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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the meeting of

The Bond Club of New York

Thursday, May 16, 1974, 4:30 P.M.

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I greatly appreciate this opportunity to talk to The Bond Club of New York and to bring up to date my familiarity with the subject of bonds. My previous first-hand experience goes back to a number of months in 1935 or 1936, when I was analyzing bonds in the investment department of a New York bank. We then developed a theory that government bond prices would rise, which turned out to be an excellent and profitable prediction. The underlying reasoning has stood the test of time less well -- it was based on the assumption that the public debt would soon be reduced and that government bonds would acquire a scarcity value.

There are few countries, even making allowance for size, that have a bond market comparable to the American. Our bond market does a tremendous job of financing, year in and year out. It differs in that regard from the stock market, which raises a much smaller net amount for business at much greater cost, the reason being, of course, that one of the principal functions of the stock market is to provide high liquidity to existing assets in addition to doing new financing.

Our bond market has stood up relatively well even under the onslaught of a virtually unprecedented inflation. Although long-term rates have been rising, it is evident that the current very high rates of inflation have not driven up interest rates commensurately. The bond market evidently believes, in my opinion reasonably, that these rates of inflation will not continue. The more moderate inflation premium that does seem to be reflected in current long-term rates nevertheless points to an expectation on the part of the market concerning future inflation that is higher than I would like to see.

We should not take the ability of the bond market to resist even temporary spurts of high inflation for granted. In Germany, where I have just spent a few days, the rate of inflation currently is well below ours; it seems to be running a little above 7 per cent. But the German long-term bond market, in the context of a vigorous anti-inflation policy, nevertheless has suffered severely. Rates are as high as 11 per cent. New issues have had to be confined to intermediate maturities. The German experience is a warning of what inflation can do to a normally well-functioning bond market.

One of the things that inflation has already done to the American bond market is to widen price movements. This is not confined to the depressing effects of high market yields on low-coupon bonds. As has often been pointed out, high interest rates make for greater volatility even of high-coupon bonds. Wider swings in prices, in turn, increase the importance of price changes relative to interest yield in the total return on bonds. This reference to total return brings me to the topics that I would like to discuss with you this afternoon.

The concept of total return has been widely discussed in recent bond market literature, to which the members of this group have contributed so importantly. Total return, over a given period of time, means adding together the yield to maturity, the net appreciation or depreciation during this time, plus the yield from reinvestment of interest during that period. The concept of total return was borrowed, of course, from the stock market, where it has had a long and somewhat checkered history. In the stock market, the theoretical logic of adding together dividend and capital gains is hard to refute. A company, after all, has the option of paying out its earnings or retaining them, so that dividend yield and appreciation become alternative ways of conveying profits to the shareholder. As a practical matter, I have always felt uneasy about treating a bird in the bush as if it were a bird in the hand. The stock market, I suspect, has the same reaction as it contemplates the relative merits of a dollar's worth of dividends and of expected growth. Investors who have tried to rely on total return, moreover, have had some rude awakenings since 1968.

But total return in the stock market is one thing, and in the bond market it is another. In the bond market, total return depends heavily upon the time period over which it is measured. Usually this is taken as one year. Over a period of one year, bond prices often have moved by considerably more than the yield to maturity. I should add that I am using the term "capital gains or losses" for only that part of a bond's price changes that is not the reflection of its steady movement toward par at the time of maturity. In some years, total return has been more than double the yield to maturity, in others it has been negative. Going to quarterly periods, the relationship becomes even more extreme. Quarterly price movements have been quite large, quarterly yield to maturity is necessarily small. For short periods, therefore, the price movement tends to dominate the interest return.

This points up a basic weakness of the total return concept in the bond market. If we reduce the period over which the return is computed from a year to a quarter, a month, or a day, and if we then annualize the "return" obtained from price changes during these mini-periods, we get sky-high rates of total return, positive or negative. If a bond with a 9 per cent coupon and selling at par goes up 100 basis points in one day, the annualized total return is 369 per cent, ignoring the minimal matter of reinvestment of interest.

If, on the other hand, we lengthen the period over which total return is computed, and if we happen to choose the period that the bond has to run to maturity, the effect of interim price fluctuations washes out altogether. All that remains is the familiar old yield to maturity, plus reinvestment of interest if we are compounding.

The contrast between total return in the stock market and the bond market is obvious. In the stock market, the price of a common stock at any future time is uncertain. There is no fixed sum to be repaid at a fixed date. Based on past history, moreover, the trend of the stock market has been up, although the last few years raise some questionmarks. In the past at least, therefore, total return has meant adding a positive amount of growth to the dividend return.

Total return in the bond market is different. There is at least one point in time -- maturity -- when the future value of the bond is certain, assuming a good quality bond. Price fluctuations are bound to be temporary and bound to wash out. There has been no discernible secular trend in interest rates, moreover, if we go back a couple of hundred years and treat the extremes of the 1940's and 1970's as temporary aberrations attributable to depression and inflation respectively. Under these conditions, the odds for getting a positive capital gains component in the total return are much smaller than they are in the stock market.

A total bond return higher than the yield to maturity can be derived from various sources. The questions I am raising concerning the likelihood of attaining such an extra return do not apply equally to all sources. An effort to anticipate swings in interest rates by switching into and out of the market is one thing. Careful switching among comparable bonds that seem to have got out of line pricewise with one another, or painstaking analysis of the changing quality of particular bonds suggestive of future re-evaluation by the market reflects quite a different kind of approach. I am more sanguine about these day-to-day efforts to make minute portfolio improvements than about the prospect of catching the big swings in the market. I also believe that the opportunities for portfolio improvement are greater in the bond market than in the stock market. Bonds probably are more analyzable than stocks. With bonds, we are concerned with solvency and the quality of credit, in contrast to stock analysis that focuses on the entire future of an enterprise. Thus it seems promising, in the case of bonds, to take advantage of minor imperfections of the market which keep value from being recognized instantaneously in order to achieve a modest improvement in total return over and beyond a buy-and-hold strategy.

