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KAVAR Canvas

The science of investing. The art of integration.

This Newsletter is NOT about the Fiscal Cliff!

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I think that the title above was the only one remaining that mentions the market and media obsession du jour while dismissing the legendary ledge - the combo of federal spending cuts and tax increases that will combine to impose austerity on the United States in the absence of an accord in the next 28 days - as an obvious end result of decades of willful blindness on the part of our politicians. Not many more unique remarks remain about the Fiscal Cliff, whose debates and daily chatter have catalyzed recent spates of market volatility.

The inflection point on which our markets and economy are perched is the result of broad-based legislative negligence of 2 fundamental principles for maintaining a sound economy:

- Simple math is inviolable;
- Subjective misappropriation of ambiguous streams of future cash flows is incorrigible (a.k.a. – it helps to have a budget).

Our country has failed its citizenry for decades by not adhering to the first principle and steroid-a-sizing the second. Our near-term fiscal fates are now invested in a body of leaders that we elected, and in many cases re-elected, to sustain an unsustainable status quo, assuming any reckoning day is further off than the first payment to Nebraska Furniture Mart on an interest-free love seat.

But like the title says, this newsletter is not about the Fiscal Cliff. It is actually about Notre Dame Football!! OK, that was a joke, but irresistible. This newsletter is not about the fiscal cliff because I believe that the fiscal cliff will be averted – one way or another, at the 11th hour or ex-post facto – but we'll have to live and invest in its aftermath and I'm going to explore some ways to go about that.

Second to last mention of the fiscal cliff - for all I've read/heard/seen about the dastardly drop-off, I think that the best recap was from the Washington Post on 11/27/12 and can be accessed via this link:
http://www.washingtonpost.com/blogs/wonkblog/wp/2012/11/27/absolutely-everything-you-need-to-know-about-the-fiscal-cliff-in-one-faq/?print=1

In consideration of current investment strategy, I believe that you cannot fully front-run the fiscal cliff (last mention). Why not? The prospective outcomes are too varied, the resolution is not binary, and the impact is not immediate. Thankfully, despite the ideological differences of the 2 political parties there is a collective economic self-interest to be pursued. Therefore, I think it is important to responsibly weight portfolios amongst ***stores of pessimism, optimism and value*** (see the graphic below for descriptions of each) based upon your goals and objectives.

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Stores of Pessimism (or bonds): I think Municipal bonds are attractive for non-retirement accounts, and mortgage-backed securities and corporate bonds for all types of accounts – using a tax-equivalent yield (TEY) calculation to help drive the decision.

The presidential election's largest positive implication for the municipal bond market (munis) is that rates on federal income taxes will most certainly not be declining. Additionally, muni coupon interest income most likely will be exempt from the 3.8% Affordable Care Act investment surtax[1]. This could result in strong demand for munis even if a 28% cap on the interest exemption is signed into law (this was suggested in one of the president's economic proposals[2]). I suspect demand will remain robust because the tax-equivalent yields (TEYs) are superior to Treasuries consistently across the maturity spectrum. In English please……If you multiply the rate of interest rate you would receive on a Treasury bond by your federal income tax rate (since Treasury interest is federally taxable), it will most likely be less than the tax-free yield (municipal income is federally tax-exempt). Sound capital allocation leans in the direction of the higher TEY. We certainly need to be careful to know the credits (what town/city/state are we lending money to), as next year 30 of the 50 states will have Republican governors and there could be a multitude of motivations for state-funding (or withholding) of sub-components of the new Obamacare Affordable Care Act[1] and various initiatives to raise or lower state and local tax rates.

The 10-year US Treasury bond today has a yield of 1.62%[3] . Compare that to its 30-year average yield of 6.18%[3] and you have what the finance geeks call a "secular shortage of yield". This prevailing condition provides important support for credit spread products[4], particularly investment-grade corporate debt, high-yield bonds and floating-rate loans. (We target the last two of these three security types mostly through mutual funds and exchange-traded-funds (ETFs)). In addition to their positive TEYs, a shared source of their collective attractiveness is that they represent the debt of corporations (we would be loaning money to companies not people or municipalities) that have been balance sheet fortifiers since the end of the credit crisis of 2008, resulting in relatively healthy credit fundamentals.

The presidential election's largest positive implication for the housing market is that Ben Bernanke, Chairman of the Federal Reserve Board (the Fed) will most likely be reappointed when his term expires in 2014. It is Chairman Bernanke's affection for "dovish" monetary policy accommodation that has kept interest rates as low as they've been for as long as they've been. The low rates are purely a function of supply and demand in the Treasury (the aforementioned 1.61% yield on the 10-year bond) and the mortgage bond markets. The Fed buys bonds through programs such as QE1, QE2, QE3 and Operation Twist and the demand raises the prices of the bonds and lowers their yields. I think that the perpetuation of this persuasion will provide ongoing price support for both government agency mortgage bonds like Federal Home Loan Bank and Freddie Mac, as well as private market mortgage-backed securities.

Stores of Optimism (or stocks): I think stocks in "defensive" sectors with strong and sustainable dividends could provide appreciation and income in a global macro-economy that is slow-growing.

