Wellesley Asset Management
Convertible Bond Specialists
20 William Street, Wellesley, MA 02481 | 781-416-4000

What Keeps Me Up at Night

By Jim Buckham CFA, Portfolio Manager

As a follower of the markets, I am often asked "What keeps you up at night"? This is another way of asking what concerns me about the current state of the capital markets. I would like to share some of my observations about the stock and bond markets and why I feel that, going forward, investors should proceed with caution.

The Stock Market

We are currently in the second longest stock bull market in history. The price action has been fairly orderly as the market continues to grind higher in a very non-volatile fashion. Investors remain complacent and the market refuses to react to potential issues such as lack of progress with government reforms, international instability, and high equity valuations. In early October, the VIX, a well-known barometer for market volatility, closed at an all-time low of 9.19. We have yet to experience panic buying that can often signify market tops. Remember the fourth quarter of 1999 when the Nasdaq was up over 45%. However, there are some fundamental differences with the composition of today's markets that are cause for concern.

The breadth of the market rally has been fairly widespread. When one market leading sector suffers a setback, another sector takes over to lead the market higher. Despite the breadth of the market rally, fewer stocks are driving market returns higher. In 1975, the largest 109 companies accounted for half of the profits made by U.S. companies. By 2015, the largest 30 firms accounted for half of the profits made by U.S. companies. The market capitalization of the top five stocks in the S&P 500 (Microsoft, Google, Amazon, Apple, and Facebook) is greater than the market capitalization of the bottom 250 stocks. Since the performance of the index is market cap weighted, these five stocks have accounted for almost 25% of the S&P 500 return this year. Stated differently, one percent of the stocks in the S&P 500 have accounted for 25% of the index's performance, possibly raising the danger of concentration risk. It's hard to argue that S&P 500 investors are buying into a diversified index.

Another change in the marketplace has been the proliferation of passively managed funds. It is estimated that nearly 20% of the assets held by investors today are in passively managed funds, which have the goal of replicating the performance of an index. The allure of these funds is that they charge lower fees than actively traded funds and, in recent history, they have outperformed a majority of actively managed funds.

My concern is that the combination of these changes in market structure is creating a positive feedback loop. More investors are seeking lower priced funds that deliver 100% of the market return. This is creating inflows into passively managed funds. As these funds receive inflows, they must invest in the stocks in the underlying index. In the case of the S&P 500, which is the most common proxy for the equity market, a disproportionate amount of these funds is invested in the top five stocks, causing those stocks to go higher. This in turn, drives the return of the index higher and creates more demand for passively managed funds as investors chase performance.

The disconnect is that with passive investing, there is no reality check with respect to stock fundamentals. Many active fund managers with valuation disciplines have stopped buying the top five stocks in the S&P 500 as the prices have soared. Unfortunately, the more these stocks outperform the index, the larger the percentage of the index they become. It's easy to see why active managers continue to underperform the S&P 500 index (and the correspondent ETFs).

Don't get me wrong, I think these five companies are leaders in their industry with amazing potential for future earnings growth. Furthermore, they are in fine financial shape with large cash reserves and solid balance sheets. But what price should investors be willing to pay for the future earnings of these companies? The forward P/E ratio (non-GAAP) of Amazon has risen this year from 38x to 61x. At what point do investors stop paying inflated prices for high growth stocks?

I don't know what will cause this bull market to end or when it will end. Some potential bear market catalysts include the return of inflation, geopolitical risks, and anti-trust action against some of the large technology companies mentioned in this writing. It's not hard to imagine a scenario where the economy slows and stocks sell off. When this happens, investors will realize that getting 100% of the market return isn't so fun after all. They will in turn try to sell stocks as they seek to return to the safety of cash. But the marginal buyer of stocks won't buy until valuations return to normal levels or the economy starts to turn around. In this environment, I can see a scenario where active managers will outperform passive ETFs causing investors to rethink the management fee versus performance equation.

