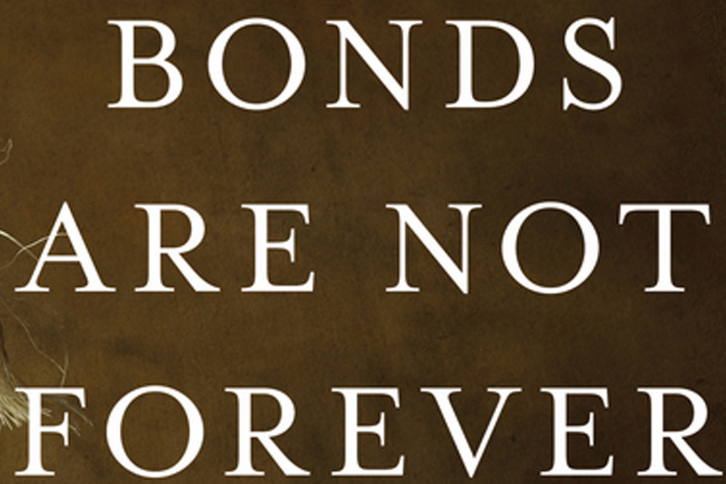

BONDS ARE NOT FOREVER

THE CRISIS FACING FIXED INCOME INVESTORS

SIMON A. LACK

WILEY

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To my grandparents, Roy and Kathleen Rogers

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PREFACE

Three big themes have linked together to dominate bond markets over the past 30 years. Since inflation peaked in the early 1980s, we've experienced a secular decline in interest rates, an increasing financial services sector, and sharply growing indebtedness. By sheer coincidence, my career began at approximately the same time that these three trends emerged, although my identification of them is most definitely one of hindsight rather than foresight.

The 2008 financial crisis was borne out of these three trends, and its aftermath has many consequences. American economic history is full of successes, although not every economic development has been good. Many financiers have made fortunes through a bigger banking sector and more widespread indebtedness, yet the inflation-adjusted lot of the typical family has barely improved. An understandable public policy response to the financial excesses is developing around the belief that, in finance, big is bad and greater oversight is in the public interest. This swinging of the pendulum back in a more populist direction likely heralds change in other trends as well. The sharp increase in government debt as a result means the weight of financial obligations will be a prominent feature on the investment landscape for the foreseeable

future. When there is an absolute abundance of public sector debt to be financed at all levels of government, the prudent investor should probably use commensurately more reticence in committing to securities with fixed returns.

This book seeks to connect the three big themes of falling inflation, a growing finance sector, and huge government debt into a coherent framework for assessing future returns on fixed income. Woven into this analysis are personal anecdotes from someone who was part of the growth of Wall Street simply because that was the intersection of opportunity and personal aptitude. Bonds have been a great investment for a very long time, but Bonds Are Not Forever.

This book includes a website, which can be found at www.bondsarenotforever.com. This website includes a description of the book, links to press coverage and events featuring the book, and links to the SL Advisors, LLC website for more information about the investment strategies mentioned here.

ACKNOWLEDGMENTS

A book is a collaborative process, and this project would not have been possible without help from many people. My business partner and friend, Henry Hoffman, provided numerous recommendations for improvement and applied intellectual rigor to assertions that might otherwise have been simply opinions. Many of the conclusions drawn herein are the result of countless hours of spirited debate with Henry about investment strategies, economics, and the shortcomings of the U.S. political process. Several friends reviewed individual chapters and offered many improvements. Chapter 2, "A Brief History of Debt," benefitted from Roger Taylor's thoughtful input, backed by his long career in bond research. Pat Britt, with whom I worked in the early 1980s, provided insightful feedback on Chapter 3, "Derivatives Growth." Jon Bramnick, New Jersey state assemblyman and Assembly Republican Leader, helpfully reviewed my analysis in Chapter 6, "Politics." Jim Glassman, senior economist at JPMorgan Chase and a former colleague, provided many suggestions and corrections for Chapter 8, "Inflation." My friend of 30 years Larry Hirshik also offered improvements and confirmed my recollection of events we shared many years ago. Fred DaVeiga cleverly suggested the title, revealing yet

another of his many talents, and my sister-in-law, Katherine Oldfield, inspired the front cover design. My mother, Jeannie Lucas, did research and initial editing and acted as cheerleader throughout. Last, but by no means least, my beautiful wife, Karen, and our three wonderful children, Jackie, Daniel, and Alexandra, provided the encouragement to pursue this endeavor and the space in which to conclude it. I am indebted to them and to all the people listed here, without whom this book would not have been written.

