing power that arises from accepting little to no return at a time when core inflation is advancing at a faster pace than the rate offered on fixed income instruments. Irrationality is justified as the price of safety, and a negative arbitrage is knowingly and willingly accepted.

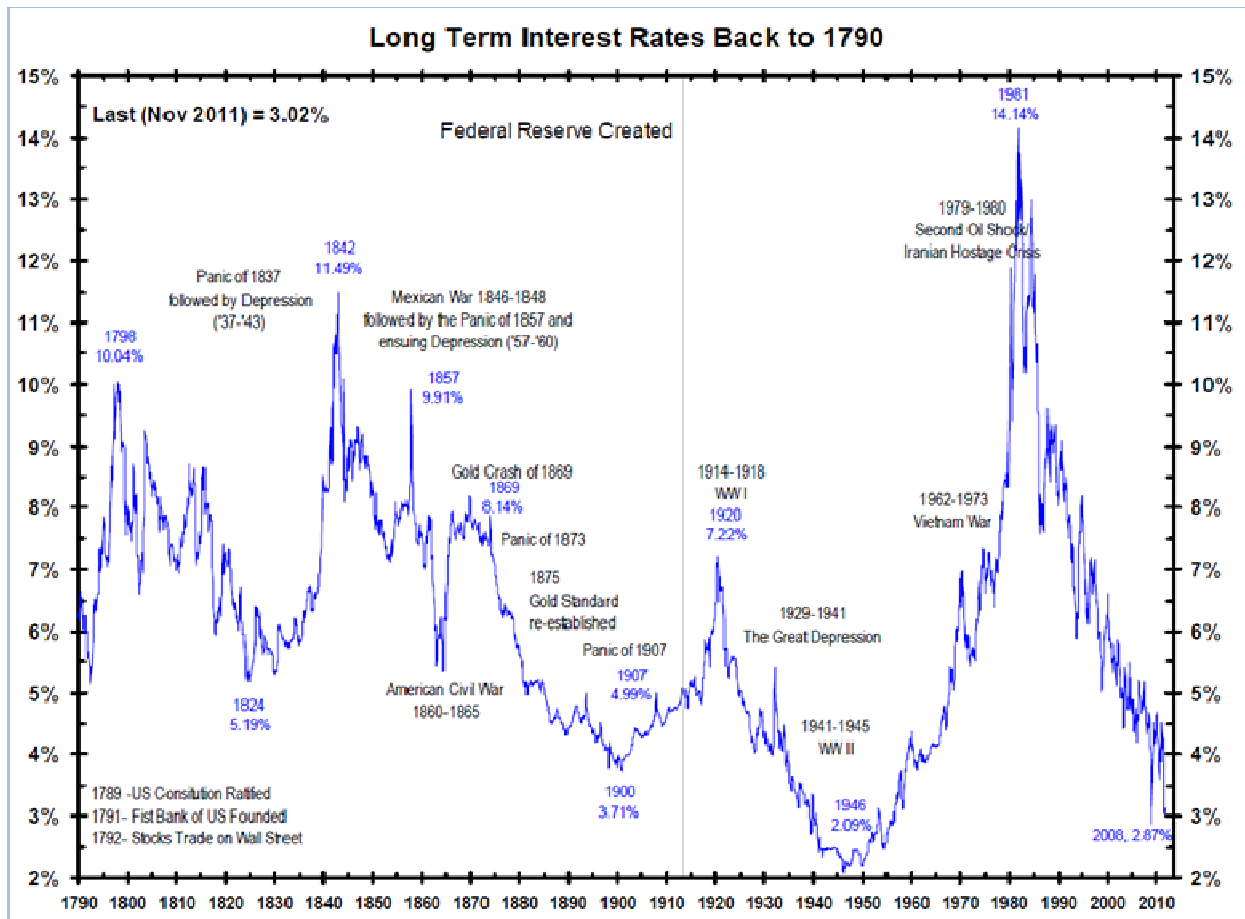
As Warren Buffet noted in his most recent letter to Berkshire Hathaway shareholders:

Investments that are denominated in a given currency... are thought of as 'safe.' In truth they are among the most dangerous of assets. Their beta may be zero, but their risk is huge.

Over the past century these instruments have destroyed the purchasing power of investors in many countries...

...High interest rates, of course, can compensate purchasers for the inflation risk they face with currency-based investments – and indeed, rates in the early 1980s did that job nicely. Current rates, however, do not come close to offsetting the purchasing-power risk that investors assume. Right now bonds should come with a warning label.