Nevertheless, the stock market carries a lesson for the bond market. Publication requirements for mutual funds portfolios have made possible very detailed testing of investment performance. These tests seem to show that, with a very few noteworthy exceptions, an active strategy does not on average beat a passive investment strategy or even a random selection. Most people, of course, will never believe this, because they see some stocks rising faster than others and because those who pick the winners naturally allow their customers (and perhaps themselves) to think that they were smart. But superior performance must be repeated over a succession of periods in order to be regarded as other than fortuitous. Proper allowance must be made for risk, moreover, because on average higher risk leads to higher return. It means nothing to show that the ABC Fund has beaten the XYZ Index, unless an adjustment is made for risk, and unless it has done so consistently.

In the bond market, it has been difficult for outside observers to perform tests of the same kind because there is little published information available about bond portfolios. Individual portfolio managers can test their own performance, now that indexes of the bond market are being developed. This technique, however, is still in an early stage, because nobody is quite sure what a good index of the bond market is.

The evidence derived from the stock market suggests, nevertheless, what we are likely to find out about the bond market if tests were possible. There is one good reason for expecting consistent above average performance to be as elusive in the bond market as it has proved to be in the stock market. If enough intelligent and hardworking people are in the market, overvalued and undervalued securities will be few and far between. Every new piece of information will be analyzed with a sharp pencil and the conclusions translated at top speed into bids and offers. That is what economists call an "efficient market," i.e., one in which all information is evaluated instantly and assets therefore at all times are priced as correctly as human ingenuity will allow. Thus, even the possibility of improving portfolio performance by continually seeking out bonds that are slightly out of line may be quite limited. Too many people are searching. Moreover, what to some may look like a movement out of line may eventually turn out to have been a well-founded upgrading or downgrading of a changing situation.

The study of performance in the bond market, as I have said, is still in its early stages. I offer my observations as a deduction from plausible premises, not as based on empirical evidence. But regardless of whether performance investing pays off for the portfolio manager or not, I would like to examine some other possible consequences of the striving for performance. Once more let me take as an example the stock market, where our experience reaches farther back and where the consequences have come into clearer focus.

I think it is probably not controversial to say that the early promise of performance investment has not been validated in recent years. Individual investors, pension funds, universities, may have demanded high rates of return, and portfolio managers may have promised them. Both have been disappointed. Meanwhile, however, structural changes, most of them in my opinion adverse, have occurred in the market, traceable in part at least to the impact of performance investing. The market now seems to move faster in response to a piece of news than it did in the past. By itself this would be an advantage. But as a result, the steps by which it moves often are bigger. This has increased the risks of being in the market, or at least people's perception of them. Higher risk, in turn, seems to have induced some investors, particularly small ones, to abandon the stock market. Reduced participation and higher risk have tended to depress the level of prices below what it might otherwise have been, to the detriment of investors and seekers of capital alike.

Meanwhile, the investors remaining in the market have become an increasingly homogenous group, predominantly institutional.

They are believed by many to have certain well-known behavioral characteristics -- such as all holding the same view at the same time. This has further increased volatility and risk in the market. At the same time, it seems to have given rise to the peculiar phenomenon of the two-tier market, which has only begun to unwind. Needless to say, a market that makes the cost of capital very low for a few favored firms while making it very high for most others, is unlikely to do a good job in allocating capital.

Turn now from the stock market to the bond market. Some of the phenomena that first occurred in the stock market are already visible also in the bond market. I do not mean to say that this observable parallelism is due entirely to performance investing. There may be other reasons why the bond market, too, is becoming more volatile, why it seems to be fraught with higher risk, and why it may be starting to induce the withdrawal, voluntary or otherwise, of some of the participants.

Of late, even something like the two-tier phenomenon seems to be reproducing itself in the bond market. Two rather distinct evaluations appear to be developing for utility bonds and for other corporates. Naturally, there are always plausible reasons for investment policies that bring this about. There was no lack of arguments to support the proposition that a small number of

American corporations deserved price earning ratios of thirty or so while a large number of others were relegated to the five to ten range. In the case of the stock market, the argumentation in many instances has already come unstuck. In the case of the utilities, I would merely point out that on purely arithmetical grounds, the number of times by which net operating income covers interest requirements cannot be as high at an interest rate of 9 per cent as we have been accustomed to expect it when interest rates averaged about half of that. A very great increase in the return on equity would result if coverage were to remain unchanged.

In closing, I would like to repeat that my concern here today has been a three-fold one. First, I have tried to illustrate some of the difficulties attaching to the very concept of "performance" in the bond market. Second, I have suggested that, whatever the concept, the achievement of superior performance in some respects is likely to be even more difficult than it has proved to be in the stock market. I should add that this evaluation relates to the portfolio management of publicly traded bonds and not to the special skills that may be employed in setting up private placements. Third, I have expressed concern that the uninhibited pursuit of performance may cause damage to the bond market as an institution and may have adverse consequences also for those who rely on it as investors, as borrowers, or as dealers.

This process of trying to get the most out of a piece of machinery, such as is the bond market, at the expense of possible damage to the equipment itself, today is not limited to the bond and stock markets. We have done the same to our currency. We have done it to the international monetary system. We barely avoided doing it to our price system. The need for a greater concern with the machinery, with the abiding fabric of our economy and our social institutions, even at some cost in terms of immediate results, a greater concern with the long run and less emphasis on the short run, is something to which we should all give serious thought.