

“It Doesn’t Pay”

Last month, our Managing Partner, Gilbert Garcia, wrote about the growing sentiment in the investment community that rates are going to rise. As he mentioned, when we see this kind of “herd mentality,” we like to “go our own way” in the opposite direction. We have been rewarded again this year, as we have been in years past, for taking a contrarian approach, as rates have generally been sideways-to-lower this year. However, even as rates have moved lower, it still seems that every time I turn on CNBC or open *The Wall Street Journal*, there is another story about how inflation is going to get out of control and rates are going to rise. What’s worse, some investment professionals are recommending that investors not only reduce their bond holdings, but they even go so far as to say that investors should short Treasuries! Based on these statements and the ongoing fears about higher rates, I thought it would be beneficial to discuss the key points of an important debate — should you stick with your long-only fixed income manager or try to short sell fixed income.

As a long-only manager, we can use multiple strategies to outperform in various market environments. More specifically, we can utilize duration management, yield curve management, and sector rotation. As a reminder, duration is a measure of the amount of interest rate sensitivity in a fixed income security or portfolio. We can manage our portfolios’ durations to be defensive by shortening duration, if we feel that rates are on the rise, or we can lengthen duration to take advantage of falling rates. Yield curve management refers to positioning the portfolio for shifts and twists in the yield curve. Because the yield curve can change shape, being a long-only manager allows us to invest in the best performing parts of the curve. Finally, we are able to rotate out of sectors which we think are overvalued and rotate into sectors we feel offer better return potential. Short sellers, on the other hand, do not have these same “tools” at their disposal – their only hope is for the price of the bonds they have shorted to decline.

Now, let’s review some of the risks involved with short selling. Someone who sells bonds short is no longer a fixed income investor; they are now employing a hedging strategy. This strategy introduces new characteristics and risks that may not be wanted in the framework of the initial asset allocation. In particular, short selling introduces inverse correlation risk – this occurs when your investment is going in the opposite direction of the market. In the case of short selling, you no longer have the exposure to the asset class (i.e. bonds) that you had originally planned on having in your asset allocation. You now have an investment that goes in the opposite direction!

Does it make sense to add this risk to your asset allocation? We believe that in the framework of an asset allocation, risk should be taken in other investments such as equities and foreign securities, but the fixed income portion of a portfolio should be a “safety net.” Particularly in times of stress in the markets, we believe the fixed income portion of an asset allocation should be there to provide downside protection.



Typically, you would expect to see a higher return for a higher risk strategy. So, does it pay to add the additional risk to your asset allocation? What might be surprising to some is that Treasuries have posted positive returns in 27 out of the last 30 calendar years; which means that despite the risk, shorting Treasuries was the right move in only 3 of those years. What also jumps out is that even when the short sellers were right, they never gained more than 3.6%!

Year	12 Month Total Return	Year	12 Month Total Return	Year	12 Month Total Return
2010	5.87	2000	13.52	1990	8.55
2009	(3.57)	1999	(2.56)	1989	14.38
2008	13.74	1998	10.03	1988	6.97
2007	9.01	1997	9.57	1987	1.99
2006	3.08	1996	2.70	1986	15.62
2005	2.79	1995	18.35	1985	20.92
2004	3.54	1994	(3.38)	1984	14.46
2003	2.24	1993	10.68	1983	7.04
2002	11.79	1992	7.21	1982	27.84
2001	6.75	1991	15.31	1981	9.24

Source: Barclays Capital Live

The reason why bonds have been an attractive investment is largely because you are paid to hold them. The owner of a bond generally receives income in the form of semi-annual coupon payments, so even when prices are flat, you earn a positive return. With short selling, on the other hand, you have the opposite: you have to pay interest (which is known as carrying cost) on short positions. So, not only do you have a lower probability of winning (given the number of positive return years versus the number of negative ones), your price bets have to be successful enough to cover the cost of carry before you even *begin* to make a profit.

In summary, as a long-only manager we have multiple strategies and tools to help us outperform in various markets. These include duration management, yield curve management, and sector rotation. As a short seller, the only way to profit is when prices fall to the extent that it covers the cost of carry.

Let’s now address that question I posed earlier about changing your asset allocation. The concern I have with the short selling strategy is that you will no longer have the protection that bonds offer investors during periods of stress in the markets. Think back to the economic shocks we’ve seen in recent years like the bursting of the “dot-com” bubble, the Great Recession, and the European debt crisis. When these shocks occurred, they were followed by lower rates as investors flocked to the safe haven of bonds. If you own both risky assets and bonds, then you have diversification in your portfolio with bonds providing downside protection. If you are shorting bonds, then you have reduced your diversification and removed your downside protection. By switching to this hedging strategy, you would be making a radical change in risk/return characteristics of your overall portfolio and not fulfilling the objectives of the initial asset allocation. To us, it doesn’t pay to get involved with short selling fixed income.

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A copy of our Form ADV, Part II is available upon request.

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