The chart on the following page illustrates Buffet's point quite convincingly. The data goes back to the late 1700's and is a fascinating look at the pattern of long term interest rates. What is most striking, however, is the unparalleled decline in rates since 1981: at nearly 1,100 basis points, the reduction in the absolute level of rates is the most pronounced in recorded history. In fact, over the course of my career, long term U.S. Treasury Bonds have performed remarkably well, benefitting initially from then Fed Chairman Paul Volcker's determination to break the back of inflation following the energy crisis of 1974/75 and the oil embargo of the late 1970's. Bonds have essentially been a one way ticket, with coupon rates generally offering a positive arbitrage to underlying inflation at the time of issuance and security appreciation accompanying the secular decline in inflation.



Source: 13D Research, LLC handout "Preparing for the End Game" May 15, 2012

While other considerations certainly exist for an allocation to fixed income as an asset class – the potential to reduce volatility, financial rules that are more benign with respect to mark-to-market accounting – those are byproducts of the decision to allocate to fixed income rather than core reasons. Alternatives – hedge funds now number 10,000 strong and have amassed an incredible \$2.5 trillion dollars in assets, roughly equivalent to the GDP of Brazil – have similarly promoted their *raison d'être* as offering attractive risk adjusted returns/reduced volatility. Conveniently, critical elements of the hedge fund model – returns and fees – receive less attention, and the omission is understandable: returns have generally lagged, and fees are exorbitant. Transparency has its limits.

The 30 year bull market in bonds looks close to having run its course. Interest rates are now only 2.8% on 30 year paper and 1.6% on 10 year Treasuries, and our national debt and budget deficits are perilously high (see table on page six). These considerations, coupled with unprecedented global liquidity (courtesy of easy monetary policies by central bankers around the world, led by the Fed), would seem to suggest accelerating inflation as economic conditions stabilize/improve.

The 2012 starting point of historically low interest rates at a time of pending inflation is in marked contrast to 1981, when historically high interest rates existed while disinflation sat around the bend. As Buffett also noted in his recent letter, "Today, a wry comment that Wall Streeter Shelby Cullom Davis made long ago seems apt: 'Bonds promoted as offering risk-free returns are now priced to deliver return-free risk.'"

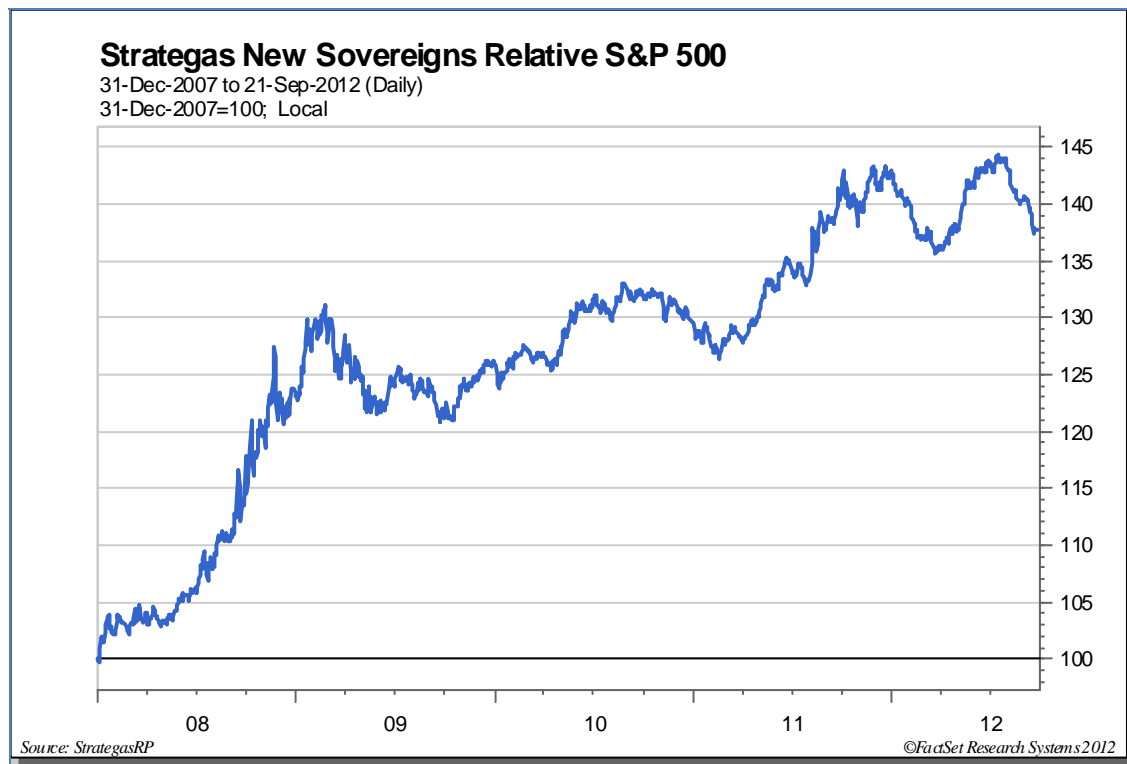
The Return on Capital: A Quality Solution to Narrow The Gap

