Equities vs. Fixed Income

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We are often asked whether we focus only on equities. The answer is no. We are now closing in on our 30th year in business, and in our history, we have invested in just about everything in which it is possible to invest. Many firms have an investment policy based purely on benchmarks. For example, one might look at the percentage of the S&P 500 represented by oil. An allocation would be chosen at that specific percentage; passive indexing or some percentage plus or minus the benchmark; and active indexing.

We, however, believe allocations should be driven by where we are in the business cycle. There are many cycles to be sure. Among them are the Presidential cycles, 20-year, 30-year, and 50-year cycles, and the so-called Kondratieff Wave Cycle. The Elliott Wave Cycle, currently espoused by Robert Prechtor, has to do with a mathematical concept called the Fibonnaci sequence (named for Leonardo of Pisa). Our purpose is not to drag you through the arcane concepts of the business, but simply to say that cycles do exist.

This cyclicality reflects the human experience: not only our longevity, but also the phases through which we pass in our lives. Frankly, it is the predictability of these cycles that should give comfort to investors. We as humans do repeat our behavior over and over again. President Truman is quoted as saying, "The only thing new is the history you have not read."

In a prior strategy update, we discussed how there were really only two assets classes: equities and fixed income. This has to do with how commercial endeavors and real estate projects are funded. One way is through equity; the other is through borrowed money. The balance between the two is affected by such considerations as the interest rate on the borrowed money, the term of the loan, and the availability of the funds. Equity capital receives what is left over after the fixed-income investors receive their interest payments and the return of their principal.

Fixed income is a contract in which one entity provides capital—usually in $1,000 increments—in exchange for a fixed rate of cash flow (the coupon) for a set period of time. At the end of that time, the borrowing entity agrees to return the original $1,000. The agreement normally does not specify any adjustment for the loss of purchasing power. It is assumed that the initial interest rate is high enough to provide an acceptable "real" rate of return meaning after-inflation. If the initial rate is set too low relative to the actual inflation rate, both the cash flow and the principal will be adversely affected over the duration of the contract.

The level of interest rates, once the contract has been signed, affects the market value of the agreement. For example, if current rates are 5%, one would receive $50 per $1,000 over the life of the contract. However, if interest rates jumped to 10% over night, it would take two of the old contracts at $50 per year to equal the cash flow available on the new contracts. Therefore, the value of the old contracts would have to fall by 50% so that one could get the same cash flow from either two of the old or one of the new. Rising interest rates during fixed arrangements can be quite painful for the lender. We find ourselves at such a point in history. During the 1970s, the most recent period of rising interest rates, bond and other fixed income holders were savaged by the combination of rising rates and rising inflation. Not only did the nominal value of the contracts decline precipitously, but the dollar value of the cash flow and the marketable value of the bond eroded significantly. Government rates eventually peaked in the high teens—levels not seen since the Civil War.

Those who invested at the peak of rates in the early 1980s benefited greatly from falling interest rates. Not only did they receive huge cash flows, but the value of those contracts rose tremendously. It was an extraordinary period to own fixed income.

Rates declined to historic lows as governments around the world flooded the system with money to arrest the economic collapse that threatened twice this decade. Short-term interest rates became zero for all intents and purposes. One does not want to own contracts with fixed rates of interest at historic lows.

Rates are going to rise. The first reason is that the massive amount of global stimulus is working with a vengeance. Most indicators of economic activity and the various precursors are all very strong. As mentioned in the prior piece, unemployment is a lagging indicator, so we will not see that turn for another quarter or two.

The second reason for rising rates is inflation. While the pundits say there is little evidence of inflation, anyone who drives a car and has seen gasoline go up in cost by 50% in recent months would strongly disagree. It is out there and coming toward us in a major way. The price of all this stimulus will be a proportional amount of inflation.

The third reason is the printing of money. As we have asserted, the printing of money (as a means to accomplish certain social/political/economic goals) will cause a serious strain on the U.S. economy through higher interest rates and inflation. The world knows it and has already begun moving out of Treasuries and into traditional forms of wealth, commodities, and hard assets.

We have no fundamental bias against fixed income. We just do not want to buy them at this point in the business cycle. Unfortunately, we see interest rates moving up significantly as seen in past cycles.

We see a super-cycle favoring equities, hard assets, commodities, and growth stocks. Fixed-income investors risk losing their savings—perhaps in a very short period of time. Cash is not safe. It is in the cross-hairs of what is to come.