INVESTMENT PERSPECTIVES
QUARTERLY UPDATE – JANUARY 1, 2010

BROWN ADVISORY

BUBBLES

It's been over 40 years since Don Ho wrote and sang "Tiny Bubbles," but many still remember it. As we conclude a remarkably good year in the markets and look ahead to 2010, a sip of the bubbly seems appropriate.

Tiny bubbles
In the wine
Make me feel happy
Make me feel fine.

Tiny bubbles
Make me warm all over
With a feeling that I'm gonna
Love you till the end of time.

In the investment world, of course, bubbles have a different meaning. As in champagne, smaller bubbles induce a feeling of warmth and comfort as investors become convinced they've found an attractive investment that they can really "love." The problem, however, is that some of these bubbles tend to grow into very large ones that eventually pop, causing severe discomfort or even pain. Recall the Internet bubble of the late 1990s and the more recent housing bubble that caused the near financial melt-down of late 2007-2008, just two examples of excess that ultimately ended badly.

Bubbles are much easier to see in retrospect than to anticipate. Thus, it's instructive to review how bubbles have behaved—or, more accurately, how investors have behaved to create bubbles—in order to avoid being surprised by the financial crises that inevitably result.

In the spirit of the capitalistic system, free markets fundamentally operate on the profit motive. As Gordon Gekko said in *Wall Street* (and may well say again in the upcoming Oliver Stone sequel), "Greed is good." The desire to make a profit motivates investors to take risks, but the degree of risk they are willing to take is largely a function of perception. When risk appears low, more people will invest. As they begin to enjoy success, others are inevitably drawn into the game, and asset values increase. Rising values eventually reduce the potential for gain, but some investors take on debt in order to leverage modest returns into something larger.

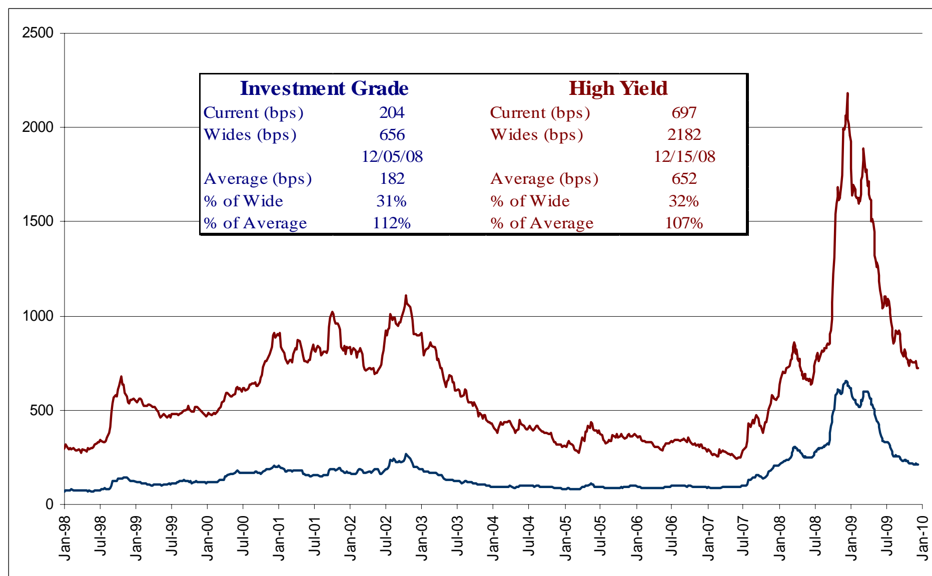
A good example is provided by the massive issuance of bonds backed by pools of non-government guaranteed mortgages. By aggregating mortgages into large pools, underwriters were able to include less-than-prime credits to enhance the yield of the pool (and hence the interest paid on the bonds). In a robust housing market, in which homeowners' equity kept rising, investors overlooked the risk of a possible decline in the bonds' underlying collateral. Increasing comfort with these risks caused the price of the bonds to rise and yields to fall. Some, like commercial banks, used considerable leverage to turn the narrow spread between their borrowing costs and the mortgage-backed bond yield into a better return on equity. Thus, the lack of skepticism regarding prospects for default (i.e., low perceived risk), coupled with huge financial incentives for traders, investors and underwriters to make a profit, contributed to a bubble that proved unsustainable.

A "Safe Place?"

