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Investing After the Crisis, Price Matters Most

By Jane Bryant Quinn
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Here's one of Wall Street's best-kept secrets: If you were investing 30 years ago, your best choice, for the long run, would have been super-safe Treasury bonds. That's where the money turned out to be. Investors erred in their religious belief that stocks always outperform bonds, over holding periods of 10 years or more.

If you rush to safe havens today, though, you may get it wrong again. Looking forward, the opportunities probably lie in risk -- bonds as well as stocks.

It's easy to see that bonds have done better than stocks for the past 12 years. For that matter, so has your mattress. Stocks have surrendered all the gains they made since 1997, in what investors are calling their "lost decade."

And that's not the half of it, says Robert Arnott, founder of Research Affiliates, an investment management firm based in Newport Beach, Calif. It's more like a lost generation.

Starting in 1979, and taking any month you choose, rolling 20-year Treasuries have beaten the Standard & Poor's 500-stock index with income reinvested. "Astounding," is how Arnott describes it. There's even a specific period when 20-year Treasuries did better over 40 years (February 1969 to February 2009). His research will be published in the May/June Journal of Indexes, which covers index investing and trading.

Arnott's point isn't that bonds will continue to be the best investment for the long run. Stocks are a far better story today, with valuations low and T-bonds yielding 3 percent. He's reminding you that it's not the asset that matters but the price you pay for it. When you buy high, you can't count on coming out ahead no matter how long you hold.

Today, the overpriced asset appears to be fixed-rate Treasuries. There's no default risk but a high risk that you will lose money after taxes and inflation.

On the other hand, Treasury inflation-protected securities -- Treasury bonds whose principal value rises with inflation -- are looking cheap. Twenty-year TIPS are priced for an average inflation rate of a bit more than 1 percent over all those years. That seems pretty low, considering the government's vigorous attempts to re-inflate the failing economy.

Policymakers will need an inflation rate of 3 or 4 percent to grow the economy and end the debt destruction, says TIPS enthusiast and bond expert Bill Gross, co-chief investment officer of Pacific Investment Management in Newport Beach, Calif.

Besides TIPS, Gross makes a strong case for bonds supported by government policy: high-quality mortgage-backed securities and the bonds of financial companies that have access to taxpayer funds. As a P.S., he e-mails, "High quality corps OK too, 5-6 percent yields." At those yields, the bonds of many corporations look more attractive than their stocks.

Conservative investors were stunned when their corporate-bond funds took double-digit losses in the frightening market collapse of September-October 2008. Long-term corporate bonds fell 16 percent through October, according to Ibbotson Associates -- their worst performance on record.

That wasn't supposed to happen. In bad stock markets, investors expect their bonds to rise in price or at least hold flat. Instead, for the first time, all the major asset classes fell together. In February, they were all savaged again.

The bond funds that held up, such as Pimco's Total Return Fund and Vanguard's Total Bond Market Index Fund, were heavily invested in Treasury or government-backed agency securities. The worst losers took unusual, even reckless risks, by using leverage or derivatives.

"Often the managers involved had not distinguished themselves as risk managers to begin with," says Eric Jacobson, a senior analyst at Chicago-based Morningstar, which tracks mutual fund data.

The bond markets are struggling technically, too. Last year brought the loss of four independent market makers (Bear Stearns, Lehman Brothers, Merrill Lynch and Wachovia), which impaired liquidity. At the same time, hedge funds have been dumping leveraged derivative bets at almost any price. "Bond trading ground to a halt at a couple of points," says Lawrence Jones, Morningstar's associate director of fund analysis.

Gross says he isn't ready for high-yield bonds, but Arnott is. "Yields are averaging 18 percent or more. How can stocks compare with that?" he says. Defaults are likely to worsen but, unlike stockholders, bondholders usually get something back in bankruptcy. Arnott says you would need a default rate of 25 percent a year for many years to overcome the value of today's unusually high yields.

Put another way, junk bonds are priced for something worse than the Great Depression. They lost an average of 26 percent last year. To investors looking for bargains today, they are low-hanging fruit.

Buyers of bond funds worry that future inflation and higher interest rates will steal their gains. Not likely, says Lacy Hunt, executive vice president of Hoisington Investment Management in Austin. The company was one of last year's top institutional managers of fixed-income funds.

Debt deflation is a long and painful process, with volatile prices, he says. You get "false springs," when the economy tries to recover and inflation notches up. Then the pressure of unwinding debt pulls business and inflation down again. You shouldn't even expect inflation until four years after a normal recession, and the recession hasn't even ended yet.

Hunt isn't buying a corporate-bond story yet. He thinks long-term Treasurys are still the best port in this storm.

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