The Bond Market

Perhaps more disturbing are trends in the global fixed income markets. In the United States, bond yields have been declining for 35 years and corporate credit spreads are at some of the lowest levels in history. In response to the 2008 financial crisis, many central banks have resorted to the similar strategies to revive the economies of the world. In an effort to promote growth, central banks have reduced short term interest rates to zero or near zero levels. Sensing that this wasn't having enough impact, many central banks purchased government bonds in an effort to reduce long-term rates. Some central banks even took this a bit farther by purchasing corporate bonds and stocks.

While central bank policy could create challenges for U.S. bond investors going forward, I feel that it has led European bond investors to grossly misprice risk. In 2009, the Bank of America Euro High Yield Index yielded 25% and had a spread over U.S. Treasuries of 22%. Today that index yields 2.3% and the spread is now below the U.S. 10 year yield. The table below shows how quickly bond yields have collapsed in Europe.

% of Eurozone Junk Bonds with Yields below U.S. Treasuries:

2017	72%
2016	16%
2015	8%
2014	5%
2013	3%
2012	0%

I have a hard time believing that 72% of the high yield issuers in Europe are more credit worthy than the U.S. government.

The low interest rate environment is also affecting the rates at which sovereign entities can issue debt. In 2012, Ireland issued a 5 year bond with a 5.5% coupon. In early October, Ireland decided to issue €4 Billion over 5 years. Because there was €10 Billion in demand for the issue, the bond was priced slightly above par with a 0% coupon. Investors who hold the debt to maturity are guaranteed to lose .008% over the five year life of the bond! A recent study by Deutsche Bank estimates that 17% or $8 trillion of global debt outstanding trades at negative interest rates.

Back in the U.S., the economy is showing signs of life as the unemployment rate has returned to the 4-4.5% range. Though inflation is running low at 2%, the Federal Reserve has raised rates four times to the 1-1.25% range as the economy returns to more normal growth. Furthermore, the Federal Reserve intends to shrink its balance sheet over the next several years. As bonds mature that the central bank bought as part of its Quantitative Easing program, the Federal Reserve will not replace them. It will be interesting to see what happens to long-term rates as one of the largest buyers of Treasuries over the last several years exits the market.

Low interest rates in the United States have been a boon for both U.S. government and corporations issuing debt. The government has been able to service ever increasing levels of debt with relative ease due to the low interest rate environment. Investors looking for yield have been forced to go further out the risk curve by extending the maturities they invest in or lowering the quality of credit they invest in. Corporations have been the beneficiaries of this as they have been able to issue large amounts of debt at historically low rates.

Unfortunately, all debt eventually matures and must then be refinanced. It is estimated that the market capitalization of the high yield market is between $1.5 trillion and $2 trillion. A recent article by Bloomberg states just over $1 trillion of junk debt will mature by 2021, with the bulk of it occurring after 2019. Given that both short- and long-term rates are trending higher and credit spreads are near all-time lows, it's hard to believe that more than half the U.S. high yield market will be able to refinance at advantageous rates over the next few years.

What keeps me up at night?

I have many concerns about investor complacency, valuations, and potential shocks to U.S. stock and bond markets. When people ask me "what keeps you up at night?" I refer to the points discussed in this piece. Invariably though, I like to talk about what doesn't keep me up at night. At that point the conversation usually turns towards Wellesley Asset Management's strategy for managing convertible bonds. Not only do I invest client's money in our strategy, I also invest a substantial amount of my own money in the strategy. Our strategy centers around one core principle: protection of principal. We have found that by investing in, short duration convertible bonds of high quality companies, we have been able to consistently outperform both stocks and bonds over full market cycles. Most importantly, by taking a conservative approach, it has been our experience that during bear markets, our strategy doesn't go down as much or stay down as long as equities. And that is what allows me to sleep at night.

Important Disclosures:

Past performance is no guarantee of future results. All investments, including convertible bonds, have a risk of loss.

No content in this article should be construed as specific investment advice, or replacement for investment advice from Wellesley Asset Management, Inc. (Wellesley), or any other investment professional. This is not an offer to purchase securities.

Although information has been obtained from and is based on sources Wellesley believes to be reliable, Wellesley does not guarantee the accuracy of the information, and it may be incomplete or condensed. All investments, including convertible bonds, have a risk of loss. DM10302017-2-207