

Don't Be a Yield Pig

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I have thoroughly reviewed the U.S. Constitution (and the Bill of Rights for good measure) and, contrary to popular belief, there is no mention of a right for savers to earn high rates of interest on government-guaranteed principal. Nevertheless, it comes as a terrible shock to a lot of people that some current short-term interest rates are only one-third of early 1980s levels. The correct response to this shock can be crucial to your financial health.

There is always a tension in the financial markets between greed and fear. During the 1980s investor greed frequently got the better of fear, with the result that yield-seeking investors, known among Wall Streeters as "yield pigs," were susceptible to any investment product that promised a high current rate of return, the associated risk notwithstanding. Naturally, Wall Street responded by introducing a variety of new instruments--junk bonds, option-income mutual funds, international money market funds, preferred equity return certificates (PERCS)--anything that promised high current yields to investors.

Unless they are deluding themselves, investors understand that to achieve incremental yield above that available from U.S. government securities (the "risk-free" rate), they must incur increasing levels of principal risk. There is no risk-free yield enhancement on Wall Street. The painful result: Higher risk investments often erode one's capital and produce lower returns--the worst of all investment worlds. Higher-returns-for-higher-risks only applies on average and over time.

Investors must carefully examine alternative investments to assess when they are being adequately compensated for bearing risk and when they are not. When the yield differential between riskless and more risky securities is sufficiently large, even a conservative investor might reasonably venture beyond U.S. government securities. Thus, for example, it made sense to buy the Federated Department Stores senior-secured bonds, Harcourt Brace debentures and Manville preferred stock when panic hit the junk bond market in late 1990 and early 1991.

These days, however, I don't believe investors are being compensated sufficiently to venture beyond risk-free instruments. Yield spreads between government bonds and corporate credits have contracted sharply this year from levels a year ago. Some bonds of such highly leveraged issuers as Burlington Industries and Unisys now trade above par. A year ago they sold at substantial discounts from par.

Yield-starved investors also have been bidding up the bonds of such deeply troubled issuers as Chrysler, Stone Container and Marriott. The General Motors PERCS--a newly

created instrument that only a yield pig could love--recently traded at a level so high that the common stock became a better buy no matter where GM common traded and no matter what action GM's board took on its dividend.

Some investors, desperate for better yield, have been reaching not for a new Wall Street product but for a very old one--common stocks. Finding the yield on cash unacceptably low, people who have invested conservatively for years are beginning to throw money into stocks, despite the obvious high valuation of the market, its historically low dividend yield and the serious economic downturn currently under way.

How many times have we heard in recent months that stocks have always outperformed bonds in the long run? Funny, but we never hear that argument at market bottoms. In my view, it is only a matter of time before today's yield pigs are led to the slaughterhouse. The shares of good companies and bad companies alike are vulnerable to sharp declines. Moreover, many junk bonds that have rallied will tumble again, and a number of today's investment-grade issues will be downgraded to junk status if the economy doesn't begin to recover soon.

What if you depend on a higher return on your money and can't live on the income from 4% interest rates? In that case, I would advise people to ignore conventional wisdom and consume some principal for a while, if necessary, rather than to reach for yield and incur the risk of major capital loss.

Stick to short-term U.S. government securities, federally insured bank CDs, or money market funds that hold only U.S. government securities. Better to end the year with 98% of your principal intact than to risk your capital roofing around for incremental yield that is simply not attainable.

I would also counsel conservative income-oriented investors to get out of most stocks and bonds now, while the getting is good. Caution has not been a profitable investment tactic for a long time now. I strongly believe it is about to make a comeback.

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