CHAPTER 1

FROM HIGH SCHOOL TO WALL STREET—*THE BULL MARKET BEGINS*

Inflation Memories

It was February 1972, and at nine years old I found playing with my toy soldiers in the flickering candlelight an exciting change from the steady illumination of incandescent bulbs. My British platoon skillfully maneuvered behind the German lines, taking advantage of the shadows to surprise and quickly overwhelm the enemy. In those days the Germans were always the competition, whether on the battlefield or the English football pitch. The change in routine caused by the loss of electricity thrilled me as a young boy, but was not so exciting for my grandparents because it was a scheduled loss of power whose timing had been announced in the daily newspaper. February in Britain is dark at the best of times. After a long winter night, a person awakes to a dull, gray sky. By the time I began my career working in London's financial markets, the British winter, while not nearly as cold as that of New York, felt rather like two months living at the bottom of a damp, dark pit, with only an occasional glimpse of daylight through a window. However, an English evening in July, when the days are long but never humid, can be the best place in the world.

Britain in the early 1970s was at the mercy of the trade unions, and a coal miners' strike was preventing fuel from reaching the power stations around the country. The proud people of a nation that still recalled the empire on which "the sun never set" found itself powerless at home, reduced to eighteenth-century means of illumination. Arguably, Britain was continuing its steady relative decline from the late nineteenth century, at which time the United States began to surpass Britain by measures such as iron and energy production, and industrial output (Kennedy, 1987). The steady rise in importance of other powers accelerated following World War II, when victory was achieved only at an enormous financial and material cost; confirmation of Britain's reduced status came during the 1956 Suez Crisis when U.S. pressure forced an embarrassing climb down on a once dominant power. Yet diminished global influence didn't need to translate into self-destructive actions at home. Nonetheless, in 1972, while the trade unions and the government argued over pay, a country once described as "built on coal" was unable to use enough of it to light its homes. There were many low points for Britain and its economy in the 1970s when I was growing up, including a bailout by the International Monetary Fund (IMF) in 1974.

Looking back at those times from a distance of 40 years and 3,500 miles in America, the 1970s were the most turbulent economic times since the Depression in the 1930s. Britain had its own set of homemade wounds in the form of militant trade unions, a manufacturing base that was losing out to its European competitors (especially the Germans), and a welfare state whose safety net was so generous it often made paid employment more costly than indolence.

Although Britain had its own partly self-inflicted problems, rising inflation in the 1970s and early 1980s wasn't limited to the United Kingdom. President Ford even resorted to handing out pins labeled Whip Inflation Now (WIN), perhaps revealing the paucity of more robust ideas within his administration. For much of the developed world it was the greatest inflation in living memory. Today, it is recounted through bland numbers on a statistical release from the U.K. government. In 1972, when the miners were forcing Britain to her knees, inflation the United Kingdom was 7.6 percent (see Figure 1.1).

