

Gundlach on the Key Risk for Bond Investors

By Robert Huebscher

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Watch out if you own a bond fund that underperformed its benchmark by 2% or more last year, as most did. Rather than put their careers at risk by suffering a second year of poor performance, those fund managers will turn to indexation, according to DoubleLine's Jeffrey Gundlach. And since the Barclay's Aggregate Index holds nearly 35% of its assets in Treasury bonds with near-zero yields, its investors will endure poor returns.

It's "game over" for fund managers who take the same risks they took in 2011 and repeat their underperformance in 2012, he said. Investors need to understand that "there are other motives than just return maximization when you are running a huge bond-market business."

"Firms will start couching what they are doing in strange terms that are code words for indexation," Gundlach said. "They will say things like 'more disciplined active risk-taking,' 'tighter parameters around deviation,' or 'more awareness of tracking error.' All that means is a move towards indexation."

Gundlach made those comments during a conference call with investors last week. He also criticized Morningstar's selection of its bond fund of the year. We'll see why, but let's look first at the primary purpose of the call – which was Gundlach's forecast for 2012 performance across the capital markets.

The slides from Gundlach's presentation are available [here](#).

Avoid all other currencies

Gundlach's overarching theme was that investors should be purely dollar-denominated and avoid all currency risk. He warned that a number of risks, particularly in Europe, are not fully priced into the market.

According to Gundlach, a key issue in Europe is whether Italy will be able to successfully roll over its debt, as it faces many large maturities in the months ahead. A total of 300 billion euros of Italian debt matures in 2012 and another half that amount in 2013.

"There is a lot of financing pressure in Europe, and it's very likely to make the crisis accelerate and heat up further, if it is not hot enough already," he said.



“I do not believe for second that you can say that the European bond markets are fully discounting the potential for, say, an Italian default, which is clearly nonzero,” he said. “I don't say that the debt crisis in Europe is fully priced in.”

Across Europe, Gundlach said that the banks are, to an increasing degree, “living on life support from the ECB.” He noted that ECB bond purchases, which were almost nonexistent in the late spring and summer of 2011, have reached an alarming level today. The ECB needed to step in, beginning in August of last year, since there were no other buyers of Italian bonds. Gundlach said yields of approximately 7% on Italian bonds represent *de facto* price fixing through ECB purchases.

Beyond the precarious position of its banks, Gundlach said Europe is also staring down the risk of a recession. Portugal's GDP growth has turned negative, he said, and Spain may soon follow. Germany's forecast for 2012 is 0.6% growth.

Looking ahead to 2012, Gundlach said investors should be dollar-denominated, because there is a scramble now to put money to work in US markets, in part because investors are fleeing to safety. He said the overall behavior of the US economy and markets will be roughly the same as it was in 2010 and 2011. The Q4 2011 economic indicators will “surprise on the upside,” he said, but the question remains as to whether this will prove self-sustaining.

Slower growth in the rest of the world will lead to an appreciating dollar, as measured against the trade-weighted index of currencies (the DXY), Gundlach said. Problems among the European banks will cause a repatriation of euro back to those banks, which will mean divestments from emerging markets. “The US dollar and the US markets are the beneficiary of stresses in the system, the US dollar should continue to rise,” he said.

Gundlach added that the DoubleLine funds are 100% dollar-denominated.

Looking across the capital markets

Here's what Gundlach said about a number of key asset classes:

- **Gold** – Gold is due for a selloff in the months ahead, he said, but noted that he is not a “mega-bear” on gold. He acknowledged that gold protects investors against extreme crises, but said that other assets serve the same purpose, and some are more portable or less vulnerable to frenzied speculation: gemstones, fine art and land.
- **China** – The Shanghai market is extremely weak, he said, hardly suggestive of a healthy economy. “This is a caution flag, for sure,” he said, adding that the Chinese market has not priced in a hard landing of its economy.



