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Worldviews

My first day as a professional investor was July 31, 2007. Exactly two weeks earlier, a pair of internal Bear Stearns hedge funds had shut due to wrong-way bets on mortgage securities. The financial crisis was underway.

We are each shaped by formative experiences that indelibly mark how we view the world. The first two years of my investment career were spent living through an economic and market collapse caused by the unwinding of a bubble in the US housing market. My worldview is etched with the learnings of that experience. I am conditioned to keep my antennae up – to be on perpetual lookout for a return to market over-exuberance.

History doesn't repeat, it rhymes. The next crisis will likely not involve the US housing market. But certain warning signs are timeless, they are hallmarks of every crisis. Leverage. Deteriorating lending standards. Unbounded investor optimism. Asset prices untethered from a prudent view of risk vs. reward.

Six years after the crash, the leading indicators are once again blinking yellow – if not red. Investor leverage (margin debt) is at a 20-year high. Covenant-lite loans now make up 60% of all new corporate loans vs. 20% at the pre-crisis peak. Junk bond issuance is at record levels (50% above 2007). Investor surveys routinely show widespread bullishness. Whole asset classes no longer reflect a sensible understanding of risk and reward.

In our view, these facts call for more caution, not less.

In this appendix, we offer a survey of the institutional structures that have biased policy and investment decisions towards accepting (and encouraging) broad misallocations of capital. We begin with a review of the Federal Reserve and its policy choices. We then turn to the structures and incentives that dictate how most institutional capital gets invested. We conclude by showing how the interaction of policy and market structures can lead to the widespread misjudgment of risk and reward – a situation we believe to be in evidence today.

The Federal Reserve

The Federal Reserve System (the "Federal Reserve" or the "Fed") is the central bank of the United States. A quasi-independent institution, the Fed's twelve regional banks are "owned" by private sector commercial banks, but all profits of the Federal Reserve System are remitted to the treasury of the US Government. While financial systems can function without central banks (as the US did from 1811-1816 and again from 1837-1913), a central bank is widely viewed today as an essential institution in a modern economy. Virtually all countries have one.

The Fed, in addition to certain regulatory and operational duties, has two primary responsibilities: (i) to act as the "lender of last resort" in a financial crisis and (ii) to oversee and implement the nation's monetary policy.

The Federal Reserve's record as **"lender of last resort"** in the inevitable/cyclical credit-driven downturn is generally favorable. Commercial banks tend to maintain an asset-liability mismatch on their balance sheets: their liabilities are short-term (such as customer deposits, which can be withdrawn at any time) and their assets are long-term (such as residential mortgages, which can be as long as 30 years in the US). In a financial panic, the bank's creditors may demand their money immediately – causing a liquidity crisis even for banks that are solvent (i.e., their assets are greater than their liabilities). The Fed has played an effective role stemming such panics by providing liquidity in moments of need; the savings and loan crisis of the late-1980's/early-1990's and the "Great Recession" of 2008-2009 are two good examples of the Fed capably fulfilling this responsibility.

The Federal Reserve's record effectuating successful **monetary policy** (setting an appropriate supply of money in the economy) is more mixed. The Fed operates in the US under a so-called "dual mandate" with the twin goals of (i) maintaining price stability (i.e., low inflation) while (ii) also maximizing employment. To accomplish these objectives, the Fed executes "open market operations" – the purchase or sale of US Government securities from and to private sector dealers – which in turn influence the overnight rate of interest banks charge each other on excess reserves. The Fed adds liquidity to the system (and lowers interest rates) by purchasing US Government securities and removes liquidity from the system (and raises interest rates) by selling US Government securities.

Over time, the Fed has generally proved adept managing interest rates at the extremes. When inflation in the US economy gets out of hand, the Federal Reserve has aggressively raised interest rates to bring inflation back under control; the textbook example is the Federal Reserve's successful effort in the early-1980's under Chairman Paul Volcker to tame runaway inflation by increasing interest rates to as high as 20%. On the opposite extreme, the Fed has moved swiftly to lower interest rates and cushion the economy during a number of cyclical downturns.

The Fed struggles, however, when not operating in crisis mode. As mentioned previously, the Federal Reserve is not a fully independent institution – it remains subject to a range of pressures from outside parties. In particular, **the Fed has an institutional bias towards erring on the side of lower interest rates**. This makes sense: higher interest rates can be painful for the economy. The cost of capital rises, making it more expensive for businesses to finance themselves. Consumers feel the pinch via higher mortgage payments. Workers at manufacturing companies may lose their jobs as rising interest rates often presage a stronger currency, harming exporters' ability to compete in a global economy. For the Federal Reserve Chairman facing the bright lights and withering scrutiny of the masses (and Congress), it is only natural to keep rates low just a little while longer – just in case.

And therein lies the problem – for misjudging the appropriate level of interest rates in either direction is a serious issue with tangible real-world repercussions. Keep rates too high and the Fed holds back economic growth and jobs. But keep rates too low, and the consequences can actually be far worse.

