

## Debt Is The New Equity

**Debt is the new equity.** This phrase, unfortunately not coined by us, summarises well the opportunities offered by the year 2009 to a conservative bond investor. Having diverged strongly early in the year, credit spreads<sup>1</sup> entered into a phase of marked compression during the remainder of the year, offering double digit returns (capital gain plus interest earned) even to conservatively-minded investors in investment grade issues. Investors venturing into the lower echelons of credit hierarchies<sup>2</sup> were even able to achieve returns far in excess of 20%. Indeed, the generally ultra-conservative bond investors were presented with returns normally only available to equity investors.

Will 2009 remain a “cru exceptionnel” or will lenders continue to be able to achieve equity-like returns in future? It is unlikely that the future will offer such a wide range of opportunities as seen early in 2009. We do not anticipate another new financial crisis nor do we expect a V-shaped recovery in the developed economies accompanied by a parallel formation of bubbles in the established financial markets. However, we clearly see before us a period in which lenders will be intensely courted. The dramatically rising bond issuance of Western governments will compete directly with corporate borrowers whose banks are preoccupied with balance sheet repair rather than lending. Last but not least, this will be reflected in the margins which borrowers whose quality is not beyond question will have to accept. This is likely to impact sovereign as well as corporate borrowers equally. As a result, the relative cost vis-à-vis a risk-free investment is likely to increase, which in turn will be positive for the risk-adjusted returns available to bond investors.

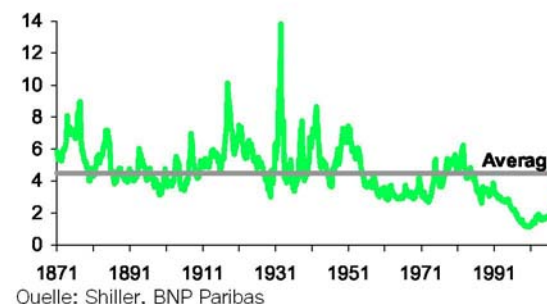
But how does it look on the other, the equity side, of the equation? After a difficult start, here too, we experienced a fulminant year 2009; returns of 20+% were not far and few between but rather the norm. As a result, valuations in the developed markets rose from the valley of panic early in the year to the plateau of normality, with correspondingly less attractive valuations. If our prediction is correct and we see steady recovery but not growth above the long-term trend, it is likely to be difficult for profits, respectively, valuations to continue to run ahead of actual developments in future. The principle of hope will yield to the soberness of estimates or to that of ac-

tually-achieved results. The V-shaped recovery of the exchanges will align to the L-shaped recovery of the economies.

After all this prose, time for some figures to support our case for corporate bonds. Dividend versus corporate bond yields as of the end of November:

	Dividend resp. Yield to Maturity <sup>3</sup>
EUR Corporate Bonds	4.39%
European Equities (DJ Stoxx 600)	3.36%
USD Corporate Bonds	5.56%
US-Equities (S&P 500)	2.25%

On this basis, USD as well as EUR denominated corporate bonds are attractive in comparison with comparable equity markets. In the US, the dividend yield of the S&P 500 is currently even below its long-term average, as is shown by the chart below. This does not put equities as a whole in a favourable light. Unfortunately, similar long-term data is not available for the European market.



