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Market Comment

CLARMOND

Rendezvous with Risk.

Five years of dizzying bond issuance by the treasuries of developed nations, facilitated and cheaply paid for by their central banks, has flattened the capital structure. This has caused traditional reward and risk metrics to become skewed, leaving investors open to an unexpected re-emergence of permanent losses.

The word 'rendezvous' brings with it certain connotations; chancy behaviour and a hope that one does not get caught. The word 'risk' in 'market-speak' is a by-word for volatility - for instance JP Morgan's Value at Risk measure (VaR). But perhaps we should heed the words of Mike Milken, the conjuror and creator of our current capital markets, who defined 'risk' to denote where an investment is placed in the capital structure, and not at all by its volatility or standard deviation.

To put the capital structure in context Milken wrote an insightful prosperity formula that addresses its central position. The formula states the following:

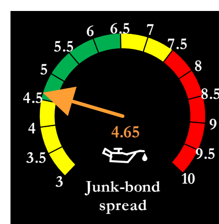
$$\text{Prosperity} = (\text{Human Capital} + \text{Social Capital} + \text{Real Assets}) \times \text{Financial Technology}$$

Milken defined 'financial technology' as the ability to alter the capital (debt) structure.

Herein lies the key...the various forms of capital created, such as, high yield debt, mortgage backed debt, asset backed debt, are the leverage points for the economy and the markets. For Milken increasing forms of debt equals prosperity; he states it is "debt values that underpin all capital markets." If the value of the various forms of debt falls, then the economy and the markets are in trouble.

The Milken prosperity equation is actually a mechanism for asset reflation or deflation, a prescription that central banks have taken to heart by transmitting monetary policy through decreasing the cost of debt and thereby nudging investors into different assets.

The conventional and non-conventional actions of central banks such as the Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) have flattened the traditional Milken capital structure; Dallas Fed Governor Fisher recently used a speedometer to illustrate that the basis point spread between junk bonds and AAA bonds is too low. This was disingenuous since the market has been brought to this point by the central banks.



Signal loss

By deliberately altering the price signals provided by the capital structure and driving down the yields of high quality debt, central banks have preserved the fragile financial system and have bullied investors into the lower quality end of the capital structure - such as equities, real estate, and high yield. We all complain about central banks but still, with open palms, welcome the returns we are offered, low quality or not.

There is no longer a clear difference of reward between high and low quality debt. Milken's capital structure has become compressed and the result has been a successful asset reflation; financial technology has performed its magic. Milken, though, refuses to go away and reminds us that the cost of debt needs to be correctly priced or the capital will be misallocated.

Does this matter...

Therefore what should be the measure of risk if not the capital structure? Should we return to standard deviation as a risk measure...we think not. Will the capital structure, once again, return to its traditional price signal role?

Yes.

Given that we live and invest in markets dominated and run by debt, we have a rendezvous with Mike Milken's world of risk. ■

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