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What Ted's Thinking

Playing for Tomorrow

What return was available on a 5-Year U.S. Treasury two years ago?

Observing market conditions, you might have said 0.8%. That was the paltry current yield on a 5-Year U.S. Treasury at the time.

Is that the answer?

Yield hungry investors like SVB thought so. They scooped up what yield was available and extended duration to earn more, like doubling expected returns to the 1.6% yield on a 10-Year.

They were wrong.

If we held cash in lieu of that tiny yield two years ago, waited for better opportunities, and bought a Treasury today with three years of duration remaining until maturity, we could have earned 2.2% over the five years (0% for 2 years, 3.6% for 3).

Limiting an assessment of returns only to market conditions in the moment fails to consider the wide range of possibilities of what might happen in the future.

The dramatic change in recent market conditions reminded me of a piece I wrote back in 2006 about the potential disappearance of the abundant liquidity available in markets at the time. It proved prescient when the financial crisis froze credit markets two years later. My favorite excerpt from the piece is a quote from Seth Klarman at Baupost, who brilliantly articulated this concept in his annual letter twenty years ago.

One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Limiting your investment opportunity set to only the one immediately at hand would be like being required to choose your spouse from among the students you met in your high school homeroom. Indeed, for almost any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities; but it would be foolish to ignore them as if they will not exist.[1]

In absence of good present opportunities, holding cash has enormous option value. That's easy to say, but not easy for many to do. Accepting low returns in the short term is structurally untenable for many investors. Most answer to clients and feel pressure to deliver relative to their peers. Chuck Prince, the CEO of Citi during the financial crisis, famously said "As long as the music is playing, you've got to get up and dance." He was maligned for the seemingly stupid statement at the time. But in retrospect, Prince underscored a fundamental truth about what it takes to succeed in the asset management business.

I mentioned at the end of Short-Term Gain, Long-Term Pain, Part 2 that things are about to get interesting. Here are five changes in the investment landscape that I believe may happen with a greater than 50% probability and reasonable confidence:[2]

1) Static or higher interest rates increase the appeal of fixed-income investments.
2) The shift away from U.S. dominance as a global hegemon favors international markets over the U.S.
3) Long-short equity hedge funds earn higher returns than expected, fueled in part by a market that has either never experienced or forgotten about short rebates.
4) Contraction in lending from banks increases the volume and speed of start-up failures.
5) Higher corporate default rates hurt returns to existing private credit portfolios, while simultaneously increasing prospective returns on new loans.

And six more where I believe the odds are even more likely to occur, defined as 75% probability:

1) The movement to reduce carbon emissions causes an attractive secular beta in environmental markets (listen to Colin Campbell on Capital Allocators to learn more).
2) U.S. small-cap value stocks outperform.
3) Commercial office real estate prices have a prolonged slow decline, as leases rolling over across the next 5-10 years reflect the post-Covid working world.
4) Private equity owned businesses have a significant negative re-rating due to softer economic conditions and a higher cost of capital.
5) Less correlated, idiosyncratic assets like sports teams and tax assets catch a strong bid by institutions. (listen to Arctos and Parallaxes on Capital Allocators)
6) Institutional capital gravitates to investments in empty rooms, including opportunities with known risks in unconventional geographies like Venezuela or Africa, out of favor sectors like biotech, and misunderstood assets like CLO equity or taxes. (Search for 'Empty Rooms' as a Topic on the Capital Allocators search page.)

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[1] Seth Klarman, Baupost Limited Partnerships 2003 Year End Letter
[2] Tip of the hat to Michael Mauboussin for his recent piece Confidence, which discusses the difference between probability and confidence and the importance of both.

Some of these ideas may offer opportunities. Others suggest risk. As always, price matters and from time to time may reveal disparities between what I see and what others do.

The hardest day to invest is *always* today, and today is no exception.

I am holding a bunch of cash as I watch tomorrow's opportunity set unfold. Sitting on cash could have been extremely valuable two years ago, and it remains so today. Cracks in the surface are starting to appear, and I suspect deeper ones are coming.

It sure is a lot easier getting paid 4% to wait than accepting a whole lot of nothing.