

Buying in the Face of Fear

10/13/2008—Rob Arnott, head of PIMCO sub-advisor Research Affiliates, believes that glimmers of opportunity are beginning to emerge.



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A target-rich environment

Bear markets are undeniably painful, particularly for investors liquidating assets in retirement. At the same time, it is well worth noting that they can also be cathartic and cleansing experiences. Net investors—those who are adding to their portfolios over time—stand to benefit once markets recover: buying assets at a lower price means that they own more of their chosen assets than they would have owned absent the market decline. It's important to note however that such buying does not assure profit and does not protect against loss in declining markets.

By any measure, though, September was extraordinary in the sheer scope of the declines, and early October has offered no respite. Of the 30 strategies Research Affiliates covers, none was up over 1% last month, with the sole exception of one strategy. We have not seen another month in the past 20 years in which the spectrum of opportunity has been so one-sided.

Many of our customers and friends have probably wearied of my cautionary comments about long-term prospective returns. Accordingly, it may come as a shock to many to learn that I see more interesting, and better, investment opportunities now than I've seen in many years.

In our view, the depth of pessimism in the marketplace has helped seed a target-rich environment. Just as bull markets are propelled by human nature, as investors seek to invest more and more into the markets that have treated them kindly, bear markets are fueled by the mirror image of that self-same human nature, which leads people to sell after a disappointment.

Chasing past successes and selling recent disappointments—after the damage has been done—is the path of greatest comfort. But, the capital markets do not reward comfort. For those wishing to patiently pursue *effective* investment strategies, we believe this

environment of grinding fear creates opportunities to buy, in the face of that fear.

We often hear investment professionals discussing the concept of the “risk premium.” In recent years, this concept has been warped into a view that, if we're willing to accept more volatility, we're *entitled* to a higher return. The *correct* definition is that an asset that exposes us to greater risk—and, importantly, greater risk of large losses—should be *priced* to deliver a higher forward-looking return. There's no mention of entitlement, nor any assurance of higher returns. *That's why it's called a risk premium.*

For credit markets, the worst may be past us

While it is impossible to call an exact bottom in any market, we believe that there are fewer credit shocks ahead of us than behind us. This does *not* mean that there will not be additional failures in the financial services community, or that credit will quickly ease. It merely means that the shocks of the coming months, which may be daunting, are likely to be less so than those of recent months.

If we are correct in this view, then we are in the midst of an “anti-bubble” for financial services stocks and credit markets, which may present buying opportunities. What do I mean by “anti-bubble”? A bubble is a market in which a broad segment of investments lofts to valuation levels that would not be justified by reasonably plausible future prospects. An “anti-bubble” is a market in which a broad segment of our investing opportunity set is priced low enough that only the bleakest scenarios would justify the pricing.

Equity prices for financial services firms have been battered to reflect the bankruptcy or failure risk of each individual company. And yet the simple fact is that with each failure, the competitive landscape is made less daunting for the survivors. For them, pricing power and prospective profits are improved. Five years hence, financial services companies will represent approximately the same share of our economy as they have in the past five years, and will be priced accordingly. So, while we cannot know which firms will be the survivors, we can be reasonably confident that the survivors are substantially undervalued.

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into the current
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The situation is similar for the distressed credit markets, in that the prospect for yield spreads on illiquid or distressed assets rising drastically from current levels, *and staying there*, seems remote. At the peak of the cycle, less than two years ago, high-yield spreads were 2% to 4% relative to Treasuries. Today, mainstream high-yield bonds are showing over a ten percent premium to Treasuries.

Non-financials, housing still vulnerable

There may be worse yet to come for some other assets such as non-financial stocks and housing.

- For non-financials, the other shoe—which has yet to drop—is an acknowledgement of a sharp decline in consumer spending. This economy has been riding singularly on the back of the consumer, whose knees are buckling. Yet, even now, few press reports are focusing on the sharp pullback in consumer spending that is already under way.

Consider that at their July 15 trough in *relative* price, financial services stocks were down 46%, while the market was down 20%. That means that non-financials were down only 12%, a level not consonant with a recession. While stocks have fallen sharply since then, financials and non-financials alike, they may not fully reflect the recession risks that are now becoming self-evident to us.

- Housing markets are likely to continue to founder. Prices cannot rise while inventories are rising; inventories cannot fall while foreclosures are rising. And the rise in foreclosures, in our opinion, is only just getting started.

It's important to keep in mind, too, that housing is a lagging indicator. Housing prices generally begin to recover six to 12 months after the economy turns, and the economy turns generally six to 12 months after the market turns. Assuming we're in the late stages of a bear market and early stages of a recession, it is fair to say it will be 2010 before housing prices begin to recover.

Risk assessment over full cycles

PIMCO's All Asset strategies seek to provide attractive real returns over full market and economic cycles. It is folly to try to pick market turning points, but it is common sense to trim our perceived risk exposure when markets are not priced to reward risk-bearing, and to take on incremental risk when fear reigns supreme. In this environment, then, we see risk not as something to be shunned but something to be taken on, carefully and selectively.

Opportunities for investors with resources

We have been running the All Asset strategies at what we believe is an unusually low risk level for over two years. As prices have come down, however, some low-hanging fruit has become evident in our view. In recent months, we have begun to take on modest incremental risks, in response to these exceptional market circumstances.

Over the past year, we have been building large positions in developing and emerging local market bonds (i.e., those denominated in local currencies). Although these bonds have been suffering the ripple effects of the market's severe risk-aversion, they are arguably more creditworthy than U.S. Treasuries, by conventional debt coverage ratios. In many cases, these countries have fiscal and current account surpluses, massive foreign reserves and debt coverage ratios that we can only envy.

Even as these bonds have been hit in parallel with high-yield bonds and other credit risks, these assets have been providing incremental yield from three sources: 1) investors' current fear of emerging markets, 2) investors' discomfort with any exposure to emerging markets' local currencies and 3) the possibility of currency *appreciation* at times, due to the fact that many of these emerging economies' currencies are cheap on a purchasing power comparison.

Another area of interest is convertible bonds, which typically soften the downside, but which have declined even more than the S&P 500 in the face of a major bear market. Part of this is due to exogenous supply from convertible arbitrage hedge fund managers, who have been forced to liquidate, both due to customer redemptions and due to the SEC proscription on short-selling for many companies' stocks. This has created compelling opportunities.

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Value stocks have been savaged relative to growth stocks, in a pattern that is most uncharacteristic of a bear market. We believe these stocks are reaching attractive valuation levels. If growth stocks are hammered in the coming months, they too may become compelling.

We see a number of other asset classes are likewise providing appealing yields. For investors who have kept their powder dry, the months ahead may provide exceptional opportunities to pounce.

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