

Bondification. The Quest For Yield And The Turning Point.

When we buy an equity or a bond we buy a claim on a business but with differing payoffs, rights and obligations. The rational investor would first decide if the business in question was something they wanted to own before deciding on whether to own it through the equity or the debt. If indeed the business was attractive then the analysis would progress to which claim to buy, an analysis which would take into account the prospects for the business, the riskiness of the business and the available claims. The assessment would be made on a risk adjusted basis and not on the absolute attractiveness of the claim. I say this because if it was decided that the most senior claim was the right one, leverage could be used to scale the investment to the right size. If for example equity was the right claim but the investor was targeting a low risk, then a deleveraged position could be taken (that is pairing the position with cash).

We apply this methodology with the prices before us. Its really the best we can do. The methodology may well drive us to hold lots of cash for example if equity was the more attractive claim, yet our desired volatility was lower than the unlevered cash equity. In this case we would hold a deleveraged position, meaning a portfolio of positive cash and positive equity.

Current valuations are quite balanced. Looking at aggregates, equities are cheap compared with government bonds but they are fairly priced on a historical basis when compared with corporate bonds. The spread of investment grade corporates to treasuries is moderately attractive and at this point at least, a comparison of high yield to investment grade yields is equivocal.

The investment problem is that government bond yields are too depressed. Valuations made against government bonds are a risky practice since yields are likely to rise and could render reasonably priced assets expensive quite quickly.

It was low interest rates in 2003/2004 of 1% in the US, now a princely level, which saw the reach for yield in that decade which was sated by ratings arbitrage, necessary because institutional investors were constrained by ratings requirements. The ratings arbitrage resulted in clever constructs like CLOs and CDOs. Demand for yield drove demand for CLO origination which in turn drove demand for ABS and in particular RMBS origination to the point that the banks were more willing to lend than the homeowner was to borrow. This was the tipping point.

As we reach for yield today we should be aware of the balance of enthusiasm between lenders and borrowers. When lenders are more motivated to lend than borrowers are to borrow it is usually a sign of a credit bubble.