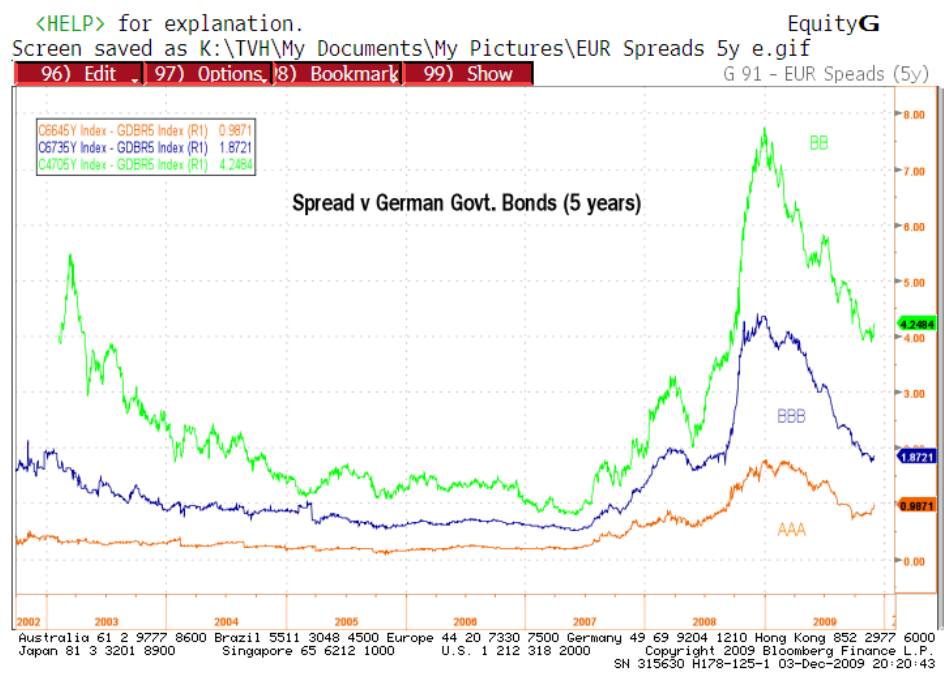
Over a shorter timescale, the following graphic underlines that in spite of the recent movement, corporate bonds continue to be attractive, offering a premium above the average of the last seven years.

<sup>1</sup> The higher interest rates which borrowers of inferior quality must pay compared to borrowers of higher quality when securing finance.

<sup>2</sup> The ranking of borrowers, e.g. secured by a first mortgage compared to a subordinate mortgage.

<sup>3</sup> Source: BNP Paribas, iBoxx, Bloomberg

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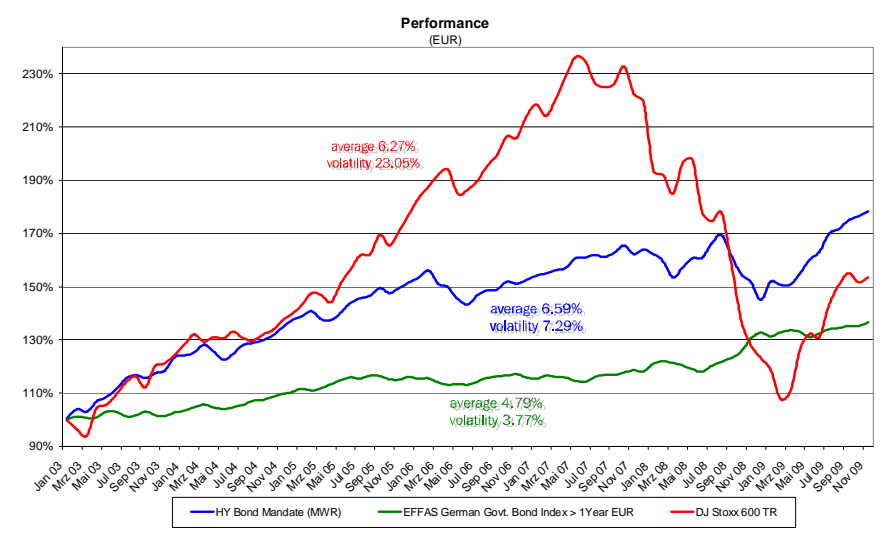


Will inflation put a spoke in our wheel and impair nominal yields in real purchasing terms? In the next three years, we do not foresee this risk for either the USA or Euro-land. Though we do have on the one hand, the massively increased budget deficits on both sides of the Atlantic, however on the other hand, a high degree of economic capacity is available and a level-headed consumer whose appetite for consumption has made way for a savings diet. There is therefore little cause to worry about a rapid rise in inflation.

In short, from a European point of view, an engagement in corporate bonds is likely to yield, if not equity-like, certainly above-average returns during the coming months/years.

SIM is offering interested clients the opportunity to participate in this development by means of a specialized mandate. The results of the previous years are, we feel, quite

presentable. An average monthly year-on-year return of 6.6% on a volatility of 7.3% looks attractive to us when compared to German government bonds with 4.7% and 3.8% respectively and, with the benefit of hindsight, is also attractive compared to European equities with 6.3% and 23.1% respectively (all figures in Euro).



Teja von Holzschuher  
 Chief Investment Officer

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