MASTERING STOCKS & BONDS

UNDERSTANDING HOW ASSET CROSS-OVER STRATEGIES WILL IMPROVE YOUR PORTFOLIO'S PERFORMANCE

BEN EMONS

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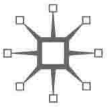

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Mastering Stocks and Bonds

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The Cross-over

Imagine you had a choice between only two investments: stocks and bonds. Which would you choose? Investors in bonds are conservative, seek stable income and have a longer-term investment horizon. Investors who purchase stocks are "aggressive" and want high returns in a shorter period of time. The distinction between stocks and bonds has been in place since the 1920s, when investing became popular. The distinction has been quantified by a correlation that has been mostly negative between the price of bonds and the price of stocks. Investors who seek diversification would therefore have a portfolio of bonds and stocks, for example, weighted by 40 percent in bonds and 60 percent in stocks. The question of which of the two investments would be the top choice is answered by the weights of each in the portfolio. The answer should also focus on the cross-over return between the two asset classes. The cross-over return is defined as the return on bonds that is influenced by the return on stocks and vice versa. Investors may not understand how much, in certain periods, the returns of bonds can be closely correlated with stock returns. The future returns of bonds and stocks may be influenced significantly by the cross-over return. When monetary policymakers use stocks

and bonds to stage a sustainable economic recovery, the correlation between stocks and bonds is an important factor to consider in asset allocation decisions. Often investors look at valuation to determine whether the correlation will change. Perhaps more specifically, the way Benjamin Graham in his book *Security Analysis* (1934) described intrinsic value as "in general terms, it is understood to that intrinsic value is justified by the facts (e.g., the assets, earnings, dividends, definite prospects as distinct, let us say, from market quotations established by artificial manipulation or distorted by psychological excesses). But, it is a great mistake to imagine that intrinsic value is as definite and as determinable as is the market price" (Graham, 1934, p. 68).

Although Benjamin Graham's point is greatly relevant, the intrinsic value of individual stocks and bonds is where a cross-over return opportunity resides. In today's marketplace, it is critical to understand how intrinsic value has been influenced by factors such as global capital flows and monetary policy. There are several aspects to the "cross-over perspective" of investing. A person who invests in bonds may have a different mind-set than a person who invests in stocks. Neither may be aware of how the other may think when it comes to asset allocation. Several studies on investor behavior by the Federal Reserve (Bernanke, 2003), suggest that bond and stock investors have "active" and "passive" asset allocation tendencies. Active management is best described as "bargain hunting." Every day there are "good deals" or "bad choices" in financial markets. Active management is a method to identify securities that are "good deals" and those that would be a "bad choice." In active investment management there are methods used such as fundamental analysis, technical analysis, and macroeconomic analysis. These methods are typically combined

in an investment strategy to spot trends in the economy and market place. Passive investment management on the other hand does not distinguish individual securities, neither to predict their price movements nor to actively time markets. A passive manager invests in the broad market, like the S&P 500 Index. A passive manager has a similar motivation as an active manager: to make a profit. The difference between passive and active managers is the former is willing to accept the average market index return. The active manager on the other hand does not accept earning just the benchmark index return. These managers actively seek opportunities outside the index universe to generate excess return. Active managers are called "alpha" investors, whereby alpha is defined as the return in excess of the index return. In principle, there should be no difference between an equity and a bond investor in the application of active or passive strategies. There are, however, different ways of investing passively or actively in bonds as compared to stocks. An active fixed-income approach to a stock portfolio is an example of a "cross-over strategy." Thinking of such a strategy, one has to identify the difference characteristics of bond and stock investors.