Bubbles

In a nutshell: **keeping interest rates too low causes bubbles**.

Interest rates determine the "price" of money. In a free market economy like the one we have in the US, this is of critical importance: our economy works by having the market send price signals to people and businesses who then respond to those signals. If the price of bread goes down, people will buy more bread. If the price of oil goes up, Fed-Ex and UPS will buy more fuel-efficient vehicles – or switch away from using gas vehicles entirely.

If the Fed keeps interest rates too low, the "price" of money becomes distorted – and market participants respond accordingly. Cheap credit incentivizes people and businesses to take on more debt. An artificially low cost of capital incentivizes risky projects to receive financing and bad businesses to receive capital. As easy money floods the economy, asset prices rise – bailing-out the speculators who misallocated capital in the first place, and emboldening them to take on ever greater leverage in pursuit of ever higher returns. Prudence is replaced by greed, then by a sense of invincibility. Businesses with no revenues and no profits sell for billions. Homes are built, one after the next after the next, in the expectation they can be sold to increasingly less-well-off families with increasingly small down payments. The prices for food and metals and oil soar to unprecedented heights as cheap dollars chase assets that seemingly can only go up in value.

Take, for example, the housing bubble of the mid-2000's. No bubble has just one cause, but **a direct link can be drawn between Fed policies that kept interest rates "too low for too long" and the frenzy that simultaneously engulfed the US housing market**. With the "price" of money so cheap, individuals and families were incentivized to take on debt – and nowhere could they borrow so much as with a residential mortgage. Home values started to rise, bailing-out those who initially borrowed more than they could afford. With the consequences for poor decisions obscured, speculators swooped in: TV shows urged "house-flipping" as a profession, and an infrastructure was created to churn out residential developments and cheap mortgages and sell them boiler-room style. It worked for a while – prices went up, lenders were paid back, real estate brokers and appraisers were hired, flippers went from owning one house to owning three to owning ten. It worked, that is, until it didn't.

The consequences of a recession are bad. **But the consequences of a bubble bursting are orders of magnitudes worse due to the accompanying misallocation of resources.** When we think of the fallout from the housing bubble, we begin with the foreclosures, the empty neighborhoods, the personal bankruptcies. But we also ought to think of the young people trained for jobs that would soon disappear, the parents who switched careers only to be laid off, the money and time and effort wasted building unnecessary infrastructure in an industry way over its skis, the unemployed graduates who would struggle for years to begin a career in the midst of economic collapse. When a bubble bursts, it disrupts a generation. It impacts real people, leaving scars that don't quickly fade.

The problem with keeping interest rates too low is that by distorting the "price" of money, the Federal Reserve pushes our economy into an increasingly severe cycle of speculation, leverage, booms, and busts. Fifty years from now, economic historians may label our age the "Era of Bubbles." The Dot-Com Bubble. The Housing Bubble. The Commodities Bubble. And today, perhaps, the Financial Assets Bubble. Bubble after bubble after bubble – each of which can be traced to a Federal Reserve chronically erring on the side of too-low interest rates.

Institutional Structures and Incentives

The Partnership's philosophy is founded on **absolute value**. We believe all investments have some element of risk to them – that there is no such thing as a "risk-free" investment – and our job in managing the Partnership is to seek out opportunities where the skew between risk and reward is heavily tilted in our favor. When the risk/reward is sufficiently asymmetric to our advantage, only then do we deploy capital.

Two important attributes of the Partnership allow us to pursue this absolute value, risk vs. reward approach. First, we do not measure the Partnership against any benchmark or return target. As a result, we are not pressured to manage the Fund more aggressively or more cautiously than we otherwise would just to match a target or outperform an index. Second, the Partnership is under no obligation to be fully invested. If we cannot find attractive risk/rewards, we sit in cash and patiently wait for the right opportunities to come our way.

The vast majority of institutional capital, in contrast, is managed via a **relative value** approach. Of approximately $225 trillion in global financial assets, only a couple trillion dollars (less than 1%) is invested in absolute return vehicles. Instead, most institutional investors are subject to a different set of incentives and constraints. Their performance is measured against benchmarks or return targets. They are required to be fully invested. And as a result, instead of weighing the prospective risk and reward of an individual security or asset class, their approach must be to compare different securities or asset classes against one another and select the most attractive.

A technology mutual fund, for example, may be required to always have 95%+ of its assets invested in tech stocks, **regardless of whether tech is expensive or cheap**; the fund's manager invests on a relative basis, hoping to overweight the tech stocks that will perform better and underweight those that will lag. Similarly, a pension fund or college endowment may be required to always have 95%+ of its assets invested, **regardless of whether financial assets in general are expensive or cheap**; the manager of the pension fund or endowment invests on a relative basis, hoping to overweight asset classes that will perform better and underweight those that will lag.