- **Emerging markets** – Although he said emerging markets will come under stress in the near term, long-term investors – those with a 10- or 15-year time horizon – should hold those assets. He recommended dollar-denominated emerging market securities, which he said are priced at an “average valuation” and make up 10% of DoubleLine’s core fund.
- **US equities** – Gundlach said he does not expect a large rise in 2012 from 2011 year-end prices. He said there is some room for P/E expansion, but that may be offset by downward pressure on earnings. “The stock market seems about fair-value,” he said.
- **US Treasury bond yields** – Short-term rates (maturities of five years or less) will remain at unattractively low values throughout 2012, he said. Nor will he be very interested in owning 10-year bonds unless their yields rise to 2.5%. He said 30-year yields are unlikely to go much higher in 2012 than they are today and will likely offer yields at some point this year that are even lower than today’s. Without global economic growth and with the Fed keeping short-term rates low, Gundlach said, there is no catalyst for higher interest rates.
- **Investment-grade bonds** – Gundlach recommended buying bonds of “good-quality” companies, and avoiding banks. Such bonds, he said, offer reasonable risk-adjusted yield and protection against a recessionary scenario.
- **High-yield bonds** – The fundamentals of junk bonds are likely to erode in the coming year, Gundlach said, and investors will suffer defaults on the “bad issuance” of those bonds in 2009 and 2001. Junk bonds are now one-standard-deviation underpriced, but Gundlach said their prices need to be two standard deviations below fair value – what he called “old-school cheap” – for investors to purchase them.
- **Mortgage-backed securities** – Gundlach said GNMMAs are slightly undervalued, although still risky. He cautioned against the belief that refinancing and prepayments are less of a risk today than they have been historically, because interest rates remain low. He said he is waiting for a possible selloff of non-agency mortgage-backed securities by European banks, which would give him the opportunity to buy those bonds at attractive prices.
- **Municipal bonds** – Early last year, Gundlach said munis were due to perform poorly either because of an overall increase in yields or because of a weak economy (which would correspond to low yields); neither happened, but he said he is still confident one of those two scenarios will unfold, and he added that prices in the muni market do not currently reflect the possibility of a recession in the US. Nonetheless, he said the best-quality long-term munis will do reasonably well in a weak economy.



- **REITs** – Leveraged agency-mortgage REITs are very vulnerable to the risk of a government-sponsored refinancing program, Gundlach said. Investors are exposed to dividend cuts, he warned, which would cause many to sell those securities, driving prices lower.

Morningstar's fund of the year

In announcing its nominees for fixed-income fund manager of the year, Morningstar [said](#) that Gundlach's funds were undeserving of recognition because they were too risky. Following Gundlach's previous conference call, I [wrote](#) about a [blog post](#) that made a compelling argument that Morningstar's view was incorrect.

Gundlach commented that the eventual winner of the fund of the year, Fidelity New Markets Income fund (FNMIX), experienced a lot of volatility during the financial crisis of 2008. Using daily data, that fund had a drawdown of 40%, as measured by the difference between its highest and lowest closing prices.

By contrast, Gundlach said his total-return strategy had a drawdown of less than 1% during the same period, even though it owned non-agency mortgage-backed securities, which were the bonds that Morningstar said made DoubleLine's funds unacceptably risky.

Gundlach also commented on Morningstar's 2010 fixed-income fund of the year, the Templeton Global Bond fund (TPINX), which has substantial exposure to Asian-Pacific currencies and had a decisively negative return in 2011. "It seems they love high-risk funds over at Morningstar," he said, "and they like calling low-risk funds high-risk funds, for reasons that escape us."

"It's the risk integration that makes all the difference," Gundlach said. Gundlach employs a strategy that incorporates agency bonds (GNMAs) and non-agency securities. Those bonds, he explained, behave differently based on economic scenarios and investor's expectations of inflation, prepayment and credit risk.

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