More broadly, in the years leading up to the financial collapse of 2008, investors considered the world a "safe place" to invest, in large part because of the Federal Reserve's accommodative policy that was successful in deftly deflating the Internet bubble, the perception that the Fed would serve as a safety net for investors (the "moral hazard" argument), and the willingness of much of the world to finance U.S. government debt. The premium paid for taking risk declined accordingly, and many investors leveraged up to make investments they considered sure things. Such is the nature of bubbles.

As we've seen, extraordinary measures by governments and central banks around the world have averted disaster, and the recovery process is now taking hold. Monetary policy has, in fact, been designed to encourage investment in risk assets following the near freezing of the capital markets in September of 2008. The yield curve, for example, slopes sharply upward, providing virtually no return on short-term money market instruments while offering decent yields for those willing to take the risk of owning 10-30 year maturities. Although bank credit remains depressed and will likely take a long time to recover, corporations are once again able selectively to tap the debt and equity markets to raise capital. Evidence of this improvement is provided by the dramatic decline in yield spreads from their late 2008 highs.

Credit Spreads



Source: Bank of America Merrill Lynch

So what do we worry about, and where could the next bubble lie? In looking for trouble spots, it's useful to start with the source of greatest leverage, in this case, government. In contrast to the de-leveraging process taking place in the private sector, federal fiscal policy resulting from the stimulus plan, TARP, and other programs has resulted in current deficits higher than any since World War II, more than 10% of GDP in 2009 and 2010. Clearly, these will need to be reduced and likely *will* be on a cyclical basis as the economy recovers and tax rates are increased, probably in 2011.

Deficit Worries

What concerns us more than the cyclical deficit is the less obvious but more insidious structural deficit resulting principally from a combination of growth in entitlements and the rising cost of debt service. The problems with Social Security are familiar to most investors: the aging population will place an increasing burden on working Americans to support those who have retired. Those challenges can, for the most part, be addressed through adjusting benefits, taxes, and the official retirement age if there is sufficient political willpower to do so. Health entitlements, in contrast, are a much larger potential problem. While federal health programs currently cost about the same as Social Security, they are destined to rise far more rapidly. The graying of America and increases in health care costs that far exceed the overall rate of inflation will push spending on health care to twice the level of Social Security by mid-century, according to studies. In addition to entitlements, debt service will add substantially to future deficits. It's in this sense that the current deficits are connected to a longer-term problem since every dollar borrowed today adds to the cost of servicing debt tomorrow. The Congressional Budget Office estimates that total federal debt will reach 100% of GDP by 2023, up from 41% at the end of 2008. Interest costs on the debt will rise from about 5% of federal spending currently to approximately 20% in 10 to 15 years. The accuracy of these projections will depend on the level of interest rates over the period, but it's probably safe to say that such a large increase in federal debt will cause overall rates to rise significantly, penalizing overall economic growth and, in turn, constraining tax revenue. It's also clear that such a situation is unsustainable. Early in December, Greece's sovereign debt was downgraded to BBB after reaching 130% of GDP. The world's financial system, much less the United States, cannot afford a downgrade of U.S. debt. Something will have to give.

This bubble on the horizon may seem tiny now, but we pay close attention to it as we consider how to advise clients on their investments. One of our most important tasks as investment advisors is to navigate choppy waters through sensible asset allocation, achieving an optimal combination of risk and return (enhancing returns while minimizing volatility) while providing for appropriate liquidity. Although the risks of today seem mild compared to those of a year ago, we cannot let our guard down. There will be other bubbles and subsequent financial strains in the years ahead, and while we may not know the exact nature of them, we need to be prepared by adequately monitoring and managing risk. We see several kinds of risk associated with the unwinding of the recent financial crisis and the growth of the resulting deficits:

- The cumulative deficit could rise over the next few years for reasons cited above, leading to higher interest rates and "crowding out" business borrowers.
- Inflation could accelerate as the Treasury monetizes the U.S. deficit and monetary velocity picks up.
- In their quest for yield, investors sitting on cash or short-term bonds may be tempted to extend maturities, underestimating the risk that rates will rise and bond prices fall as the government attempts to finance the deficit.

- Political reaction to these challenges is difficult to gauge since the authorities in power to address them will be different from those who devised the rescue plans. The U.K., for example, will hold elections in the spring, and the U.S. faces mid-term elections next fall.
- If the investment environment remains volatile, the correlation among asset classes could remain high, much as in 2008, thereby making it challenging to achieve effective diversification in portfolios.

Lessons from the Crisis

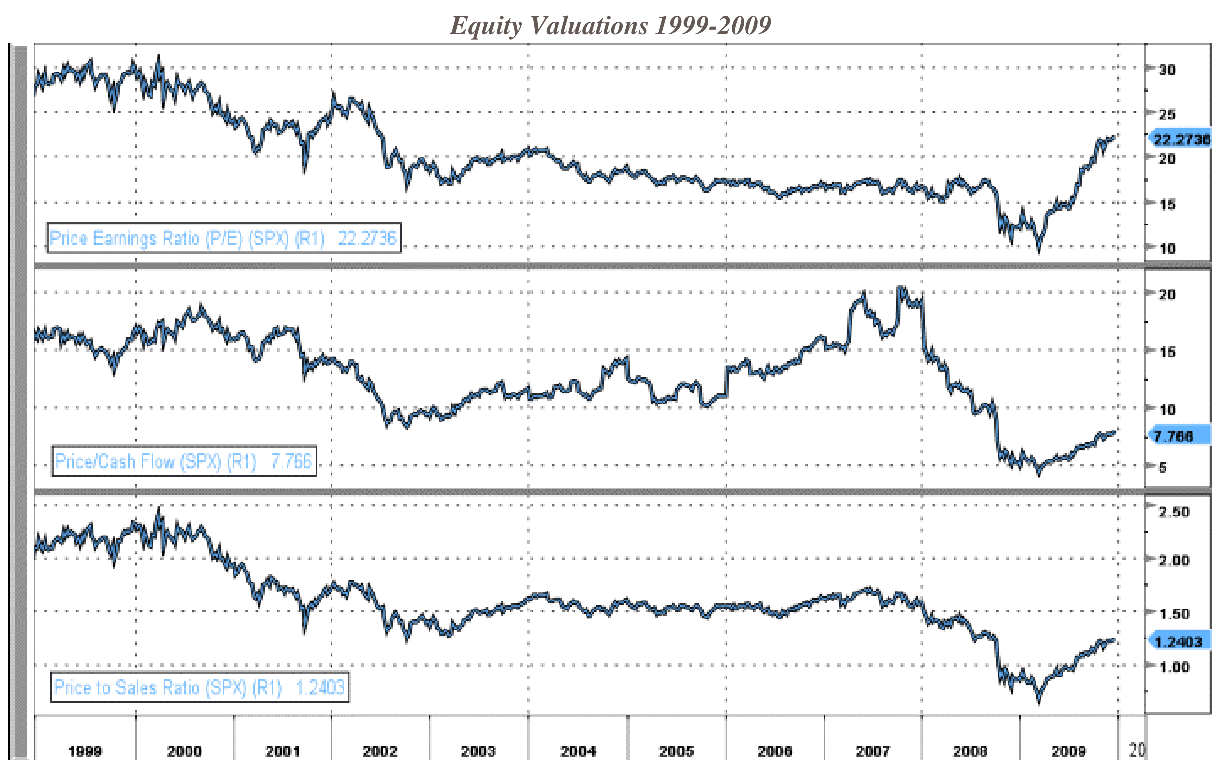
One of the most important lessons from the recent crisis is to provide adequately for liquidity needs. Much has been written about the troubles encountered by Harvard and other large endowment funds as they struggled to meet capital calls on huge private equity commitments at a time when they were heavily allocated to illiquid alternative assets and the value of their marketable securities was severely depressed. We are big believers in private equity and other forms of alternative assets, but they should be managed in such a way as to smooth capital commitments to the extent possible, recognizing that general partners can always speed up or slow down calls for capital as they see profitable investment opportunities.

Nor was the shortage of liquidity limited to investors faced with capital calls. Private clients, as well as endowments, were in many instances forced to sell assets at market lows in order to meet their spending needs. To counter these pressures, we continue to advocate that clients carefully examine their cash needs (for spending, capital commitments, etc.) and set aside at least a year's requirements in advance. The exact amount will depend on one's risk profile, the cash flow coming from other sources including earnings and portfolio income, and how reliable or predictable those sources are. Just because the markets have calmed and prices have lifted, clients should not assume that the need for maintaining liquidity is any less than it was during the crisis.

Since money market yields are so low, some investors may be tempted to sacrifice liquidity for yield by moving excess funds into bonds and perhaps even extending maturities to gain extra returns. Certainly, bond funds have been the beneficiaries of heavy inflows this year, with most, if not all, of the money having come from money market instruments. We think it would be a mistake in the current environment to stretch for yield with funds intended to provide liquidity, as interest rates will probably move up rapidly when inflation returns and the current relaxed monetary policy is reversed. For now, the Fed has clearly indicated that it intends to keep short rates near zero, but that will change as the recovery gains traction.

The shape of the recovery is still unclear. The low level of U.S. interest rates suggests that bond investors anticipate sluggish economic growth accompanied by very modest inflation. Stock investors, on the other hand, appear to see more of a V-shaped recovery, based on the sharp run-up in equities since their March lows. We see the truth as somewhere in between. Based on recent data, growth appears to be resuming gradually in the consumer sector, and exports are being aided by the weak dollar. At the same time, there is so much slack in the labor markets and in manufacturing capacity that it's difficult to envision a meaningful surge in inflation in the next few months, and the de-leveraging of the private sector is likely to restrain growth for awhile. Rather than reflecting robust earnings prospects, the strength in equities seems to have been a function of their having been oversold earlier in the year.

Equity Valuations 1999-2009



Source: Bloomberg

Not Counting on the Cycle

The stock market's spectacular rise from its March lows suggests to some that a significant correction is at hand. We won't speculate on whether prices are ahead of themselves, but we do not see stocks as having reached bubble territory at this point. Domestic equity mutual funds have experienced slight out-flows since March, according to AMG estimates, so the general public still appears to be risk-averse. Valuations are well within historical norms—in fact, very much in line with their long-term average price/earnings ratio based on both latest 12 months earnings and estimated 2010 profits. For stocks to move significantly higher, earnings will need to grow through 2010 and into 2011, and/or price/earnings ratios will have to expand. Through most of the recession, profits have been driven largely by productivity gains, and it can be argued that not much more can be squeezed out of the labor force at this point. Revenue gains will need to come to the fore and again play their part in pushing profits ahead. Although the recovery is likely to be sluggish by historical standards, year-over-year comparisons will be easy through the first several quarters of the New Year. As far as valuations are concerned, P/E ratios have room to expand if interest rates stay low, although we are not counting on such a re-pricing to produce returns.

In general, we are positioned to make money for clients independent of the profit cycle. Our investment philosophy in equities is to focus on companies that are capable of delivering solid growth even in a slow recovery. This bottom-up approach has worked well during the downturn and should continue to serve clients effectively as the recovery unfolds. In international equities, we particularly favor emerging markets where secular growth is high. Alternatives, too, offer an opportunity to make good returns even in the absence of a strong cyclical recovery. The hedge funds that we own for clients generally involve low leverage and are primarily positioned in long/short (i.e., not taking a strong net position on the market), distressed debt (taking advantage of dislocations in the credit markets) or international/emerging markets. Similarly, the venture capital and buy-out funds in which we are active are not particularly leveraged to the cycle, since their objective is to add value to companies over their respective investment periods rather than capitalizing on a cyclical upturn. Finally, in real estate our largest commitment is to a Washington, D.C.-based partnership that concentrates in the D.C. metro market, which is known for its stability. In addition to these relatively non-cyclical investments, we have been active in commodities, through ETFs and natural resource funds, as a way to hedge against the possibility of accelerating inflation over the next few years.

If the economic winds blow harder in favor of a cyclical upturn, so much the better; our clients will benefit from owning risk assets. In the meantime, our concern is that the lessons of the last bubble—liquidity, attention to risk—should not be lost. When investors begin to feel that the world is a "safer place" and risk premiums decline, it's a good time to make sure we've been thoughtful about the risks that do exist. The cost of losing money by being greedy and underestimating risk generally out-weighs the opportunity cost of missing a chance to participate in an already crowded trade. The bubbles we see on the horizon currently are still relatively small or too far away to gauge accurately, and in general we are optimistic about 2010. At the same time, we are mindful of how rapidly the financial picture can change, and we remain committed to monitoring it carefully as the recovery unfolds.

We take this opportunity to wish our clients and friends a happy and healthy 2010.

William L. Paternotte, CFA