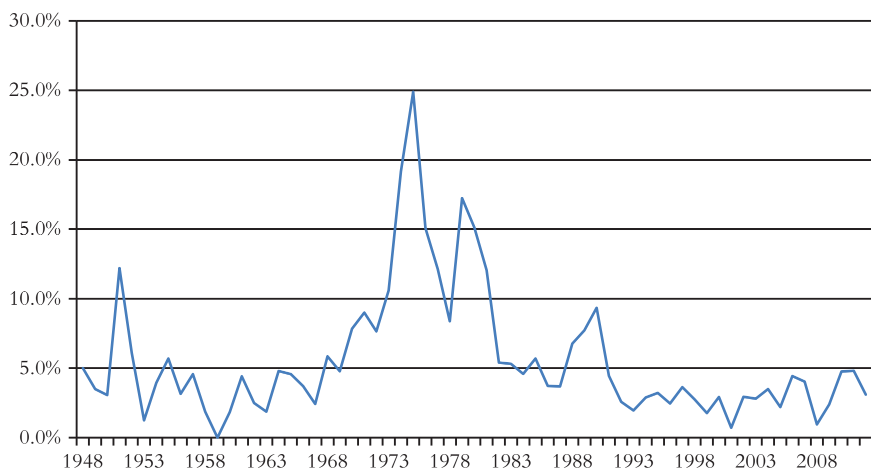

FIGURE 1.1 U.K. Inflation 1948–2012

Source: U.K. Government, Office for National Statistics.

Two years later, fueled in part by generous pay settlements won by the coal miners and other unions, it was 19.2 percent. A year later, in1975, U.K. inflation reached 24.9 percent, a level at which money loses half its value in just over three years. In one month (May 1975), prices jumped 4.2 percent, an annualized inflation rate of 63.8 percent!

This is an abstract notion for most Westerners today. We read about inflation in Latin America, about hyperinflation in countries such as Zimbabwe, but few of us below the age of 60 have had to manage a household budget and make personal financial decisions under such circumstances. That includes me, but memories of my mother and grandparents worrying about "the cost of living," about weekly price increases and the ongoing failure of income to keep up with expenses remain a part of my otherwise quite happy childhood.

Running commentary at the dinner table about how the price of sugar, washing powder, petrol, or school uniforms had gone up since the last time we gathered were a staple part of the conversation. Of course, nobody knew when it would end, or really even what was causing it (although the reasons seem clear enough to today's economic historians). People blamed the trade unions for selfishly

negotiating pay increases not backed by improved productivity, the government for conceding to their demands, and the Organization of Petroleum Exporting Countries (OPEC) for sharply hiking the price of oil. All of these were to blame. What was worse was that at the time nobody knew if double-digit inflation or worse was a permanent part of the economy.

AS BAD AS IT GETS

Hard economic times were not limited to Britain, though. The 1970s were tumultuous in America as well. While American trade unions were not nearly as powerful as their U.K. counterparts, photos of gas-guzzling cars lined up waiting to refill their tanks became an iconic image of that time. Shortages of basic goods, often accompanied by inflation, were a global phenomenon. The lax monetary policies followed by central banks and governments combined with some features unique to each country. In Britain, a steady loss of competitiveness, on top of an overly generous welfare state, was ultimately reversed by Maggie Thatcher when she came to power in 1979. In the United States, blame for the economic turbulence of the 1970s typically traces back to the 1960s, with the costs of financing the Vietnam War coincident with an expansion in welfare under Lyndon Johnson's "Great Society." The subsequent loss of confidence in the U.S. dollar led to the breakdown of the Bretton Woods Accord when President Nixon suspended its free convertibility into gold in 1971. This ushered in the current era of "fiat money," in which a currency's value is only as good as the market's confidence in its government's policies.

The 1970s and early 1980s saw two major oil price hikes, economic upheaval, and ultimately strong leaders in Margaret Thatcher and Ronald Reagan, determined to lead their respective countries along a better path to smaller government, sound money, and improved living standards. Britain and America share a great deal in terms of history and values. At that time, both countries were in need of decisive leadership to promote economic growth supported by competitiveness and sound money. Both found it.

In 1980, U.K. monthly inflation was 15 percent (in just one month, April 1980, prices rose 3.4 percent), and shortly thereafter the greatest bull market in history began in bonds. It followed the longest global bear market in history, one that began in 1946 after World War II and lasted 35 years. To illustrate, if a constant maturity 2.5 percent 30-year bond had been available throughout this period, its price would have declined from 101 to 17, a drop of 83 percent (Homer and Sylla, 2005). More than an entire generation of bond investors had lived through a relentless destruction of the purchasing power of their savings. In the years leading up to 1981 investors had been demanding ever higher yields on their fixed income investments to provide protection against the rapid erosion of purchasing power. High borrowing costs were stifling any industry that required borrowed money to operate, which is to say virtually the entire economy. As financial markets began to sense that inflation and interest rates were peaking, they bid up the prices of bonds aggressively. The long road to low and stable inflation had begun, and with it a bull market in equities as well (propelled by falling borrowing costs, which were helping so many companies).

