An Excessive Premium for “Safety”?

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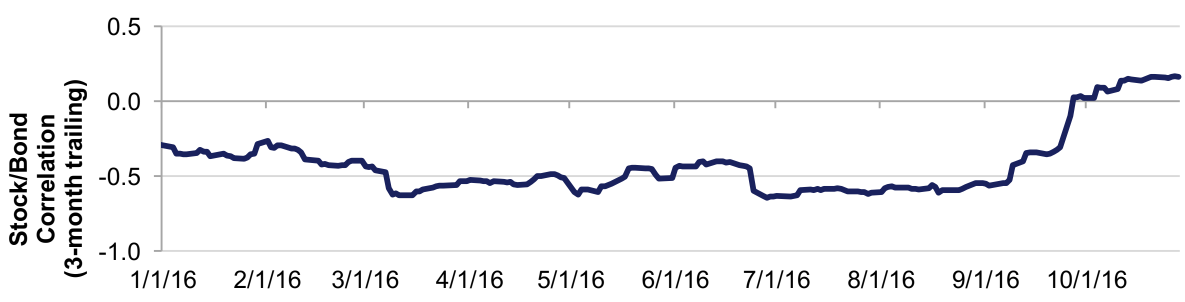
Risk-averse behavior is normal. It drives investors to diversify their exposures and to demand compensation for bearing risk. Today, however, investors seem to be paying up very significantly for any sign of economic certainty and clarity. Bonds are a prime example. With yields hovering around all-time lows, investors are paying a tidy sum for a next-to-nothing—albeit certain—return. Austria just the other day issued a 70-year bond at a 1.5% yield and it was oversubscribed nearly 4:1.

U.S. equities may now be another manifestation of this phenomenon. U.S. firms are generally viewed as possessing more stable and transparent fundamentals than those of other regions, but they are trading at multiples that look excessive versus equities in other markets. Take as one simple metric the current price-earnings ratio of U.S. equities, which at close to 20x stands greater than in 87% of the observed months since 1871. The question is whether a yearn for certainty and clarity in a murky world is distorting normal relationships between price and actual risk. To explore this issue and the investment implications we look through several lenses.

Government bonds. Investors usually own bonds as an anchor to windward—the presumption being that they will hold value or even increase in value in equity down-markets. Over the last 15 years, bonds have indeed done a good job of behaving that way in equity market declines. Equities and bonds in this period have been persistently negatively correlated and we have held bond exposures despite their low yields because they served a useful hedging purpose. Today, however, the stock-bond correlation has risen to the point where the hedging value of bonds is at best tenuous (**Exhibit 1**). Bonds may still help preserve value in deflationary and flight-to-safety scenarios, but there is now a greater likelihood of outcomes where bonds have significant downside with little compensating benefits. The need to find other portfolio hedges has taken on increased importance in this environment.

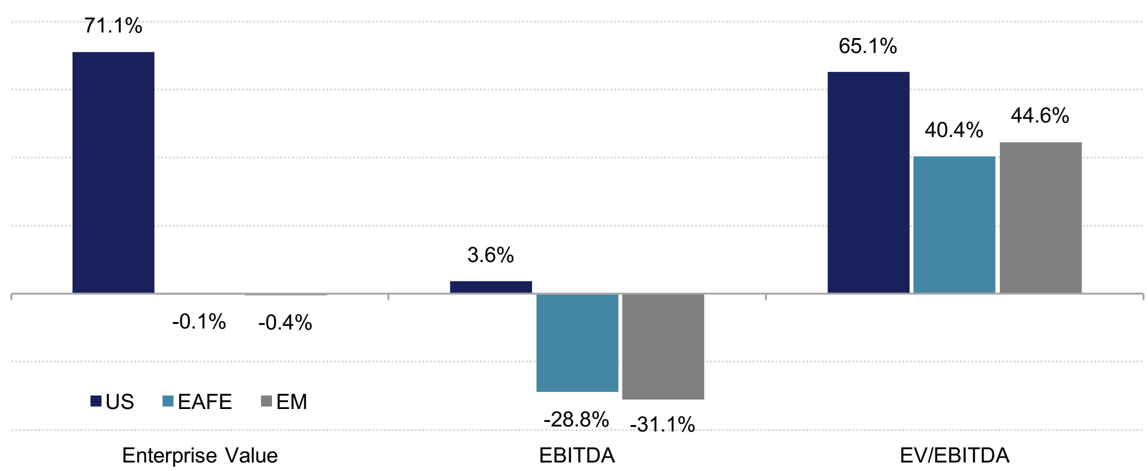
Exhibit 1: The hedging value of bonds has diminished as their correlation to equities has increased