At HS Management Partners (HSMP), we believe common stocks make common sense as a partial solution to narrowing The Gap. More to the point, we believe quality growth shares offer the balance between risk and reward that could prove an effective means to retain purchasing power in good times while helping to preserve capital when tough times inevitably arise. Buffet's comments are once again relevant:

*Berkshire's goal will be to increase its ownership of first-class businesses... I believe that over any extended period of time this category of investing will prove to be the runaway winner... More important, it will be **by far** the safest.*

What the wise man does in the beginning, the fool does in the end.

Quality always matters. And quality matters now more than ever, as anemic global growth could easily turn negative should a Black Swan wade into the pond. The chart below, courtesy of Strategas Partners, highlights the quality emphasis within the equity market. The "New Sovereigns" consist of 55 publicly traded companies (some of which reside in HSMP client portfolios) with credit default spreads lower than the U.S. government. As shown, quality defined in this manner has handsomely outperformed the S&P 500® since 12/31/07, the calm before the 2008 storm.



We thought it would be useful to compare the debt ratings of the Old Sovereigns – the government debt of China, Japan and the U.S. – with those of some of our portfolio companies for the purpose of evaluating the relative safety, growth profiles and overall credit worthiness as judged by bond investors. By no means is the list of countries or companies complete. Nonetheless, the sample is illustrative in our view, as Microsoft, Google and Nestlé enjoy credit ratings comparable to the U.S., Japan and China. Each company offers a substantially higher earnings and free cash flow yield than the 10 year bond equivalent among the three

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nations, and offer a call on estimated low to mid-teen earnings growth on a cash flow self-sustaining basis; with debt occupying a large % of GDP, the same cannot be said for Japan and the U.S.

Microsoft and Nestlé offer 3% and 3.3% dividend yields, respectively, well above the yields available on 10 year government debt issued in Japan or the U.S., and just modestly below Chinese debt. And with free cash flow yields well above their respective dividend yields, both Microsoft and Nestlé offer the potential to raise their dividend payout ratios, yielding higher dividends in the future. Even assuming dividends advance in line with 10% anticipated long term earnings per share growth, shareholder purchasing power should more than keep pace with underlying inflation. Fixed income by definition provides a static stream of cash flows and one that will dilute purchasing power meaningfully should inflation accelerate from here. Bonds hardly appear safe from our perch relative to high quality equities.

Country Name	Long Term		2012 Gross Debt	2012 Net Debt
	S&P Credit Ratings	10 Year Yield	as % GDP*	as % GDP*
China	AA-	3.5%	22%	NA
Japan	AA-u	0.8%	236%	135%
United States	AA+u	1.8%	107%	84%

**Source IMP World Economic Outlook*

Company Name	Long Term		Dividend Yield	LT Growth
	S&P Credit Ratings	FCF Yield		
Microsoft	AAA	12.0%	3.0%	10.0%
Google	AA-	5.7%	0.0%	14.0%
Nestlé	AA	5.2%	3.3%	10.0%

While the investment holy grail – the motionless pendulum where risk and reward harmoniously coexist – is an elusive destination, the tools we employ on behalf of our clients to achieve financial equilibrium make for a fun, rewarding and interesting journey. And to the extent we can be a facilitator in closing The Gap in a responsible and balanced manner, the HSMP team will find satisfaction knowing our clients’ hopes and dreams have been fulfilled.

References: [Larry Fink, CEO, BlackRock Inc., presentation at Barclay’s Capital Global Financial Services Conference, September 10, 2012.](#)
[Michael Corkery, Pension Crisis Looms Despite Cuts, Wall Street Journal, September 21, 2012.](#)
[Warren Buffet, Chairman, Berkshire Hathaway Inc., 2011 Shareholder Letter.](#)

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