A bond investor applies a different set of methods to identify value than an equity investor does. For example, investing in bonds requires an understanding of yield curve, duration, and convexity. There are differences between bonds in terms of risk premiums ("spreads"), yields, and liquidity. Bonds are about the reinvestment principle of interest and principal, rolling down the yield curve, and earning "carry" over holding a portfolio in cash. There are also fixed-income managers who specialize in arbitrage and relative value. These fixed-income concepts are often not applicable to equity investing. A stock investor looks

at earnings of a company and compares the stock within a specific sector and to the broader market. An equity investor can, however, apply fixed-income techniques to asset allocation. At the same time, bond investors can incorporate equity investing principles in their investment strategy. For example, credit analysis, albeit traditionally applied in selecting investment-grade and high-yield bonds, is rarely applied when assessing government bonds, agency bonds, and municipal bonds. Equity investing, in contrast, uses methods for comparing return on equity (ROE) or invested capital to the cost of capital. A return on equity calculation applied to a bond is a measure for determining how much institutional demand there is for fixed-income securities. For banks, for example, holding government bonds became a profitable business because of the Federal Reserve's quantitative easing policies since November 2008. Government bonds became therefore an earnings generator. This is a reason why return on equity could be applied in fixed-income analysis. The demand by institutions may therefore materially impact future returns on fixed income. A stock is traditionally valued based upon its price-to-earnings (PE) ratio, but the calculation can be applied to bonds as well. Similarly, the yield curve on which bonds are evaluated can be applied to equities by constructing an equity yield curve. A stock value can be calculated from discounting dividends or by using a forward price-earnings ratio. Stocks, like bonds, have duration. By discounting a stock's present value over its dividend yield, a stock's duration is the weighted average time dividends are paid. Equity duration, however, is not static number because stocks are not issued with a final maturity. Based on general dividend payout policy, equity duration is measured as the reciprocal of the dividend yield. On average,

equity duration can be as long as 30 years, but may fluctuate significantly if dividend payout ratios change.

People who invest in stocks and bonds have a different styles and different investment horizons. A cross-over strategy focused on investing in companies at numerous stages of the business life cycle can support a successful mix of stocks and bonds in a portfolio. The strategy is the direct opposite of the buy-and-hold method, in which the investor does not trade between the period when a security is first bought and when it is finally sold. The goal of the cross-over strategy is to get the best returns during shorter periods of time (three months up to a year). A buy-and-hold method focuses on long-term growth. Cross-over investing has been applied in specialized products. There are convertible bonds that are hybrid securities in which bond holders can convert a bond into common stock. A convertible bond also involves merger and acquisition arbitrage. That arbitrage is subjected to corporate governance and entails dividend policy and earnings. There are other "debt for equity" securities, such as contingent capital notes issued by financial institutions, subordinated debt, and distressed corporate debt. Investment-grade corporate bonds can trade closer in price terms to subordinated debt when there is financial stress. In other words, when bonds have higher credit risk, they may behave more like equity in times of high price volatility. Historically, there has been a positive correlation between the broader equity market and investment-grade and high-yield fixed-income securities when markets experience upheavals.

Cross-over investing also addresses several other issues, such as market technical factors, supply and demand, and risk premium. Liquidity in bonds and stocks is generally determined in a similar way (as it is for currencies

and commodities), and measured by a bid-and-ask price quoted by dealers and market makers. Stocks and bonds are traded electronically, and individual stock futures were introduced in recent years. Dealers' treatment of inventory does not always discriminate between bonds and stocks because they are subject to a similar risk budget set by management. The financing of bonds and stocks in terms of a collateral swap works relatively similarly too. Both bonds and stocks can be borrowed or lent on margin. In terms of flows, bond funds have seen a surge since 2009. This increase has been fueled by uncertainty as to why people would rather save by investing in securities than borrow to start a business. Market commentators view this surge as a result of Federal Reserve policy that attracted risk taking in financial markets. As a result, flows in stock and bonds funds have been in lockstep since 2009. Flows into stock index funds and government bond funds have been at a high record following the 2008 financial crisis. In a modestly recovering economy with inflation but ongoing uncertainty, interest rates and stock prices tend to move closely together. This is likely why people have been diversifying between stocks and bonds. The relationship has strengthened by way of flows into stock and bond funds. Figure 1.1 on page 9 demonstrates the trend. Bond funds in particular have moved more than $1 trillion away from their normal growth trend. Equity funds have remained below the trend since the early 2000s.

The relationship between bonds and stocks can be put into a framework. When interest rates rise in an orderly way, stock prices tend to rise because a rising rate environment contains future inflation and ensures stable economic growth. Stable economic growth and moderate inflation should be positive for companies' future earnings, and