“History does not repeat itself, but it does rhyme” – Mark Twain

In June of 2007, struck by the apparent level of complacency prevalent in the financial markets (and bruised by more than two and a half years of relative underperformance) we penned a paper highlighting our belief that the perception of risk in many corners of both the corporate and financial worlds seemed to have changed. No longer viewed as it should be - a measure of the potential variability of the magnitude of future rates of returns, risk had instead simply become for many a barometer of future returns. Years of benign global monetary policies, unsustainably high levels of corporate profit growth, rapid appreciation of home prices and strong returns from equity markets, hedge funds and private equity vehicles led corporations and investors alike to take on greater levels of leverage and pursue higher risk strategies. What followed was a historic rebalancing of the economic and financial excesses and a return to equilibrium for the value proposition of risk taking, at least for a time.

Today, the financial world we operate in is structurally far healthier than it was in the middle of the past decade. Corporate America is in good shape. Cash is plentiful, profit margins are at an all-time high - the result of years of aggressive cost cutting measures and historically low interest rates - and corporate profits have doubled over the past 5 years despite the noticeable absence of revenue growth. GDP growth is improving, unemployment measures have come down steadily, companies are ramping up capital spending, M&A activity is heating up, inflation remains muted in part due to widespread weakness in commodity prices and broad wage pressure is hard to find. With home prices recovering, consumer balance sheets have improved significantly over the past few years. Elsewhere around the world, the picture is not quite as rosy. Despite massive central bank intervention, Japan's economy is not growing. China's growth has slowed and the government is attempting to transition the country to a consumer driven economy. Other leading emerging economies have struggled with weaker growth and declining currencies in the past few years. Europe is once again teetering on the edge of recession and the European Central Bank recently announced it was launching its own version of Quantitative Easing.

Given the encouraging backdrop in the US, it is not surprising that the equity market has performed well and that companies and investors alike feel optimistic. In many ways, there haven’t been many alternatives. Nevertheless we are again struck by the fact that many of the broad measures of risk taking and complacency have deteriorated meaningfully in the past year and a half, are now quite elevated and are sending similar signals to what we saw in 2007 for lower quality, riskier assets. We are cognizant that after more than 18 months of relative underperformance, we could be seeing ghosts. But now into the sixth year of a bull market, with the last two years driven predominantly by P/E multiple expansion as opposed to earnings growth and with the recent dramatic outperformance of low quality companies, we would be remiss if we did not articulate our growing concern that complacency may have once again reached dangerous levels.
“Overconfidence precedes carelessness” – Toba Beta

As shown on Chart 1, driven by an insatiable thirst for yield in a zero interest rate environment, junk bonds have outperformed investment grade obligations over the past five years by an even greater margin than they did in the 2002-2007 period. Junk bonds now carry a 3.6% yield (Chart 2), well below the 5%-8% yield prevalent in the 2009-2012 timeframe and only marginally higher than the yields in place in 2005-2007. As a result, the current 1.35% spread between high yield and investment grade corporate bonds is similar to where it was in the years leading up to the unwinding of the financial bubble (Chart 3). Incidentally, it is striking that today, the Enterprise Yield (our definition of the true free cash flow yield) of our portfolio of high-quality sustainable growth companies stands at 3.7%, higher than the yield on low quality obligations. While admittedly not an apples-to-apples comparison, it is nonetheless a worrisome indication of diminishing risk premium.

Chart 1. High Yield vs. Investment Grade Bonds – Total Return
Source: Bloomberg, FINRA – BLP Active IG/HY US Corp Bond TR Index. 8/31/14.

Chart 2. High Yield Corporate Bond Yield
Source: Bloomberg, Barclays US Corporate High Yield Average. 8/31/14.
On the equity side, the pattern is similar. As shown on Chart 4, low quality companies (those with an S&P Quality rating of B or less) have outperformed high quality companies (those with an S&P rating of A- or better) by a greater margin in the past 5 years than they did in the 2002-2007 timeframe. In fact, the performance gap between high quality and low quality companies is twice as large today as it was at the previous peak in 2007 with all of the incremental outperformance of low quality companies over the 2007 level occurring since the end of 2012 (Chart 5). As many of our readers know, the past 18 months have been particularly difficult for our strategy on a relative basis. SGA’s focus on high quality, strong growth companies has not been rewarded.

Also disconcerting is the fact that the VIX index (a widely used measure of expectations of future volatility) has been steadily declining since 2009 with only a brief spike during the European crisis in 2011 and it now sits near the lows of the past 25 years (Chart 6). Similarly, the percentage of bearish investors (a measure of enthusiasm) now sits at nearly a 27 year low (Chart 7). Elsewhere, the prices paid by private equity firms have increased significantly in the past two years as competition for deals has increased.
**Chart 5. Performance Gap between High Quality and Low Quality Widens**

*Source: Bloomberg. S&P High/Low Quality Indices. 8/31/14.*

**Chart 6. Volatility Index Nearing Lowest Levels**

*Source: Bloomberg. VIX Index. 8/31/14.*
All of this is not meant to weave a web leading one to conclude that the next financial crisis is around the corner. Again, the landscape today is far healthier and structurally very different than it was then for both developed and developing economies. Also, not all markets have experienced the same patterns of increased enthusiasm we are seeing in the U.S. In fact, many emerging markets have performed poorly over the past few years as their economies had to adjust to years of overinvestment and to a slowdown in global demand for commodities. Only recently have those markets shown renewed signs of life. So we would not argue that the world is gripped by the same pervasive excesses it experienced nearly a decade ago. Furthermore, with disproportionate allocations to fixed income in the face of rising rates, there aren’t many alternatives.

Nonetheless there are areas of concern. For instance, there is a great deal of uncertainty around both the path the Fed will take to unwind the unprecedented increase in its balance sheet caused by years of quantitative easing and the ultimate impact this will have on the economy. We are clearly in unchartered territory here. There are also long-term questions about the coverage burden that higher interest rates will place on the Treasury as a result of the dramatic expansion of the federal debt during the past decade. Increasing geopolitical risks could also negatively impact global growth. Perhaps the increased instability in the Middle East, the growing territorial aspirations of Russia or the subtle but clear growth in protectionist tendencies on the part of China will be the catalyst that will lead investors to lose their current appetite for risk. Or it may be something that is not even on the radar screen currently. It is impossible to predict either the cause or the timing of the next reversal. Rather, we are mindful that the level of enthusiasm has increased significantly. Combined with the disproportionate outperformance of higher risk alternatives which has accelerated over the past couple of years, the stage is set for a return to equilibrium. On many measures, things have simply moved too far. We anticipate that when such a reversal takes place, the high quality companies in our client portfolios will outperform as they have in similar periods in the past.
In fact we take comfort in where our current short-term relative rankings fit in the broader historical pattern. Chart 8 shown above illustrates the historical 1-year rolling excess returns for our U.S. portfolio relative to the Russell 1000 Growth Index over time. Far from being an expression of the team’s satisfaction in our recent relative performance, our comfort with our current relative rank is simply the recognition that the dramatic outperformance of low quality companies has significantly contributed to it and that if history rhymes, now is a particularly opportune time to add exposure to our approach. Managers get most excited when they are anchored in the strong conviction that client portfolios are very well positioned for the period ahead. We fully expect to look back on this period as a great opportunity just as we did similar periods from the subsequent recovery vantage points in 2008-2009 and again in 2011-2012.

The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice.

Past Performance does not guarantee future results.