New fiscal policies, new regulations and new taxes need time for digestion and assimilation by the economy and financial markets. I think it is highly unlikely that any of the three will goose economic growth.

An example: because many provisions within the Doff-Frank Financial Reform Legislation[5] have yet to be written, there is little willingness for banks to infuse capital into the economy. Absent specific capital requirements for loan commitments or fee thresholds for depository functions, banks are content to cogitate on their cash. This decreases the velocity of money that typically accompanies a cyclical upturn. Inertia inhibits expansion.

What is a defensive sector stock? Classic defensive sectors are utilities, healthcare and consumer staples – they tend not to be highly correlated with the economic cycle and tend to align with sources of demand that are steadier, even if unexciting.

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Within those defensive sectors, I think it would wise to emphasize companies that pay dividends and have historically raised their dividends. But what if dividend tax rates go up, as currently under deliberation? Even if dividend taxes do go up, I do not think that they will align with ordinary income. There is speculation of dividend taxes in the "20s" %-wise and that seems more likely to me[6]. Also, understand that a company that pays a dividend is, for the most part, telegraphing their financial well-being, and their ability to generate cash flow, as long as the payout ratio (the dollars of dividends divided by the dollars of earnings) is within a repeatable range. And if, as stated above, the TEY yields on munis are attractive relative to treasuries, then dividend yields, even at a higher rate of tax levy, are attractive relative to both. While the risks associated with stocks and bonds are very different, the yield comparisons help in assessing the appropriate weighting between the stores of pessimism and optimism.

Given the globalization of capital markets, I also think consideration of foreign-based ADRs (American Depository Receipts)[7] within the same defensive sectors is sound. Given that foreign corporations less commonly issue incentive stock options than their American counter-parts, less of their free cash is allocated to share buy backs and more to increasing dividends.

Therefore, with my generally subdued macro outlook, incorporation of dependable dividends in less cyclical stock sectors may offer income and appreciation while new fiscal policies, new regulations and new taxes are digested and assimilated. We tend to favor individual common stock positions when possible but also utilize mutual funds and exchange-traded funds that demonstrate a consistency with this philosophy.

Stores of Value: (gold and other negatively-correlated assets) What keeps its head when all about it are losing theirs?

The intent of this Rudyard Kipling poetic pilfering is to identify some classes of assets that do well by doing differently. Differently, in this context, from classes of traditional assets like the bonds and stocks we've been discussing. Differently also, in the underlying drivers of demand that impact their prices.

One of the holy grails in portfolio management is the achievement of "negative correlation" across account holdings. What is negative correlation? Some characterize it as an internal portfolio mechanism designed to defray non-systemic risk. Others prefer to simply state: it is the tendency of some securities to zig while others zag. If designed correctly, negative correlation in a portfolio can operate as a sort of insurance against maximum loss. And, while few asset classes can perform this function perfectly, incrementally adding positions with differentiated risk and reward characteristics can hedge portfolios in a world defined by ambiguity. Positions that possess negative correlation fit neatly into our classification as ***stores of value.***

Let's consider gold, as it is has long been a popular vehicle to represent this store of value:
Gold tends to strengthen when the dollar weakens[8] (since gold is denominated in dollars, it takes more dollars to buy the same amount of gold). The dollar could weaken were three things to happen:

1. The Fed maintains its accommodative monetary policy posture (a.k.a. keeps printing money as discussed above);
2. The fiscal cliff and debt ceiling debates erode confidence in our country's creditworthiness;
3. International economic improvement – from emerging-market countries, Japan or a prospectively refortified European Union (since all foreign exchange is a relative proposition between the countries trading currencies).

Since currency weakness can also have inflationary tendencies, its impact on the traditional classes of assets is less clear. Dropping a proverbial anchor in the choppy economic waters embodies the thrust of the ***stores of value.*** Gold is but one example. Others include: bonds denominated in foreign currencies, silver & real estate. In the accounts we manage, we tend to favor mutual funds and exchange-traded funds to obtain this exposure.

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In conclusion, I believe that balance is essential in navigating the investment environment where the only true constant is change. The vacillating macro economy, italicized by the recent legislative toxicity in the US, underscores the importance of alternating the emphasis of a portfolio's power amongst the three broad asset classes discussed. The ultimate allocation will be unique to each client as it complements their long-term return objectives. The quest for opportunity is often dictated by the markets themselves and then reflected appropriately in our clients' accounts. We look forward to discussing along these lines in our meetings as we head into the New Year.

And lastly, Go IRISH!

[1] http://obamacarefacts.com/

[2] http://www.learnbonds.com/obama-proposes-cap-on-municipal-bond-tax-deduction/

[3] Source: Bloomberg Market Data

[4] The spread between Treasury securities and non-Treasury securities that are identical in all respects except for the quality rating. (Source: http://financial-dictionary.thefreedictionary.com/)

[5] http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

[6] http://www.moneynews.com/StreetTalk/Siegel-dividend-tax-higher/2012/11/28/id/465644

[7] http://www.investopedia.com/terms/a/adr.asp

[8] Source: Bloomberg Market Data

IMPORTANT DISCLOSURES: