

“They’re” Winning

Britons had been bracing to see how their vaunted sense of fair play and civil rights survives the onslaught by attackers and the measures to combat it.

“Many civil liberties will have to be infringed to impose the requirement on all communities, including Britain’s Muslims, to destroy the terrorists before they destroy us,”

author Tom Bower wrote in The Daily Mail.

– New York Times, July 24, 2005

I’ve learned more about the Capital Asset Pricing Model (CAPM) by collecting stamps than I ever learned at business school. Actually that’s not quite fair to my alma mater UCLA/Anderson, since in 1971 the CAPM was in its infancy and I was taking the course during the same semester I was applying for a job. Both pursuits it turns out were near failures at the time, the CAPM class producing a charitable “C-” and the job search but one solitary \$11,000 offer at a company called Pacific Mutual Life Insurance – the future owner of PIMCO. The stamps – and the job success – would come later although my philatelic roots were just as humbling. Shirley Gross – Mom – was a firm believer in the 1940s that collecting commemorative sheets of U.S. stamps was a great way to accumulate a nest egg to send her kids to college. Sheets of 100 would typically cost \$3.00 and her hopes were that come the early 1960s they would be worth 5-10 fold. One Friday summer morning in 1961, yours truly the future stamp collector, was sent into San Francisco – much like Jack climbing up the beanstalk with his magic beans – to reap her rewards and finance my next four years at Duke. Each stamp store gave me the same snippy answer – “get back Jack, these stamps ain’t worth beans” – not even it seems the \$3.00 per sheet my mother had originally paid. Some investment! College? Thank goodness for my SATs and the Duke scholarship to come.

And so it might seem strange to you that in 1991 I returned to philately – but not so odd if you were a psychologist and could have accessed my personality: an obsessive guy, fixated on winning, and – I suppose – intent on proving that Mom’s instincts were correct – she just hadn’t bought the right stamps. And so it turned out to be. What I’ve found by collecting stamps – and this is where it merges somewhat with CAPM – is that high quality stamps appreciate (with considerable volatility) with nominal GDP growth or the annual growth in national income. Going into the hobby in the early 90s, that made intuitive sense to me. If 10 years down the road, the U.S. had twice the income as it did before (a 7% annual growth rate in nominal GDP) then collectors could afford to spend twice as much for stamps. Actually, as CAPM experts know, stamps wouldn’t necessarily grow at the same rate if its beta was more or less than the “market” (or nominal GDP as I define it,) but classic 19th century stamps (coins as well, although I know nothing about them) seem to have a beta lower than equities and close to the market since they’re not easily leveragable and the supply is constant – they’re not making any more of them. In turn, stamps are not like rare art where many paintings are donated to museums over time, constricting the supply and therefore elevating the price of rare art from what I theorized was a near one-to-one pricing relationship with nominal GDP as well.

Now being of the “Missouri/show me it’s true” mentality I decided to “test” my theory by tracking the price performance of the very same stamps/blocks/covers (envelopes with stamps attached) over long time periods: not similar stamps subject to quality interpretation, but the unique items trading from estate to estate over many decades’ time with prices received verified in historical auction catalogues by houses such as Christie’s, Sotheby’s, and Siegel. I will spare you further ennui/“where is he going with this” and get to the conclusion and ultimate point of this *Outlook*. Over a period of 70-80 years, rare classic U.S. stamps have appreciated at the same rate as nominal GDP, which is what my commonsensical hypothesis thought they might. My mother’s mistake had been to buy new issues with millions of copies and to expect them to be more valuable to a collector than they were to a stamp licker.

And now back to CAPM and market returns. Common sense finds me at age 61 at a point where some of you might simply respond – “duh!” – and that is that investment returns/asset prices are highly correlated to the annual increase in national incomes or nominal GDP growth over long periods of time. That thought might be simple, yet it is complicated by the constantly changing division of that new wealth by labour/government/and capital. Even in its simplest form this axiom is often forgotten by investors, pension committees, and presidents in their expectations and public pronouncements for asset returns over long future periods of time. Learned experts frequently have used abbreviated histories of asset returns or even extended histories containing P/E multiple expansions to justify high expectations for certain asset returns. Bond, stock, and now real estate performance has been subject to such fallacious reasoning, riding the tail of declining yields in many cases

to justify high flying expectations when in fact similar interest rate declines are mathematically impossible. Likewise, equity performance theoretically confirmed in academia by near 100-year risk premiums of 6% – The Siegel “constant” – and therefore bearing return expectations of near double-digits, fail to recognize the expansion of P/E multiples over the same period. Investors, quite simply “voted” via their hyperactive accumulation of stocks, that the equity risk premium – stocks’ return exceeding that of riskless Treasuries – should be 6%. The number wasn’t necessarily grounded in economic common sense however, just in historical numbers pumped by increasing investor optimism.

I am more a believer in the “what you see is what you get” theory of investing. If you see a 4% 10-year Treasury yield, then over the next 10 years that’s what you’re going to get (reinvestment of coupons aside). Similarly, I believe that if nominal GDP goes up X% over the next 10 years, then overall asset prices (The Bill Gross CAPM) will probably return X% assuming unchanged percentage interests of government, labour, and capital for the same time period. With so many complicating variables, why bother you might ask? Well it helps me to put things in perspective and hopefully it’ll help you too. If nominal GDP only increases at 5% a year over the next 10 years (my maximum expectation) then asset returns as a whole should be capped at that level as well.

Now, here’s where my simplicity gets even simpler – perhaps as in “simpleton” but hopefully as in “simplifier.” That 5% doesn’t apply to each and every asset; some will return less, some will return more; and that’s not because of the randomness principle or even that riskier assets should be priced to return more than riskless assets although that’s part of the equation as the CAPM confirms. To help

me understand which assets will do what, I place them into three categories and I call them 1) riskless, 110-pound Wimps, 2) Average Joes, and 3) kick sand in your face Bullies. Let's start with #2 the Average Joe or Jane best represented by the 10-year Treasury – “the most important price (yield) in the world,” as Greenspan has called it. The reason the 10-year yield is average is that over a 50-year history, its yield has almost replicated the growth of average nominal GDP, 6.7% vs. 7.1% as shown in Chart I. Why a riskless Treasury should produce near average yields (and approximate average returns given yield curve rolldown) is explained by its price variability over the short (and long) term and the fact that investors have required an 80 basis point annual premium over Treasury Bills (the 110-pound Wimps) to compensate.

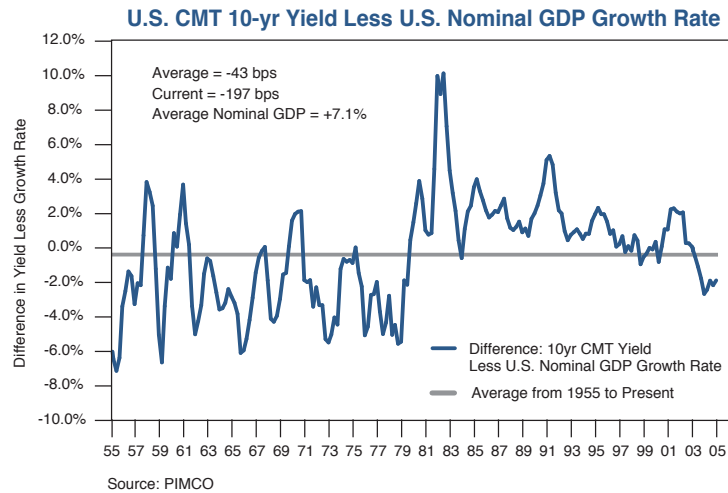


Chart I

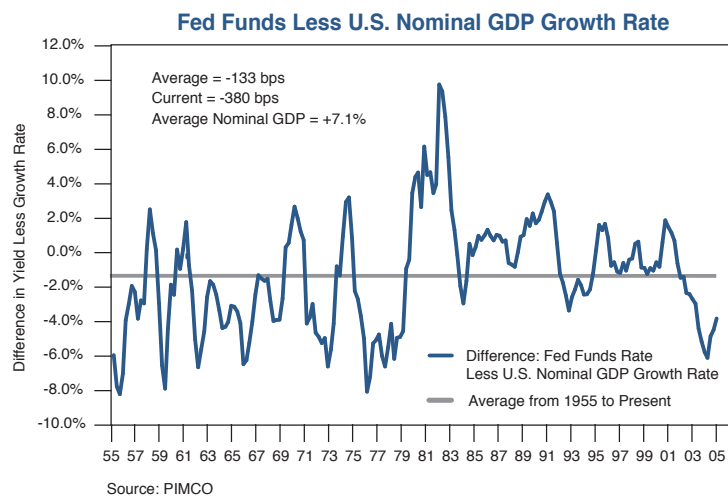


Chart II

The startling implication of this is that if an investor is willing to hold a constant 10-year maturity Treasury that has no principal risk, he should be able to increase his wealth (pre-tax) close to the average rate for all investors. Bond portfolios willing to accept the same duration risk as a 10-year Treasury (8.0 years and 3.5 years longer than market averages), while introducing credit and volatility risk into the mix, should do even better.

Such returns, however, come at the expense of and partially because of the low return/yield subsidy supplied by the 110-pound Wimpy short-term cash

holders, shown in Chart II. Because of their requirement for liquidity and aversion to price volatility, the cash Wimps – and there are \$10 trillion dollars worth of them – get sand kicked in their face. No matter, they claim, peace of mind and a sound night's sleep are their rewards and they undoubtedly have a point; still that need for comfort places them at the low-end of the total return totem pole because of their need to snooze like a baby.

The Bullies of course are the higher-risk assets such as equities (public and private), real estate, and now hedge funds which are able to kick sand in the faces of the cash

Wimps by borrowing their money and their girlfriend for the afternoon and leveraging their investments into the #3, higher than average category. While that is not the sole reason for success (equities have a “growth kicker” which itself represents a short-term and perhaps even a longer-term risk), the ability to borrow at less than the growth rate of nominal GDP is an important key to the puzzle. If \$10 trillion of wimpy short-term assets underperform the growth of nominal GDP by 1.3% annually as shown in Chart II, then \$10 trillion of category #3 Bullies should be able to outperform our Average Joe or Jane by a near similar amount. This leverage by the Bullies is the structural key to banking, hedge funds, and real estate developers/owners. While not all of them borrow at the short rate, many of them borrow at an average maturity close to it – especially homeowners of late – which is a key ingredient in their long-term performance returns (as are the tax breaks providing an even lower after-tax borrowing cost for most homeowners.) As far as hedge funds are concerned, how would a CAPM proponent be able to theoretically explain the returns of “hedge” funds which supposedly lower beta and risk, yet at the same time produce excess returns? Only in my opinion by either underestimating the long-term beta / volatility (LTCM?) or on the other hand by acknowledging their “bullying” of the Wimps into handing over cheap money.

This “Bill Gross CAPM” is of course something most of us knew all along, but then sometimes forget in our exuberance for asset class future returns. My ultimate point is that nominal GDP growth is the North Star for wealth creation adjusted for a changing of the shares claimed by labour, government, and capital. If, as I expect, that is to be 5% or less in a future economy, then average asset returns will be 5% or less, pre-tax. Investors that earn more will have to take risk by bullying and kicking sand in the faces of wimpy short-term cash holders. That of course carries risks of its own, but absent Armageddon even the levered bullies should expect no more than 6-7% going forward. Use this common sense CAPM to purchase bonds, common stocks, or second or third homes if you dare (no more homes for me, thank you.) Forget the commemorative sheets of stamps, however. They’ve never been worth beans.

And oh yeah – about the title and the sub-quote. Bag searches at public events, airports, and subways? Fine. But let’s be mindful of more intrusive escalations down the road. If we sacrifice liberties and freedoms in the blind pursuit of “the terrorists” then we potentially give up more than our daily conveniences. We risk our free society. And if we lose that, then “they” will have won.

William H. Gross
Managing Director

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Each sector of the bond market entails risk. The guarantee on Treasuries and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. P/E is a ratio of security price to earnings per share. Typically, an undervalued security is characterized by a low P/E ratio, while an overvalued security is characterised by a high P/E ratio. The Capital Asset Pricing Model (CAPM) describes the relationship between risk and expected return that is used in the pricing of risky securities.

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