TRADING IN GILTS

By coincidence, my career in financial markets began in London within a few weeks of that peak in interest rates and inflation. I had grown up during the most extended financial turmoil in living memory, with double-digit interest rates and savings that rapidly lost their real (i.e., inflation-adjusted) value. I began my career in finance within a month or two of the very worst of high interest rates and rampant inflation. It was the threshold of the gradual return to sound money, and it would be complemented by an inexorable rise in the value of all financial assets. At the same time, finance and financial markets were set to gain enormously in importance through greater employment and would contribute a substantially larger share of overall economic output. Liberalization of markets would lead to a dizzying array of financial instruments to be traded. This occurrence combined with the relentless fall in trading costs would support the

steady increase in financial engineering and debt creation that culminated in the crash of 2008. None of this was even remotely plausible to someone recently out of high school and beginning his career in "The City." Yet, in hindsight, my entry into the workplace was blessed with fortunate timing.

The U.K. market for government bonds, or "gilts" as they are known in Britain, has as long a history as any in the world. Consolidated annuities (known as "consols" for short) are perpetual securities that were created in 1756 by consolidating a series of already issued perpetual annuities. They have no maturity date (although theoretically the U.K. government may redeem them). Their history is detailed in a 2005 book soporifically named *A History of Interest Rates* by Sidney Homer and Richard Sylla. It's probably not flying off the shelves at Amazon. Nevertheless, for those interested in such things it is a comprehensive record of the cost of borrowing that goes back to biblical times in measuring the price of credit.

Bond markets are not nearly as exciting as stocks. Bonds issued by governments don't involve colorful CEOs, corporate takeovers, or profits warnings. Bonds are boring; in fact, bonds are meant to be boring. Investors don't buy them for excitement—for thrills they buy stocks or go to the racetrack. Because bonds move far less than stocks and are rarely prone to the extremes of greed and fear so prevalent in equity markets, the people who traffic in them tend to be more staid as well.

Equity traders have been known to accuse their colleagues in bonds of being communists. On days when the government releases weak economic data, government bond prices often rise (because their yields fall), and traders in most markets generally do better when prices are rising. Economic misery, which tends to restrain inflation, causes bond traders to leap for joy while equity markets and consumer sentiment both tumble. There's an essential difference in outlook between the two markets. Equity traders are happiest when they are optimistic on the economic outlook because higher corporate profits tend to fuel rising stock prices. By contrast, bond traders are often cheerful when everybody is miserable. Rising unemployment, slowing retail sales, and falling house prices are all associated with falling interest rates and a bull market for bonds. Try watching

the professionals on TV from any big bond firm (Pimco, for example) sincerely lament another weak economic report while their investments are most likely rising in price. Professed and genuine concern for the newly unemployed competes with the quiet satisfaction of a more highly valued bond portfolio.

The U.K. gilt market (so named after the "gilt-edged" credit quality of the bonds traded there) of 1980 operated in a way that was scarcely different from the 1880s. The market consisted of brokers, who charged a commission and traded with the public as brokers do, and jobbers who were market makers and did not deal with the public at all. The market was structured with two large jobbers named Wedd Durlacher and Akroyd and Smithers, in effect surrounded by a far larger number of brokers. Brokers were allowed to trade only with jobbers and investors, not with one another. The jobbers could not trade with anybody except the brokers or (occasionally) with other jobbers. The jobbers held a monopoly on market making, but in return had given up the ability to face investors. The brokers had the exclusive right to deal with the general public, and in exchange were allowed to act only as agents (i.e., they couldn't take positions themselves).