To understand financial markets, one must first grasp the structures/incentives that define the economic marketplace. It is critical to recognize that asset managers controlling billions of dollars – and when grouped with other like-minded institutions, trillions of dollars – are generally aligned with a relative value mindset.

When Policy and Institutional Structures Collide

In the aftermath of the Great Recession, the Federal Reserve slashed interest rates near to zero – a level not seen in generations (since the World War II era). Rates have hardly budged in the five-plus years since.

Over time, this policy choice has had a cascading effect across asset classes. As most capital is invested on a relative basis, not an absolute basis, **asset classes tend to trade on a "spread"** between one another: the yield on short-term US Government securities (considered the "least-risky" asset class) is lowest, followed by long-term US Government securities and investment-grade corporate bonds, then non-investment grade corporate bonds ("junk bonds"), and finally by equities (considered the "most-risky" asset class).

Since 2008, the Federal Reserve has poured trillions of dollars into US Government securities, pushing down the yield on short-term US Government securities to a miniscule one-tenth of one percent. With the reference rate so low, other asset classes have followed suit. Long-term US Government securities now yield 2-3%. Investment-grade corporate bonds yield 3%. Non-investment grade corporate bonds yield below 6%.

On a relative basis, these yields make sense. Spreads between asset classes are generally in-line with historical norms, and the risk curve flows smoothly from "least-risky" with the lowest yields to "most-risky" with the highest. But on an absolute basis, **we view these valuations as troubling**.

We consider it a poor risk/reward to lend money at 0.1% annual interest to any person or entity on earth – much less one with $17+ trillion in debt and a structural deficit of $500 billion per annum. We find it similarly imprudent to lend to corporations – even investment-grade corporations – at a 3% rate; a quick glance at a list of the largest US firms twenty or thirty years ago offers ample evidence that today's titans can be tomorrow's failures. And lending to junk issuers at a sub-6% rate strikes us as perhaps the poorest risk/reward of them all.

Across the credit world, we believe the structural/institutional imperatives of a relative value allocation framework have overwhelmed prudence, causing intrinsic risk and reward to be misjudged – or disregarded altogether. **Investors are accepting record-low yields with record-few loan covenants while issuing record amounts of credit to the riskiest of borrowers**. This is not, we believe, a story that ends well.

Portfolios

We would be uneasy if individual securities alone had detached from prudent measures of risk and reward. But there is another concern: **that risk and reward has not only been misjudged on a security level, but also on a portfolio level**. For by lowering interest rates to nil, the Federal Reserve has pushed investors with return targets out on the risk curve – encouraging them to build portfolios of increasingly risky assets.

Take, for instance, a retirement fund targeting a 5% yield. Ten years ago, such a fund could have earned 5% from short-term US Government Securities – the "least-risky" of asset classes. Today this is no longer possible. Yields on short-term US Government securities aren't close. Neither are yields on long-term US Government securities or investment-grade corporate bonds. To obtain a 5% yield, the fund must own junk bonds or yield-driven equities. And so the managers of the fund face a difficult choice: they must either (i) accept a much-riskier portfolio, (ii) sell down assets and hope yields rise in the future, or (iii) abandon their return target.

This dilemma has echoed across institutional portfolios. Rising asset prices have camouflaged problems lurking below the surface – but we suspect that when the tide again goes out, we will see that many institutions have heeded the Fed's rallying cry to step out on the risk curve. A double-danger exists that risk and reward has been misjudged both for individual securities and across institutional portfolios en masse.

A Time for Caution

It has been said that "equity markets get it last." Yields first declined for US Government securities, then investment-grade corporate bonds, and then junk bonds. Eventually, credit-like equities (such as REITs and MLPs) attracted capital flows as investors sought out yield wherever they could find it. Now, with credit markets offering an unappealing risk/reward, capital has increasingly been reallocated to the broader equity markets. On a relative basis, modestly-expensive equities look attractive set against historically-overvalued credit securities.

For absolute return investors, this presents a dilemma. Equities appear "cheap" relative to credit. But from a risk vs. reward perspective, we are observing credit market over-exuberance spilling into equities, causing the level of risk embedded in many equity prices to be unfavorable. This is particularly true for credit-like equities (REITs, MLPs, utilities, high-dividend stocks) but is also evident in a growing number of flash sector manias (3-D printing, cloud computing, battery manufacturers, social media apps, marijuana stocks) as well as no/low-growth defensive sectors suddenly receiving premium (20x+) earnings multiples (CPG companies, restaurants).

Buffett once advised to "be greedy when others are fearful, and fearful when others are greedy." We don't know when the tug-of-war will end between absolute and relative value, when risk and reward will revert to a sensible balance. Big-picture trades – the Fed-induced step-out of capital on the risk curve – can last years, and this one may have a while yet to run. But we are cautious. **Investors are misreading low yields as an indicator of low risk, when we believe the opposite is true**. In such a climate, we think it a time not for greed but for prudence.

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