Equity market valuations. As already mentioned, U.S. equity market valuations today are outsized—both on a standalone basis and versus foreign markets. Since 2011, the enterprise value of U.S. firms has increased by 71%, while that of non-U.S. firms is essentially unchanged (Exhibit 2, all in USD). In 2011, the major equity markets were trading in the range of 7x to 8x Enterprise Value/EBITDA. Today, those ratios are 13.1x for U.S. equities, 10.6x for EAFE (non-U.S. developed market equities) and 9.5x for emerging market equities. (The current U.S. EV/EBITDA multiple is only barely shy of its peak of 14x reached in the late 1990s).

The U.S. today is clearly in a class by itself—especially considering that U.S. earnings are not far below their 2014 peak levels and are up 4% since 2011, while the earnings of non-U.S. firms are some 30% below their levels of five years ago. Almost all of the 71% gain in the enterprise value of U.S. firms is from multiple expansion; for non-U.S. firms, unchanged enterprise values over the five years reflect a 40+% multiple expansion offset by the approximately 30% +/- decline in EBITDA.

Exhibit 2: Valuation of Global Equity Markets—2016 vs 2011



As striking as the earnings and valuation divergences have been over the last five years, it is of course a big leap to assume that current market valuations are irrational. What is clear is that market prices are implying that U.S. firms today are quite safe and/or have attractive growth prospects relative to foreign firms and to history. Said another way, U.S. share prices are vulnerable to economic performance short of that expectation.

Beyond bonds and equities, other manifestations of risk-avoiding behavior are particularly noteworthy:

– Individual savings rates are on the rise (approximately 6% in the U.S., up from below 3% in 2007). The slowdown in consumer spending has had much to do with anemic corporate profits.
– Corporations are choosing to distribute rather than invest their earnings. Dividend payouts and share buybacks total 100% of corporate earnings today in the U.S. and just slightly below that globally.
– Banks are far more demanding in the quality and amount of collateral they require and have all but exited certain financing markets.
– Institutions are fleeing prime money-market funds in the hundreds of billions of dollars now that those funds are being required to mark to market their NAVs. Prime funds hold primarily high-

grade commercial paper and short-term U.S. dollar borrowing costs (exemplified in Libor) have risen dramatically in recent months.

- Most important arguably are the world's central banks which are far more concerned with the risk of raising rates than the consequences of not doing so.

If there is good news, it is that excessive behavior creates dislocations and opportunities to earn excess returns. What then are the implications for investing going forward? We are of the view that macro and behavioral analysis can go only so far, and that bottom-up investing really matters. Substantially all of the capital we have with our managers is invested in this fashion. Some of our managers have very focused mandates, while others have broad latitude to roam for opportunities across regions and asset classes. A sizable portion of our managers' capital is also devoted to short opportunities, something that we see as being of greater importance in today's environment. Of course, there are many other considerations that go into portfolio management, including asset allocation, hedging and risk mitigation, and other forms of active investing, but in a world as difficult to fathom as this one, confidence in underlying economic fundamentals needs to be a critically important driver of capital allocation.

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