Business took place on the large floor of the London Stock Exchange. Jobbers stood at their "pitch," or assigned post, while brokers moved around the floor in search of the best deal for their client. A broker would ask a jobber to quote a price that was, in the best tradition of London markets, always "two-way" (i.e., bid and offer). Years later, when I was trading U.S. government bonds in New York, I always felt that the U.S. custom, whereby the client had to disclose whether they were buying or selling before obtaining a quote from the dealer, was providing a needless advantage at the expense of the client. A U.S. government bond dealer will show only one side of a two-way market—the client will ask for "a bid on 25," for example, or request that the trader "offer 50." Showing a two-way market keeps the dealer honest, in that if his bid/ask spread is wide, that's an indication that his profit margin is possibly too high and may signal the client to go elsewhere. Other markets, such as foreign exchange, always required that the market maker quote a two-way price. The trader could try to guess whether the client was buying

or selling, but if he shaded the price the wrong way, he ran the risk of the client's trading on the other side (i.e., buying when the dealer thought he was a seller) and perhaps profiting off the dealer's attempt to "read" him.

The London Stock Exchange in 1980 was only a few years away from "Big Bang," the 1986 deregulation of the overall market that would radically alter almost everything about how "The City," as London's financial center is called, operated. Back then, the entire place followed rigid work practices, from commissions, which were uniform across all firms, to career paths and how clients transacted their business. Finance had long provided jobs for those who were quick-witted and confident. London's financial market place is physically not far from the East End of London, with its rowhouses of tenements barely changed from World War II. Multiple paths existed for the aspiring financier: education at a private school (perversely called a "public" school in the United Kingdom) followed by a university degree, then entry to a blue-blooded stockbroker in the gilt market. This was dubbed by some the "champagne and polo crowd," evoking the cultural background of those whose leisure regularly includes the enjoyment of both.

THE OLD CLASS STRUCTURE

Another path was from comprehensive (i.e., not elite) school, and probably not university, to a job in the equity markets or the money markets, where one's peers would be the "gin and tonic and squash crowd," denoting less cultured and cheaper relaxation. The open outcry, rough and tumble of a large physical market was a comfortable place for someone who might just as easily be competing to sell fruit and vegetables fewer than 10 miles away for vastly different compensation. London has become a much more culturally diverse place, with little patience for the staid old ways, and that's no doubt a good thing. Still, the London Stock Exchange in 1980 in many ways mirrored the class system of the country. Britons could instantly place someone in their appropriate class as soon as words were spoken, and, while business could be transacted across class lines, social life was rarely so flexible.

Forest School in Snaresbrook is close to London's East End. The surrounding forests from which it draws its name quickly give way to gritty working-class neighborhoods as you head toward the center of the city. Before reaching the gleaming towers of London's financial district, it's necessary to pass through run-down areas such as Leyton, Hackney, and Bethnal Green, none of which could be confused with the leafy suburbs of the stockbroker belt. Historically, immigrants to the United Kingdom have often settled in the East End, from the Huguenots fleeing religious persecution in France in the seventeenth century to the South Asians today. Forest was and remains a public school with neighbors who can only dream of affording the tuition to send their children there, and yet the presence of so many minority students highlights the economic mobility that immigrants achieve. In many ways, my alma mater, Forest School, was typical—all boys, classes that ran six days a week, with a heavy emphasis on competition across all endeavors, both academic and sporting. When I was there in the 1970s, there were many boys that didn't look "English," to use the terminology of that time, because they weren't white. Today's coeducational student body is no less diverse, and yet more "English" because the country is itself more diverse.

The closely packed houses of London's East End have usually been home to workers struggling to move up a rung or two, and also home to a fair amount of crime. A student from Forest School, easily recognizable in his uniform, would head warily in that direction to a place where looking at someone the wrong way, or indeed looking at them at all, was to invite trouble. So this public school's catchment area for students included parts of London that wouldn't normally send their children to one. Nonetheless, the experience was typical of most public schools. Boys were assigned to "houses," which were the basis for intense internal competition in everything from sports to drama. In fact, competition was ever present, whether it was in class rankings for subjects or an English football game with a neighboring school. Anything that mattered was subject to comparison with your peers.

"Monitors" (selected students in their senior year) were the first layer of sometimes arbitrary discipline, empowered to administer corporal punishment if they judged it appropriate. It was its