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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- Through Memorial Day Weekend, the S&P 500 was up 2.1% for calendar 2006.
- By 2009, higher income individuals will have to pay over $400 in monthly premiums for Medicare part B. Today, wealthy beneficiaries pay 25% of Part B's cost but this will increase to 80% over the next 3 years

Risk Aversion in the Financial Markets

The recent sell off in financial assets in May's financial markets put terms like ***volatility*** and ***risk aversion*** front and center in the financial news. Most stocks decreased in price not because of diminished expectations in corporate earnings or increases in interest rates. Instead, there is a widespread perception that investors are demanding higher risk premiums for stocks. The market is therefore more risk averse.

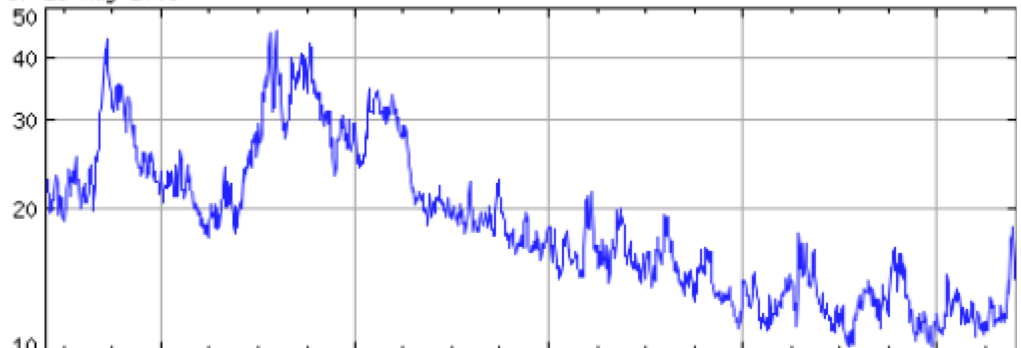
The measured volatility in the stock market has decreased substantially since the stock market bubble at the turn of the century. Most investors have perceived this intuitively as day to day market movements have been less severe than during the high tech boom. The options market, which prices anticipated volatility, has evidenced consistently declining option premiums.

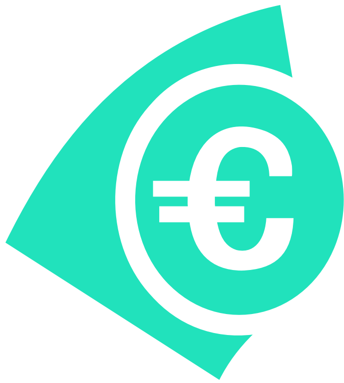
The Chicago Board Options Exchange Volatility Index, known as the **VIX**, shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. After reaching an all time low implied volatility last summer, the VIX index spiked upward to an implied volatility of nearly 20% on May 22nd. It has now returned to about 15%. See the chart below. This spike in volatility has dovetailed with sell offs in global markets.

Another measure of investor comfort with risk is the spread that bond investor investors demand to invest in emerging market debt obligations. Generally when risk is perceived to be low, riskier investments enjoy inflows of capital at the expense of safer benchmark assets. The JP Morgan Emerging Market Bond Index's (EMBI) spread over 10-year US Treasuries fell from over 400 basis points in 2003 to a record low of 1.72% on 1st May of this year. Apart from risk perception, the bull market in emerging market bonds has been buoyed by strong balance sheets – over $500 billion in net exports in 2005.

The fundamentals for emerging markets remain strong despite a sell off in May that has seen emerging market bond spreads increase to 2.19%. Commodity prices have continued to increase to bolster these smaller econopmies. What then, might be the source of all this risk that investors are pricing in? There remains a fear that smaller economies could be vulnerable to a decline in global consumption.

It is notable that conventional measures of

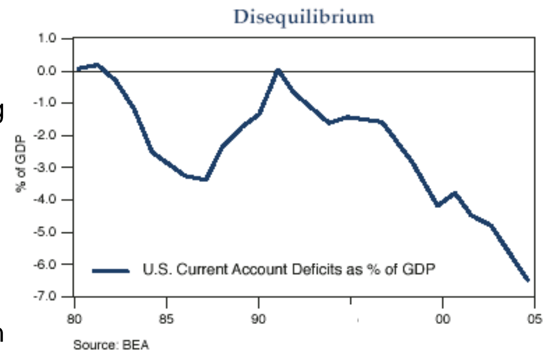




economic health such as corporate earnings and interest rates did not deteriorate during the month of May. One area of potential concern, though, is the US consumer. We remain the engine of the global economy. Collectively the surpluses of emerging markets fund nearly the entire US current account deficit. This deficit is increasing in both relative and absolute terms. See the chart to the right.

The American consumer has become a net dissaver that is supported by ever increasing real estate and investment portfolio values. The dollar is supported by the accumulation of dollar reserves in Asian central banks. There is no reason to believe that these economic facts are in immediate jeopardy. However, continued health in the world economy will depend on an orderly transition of net consumption from the United States to these emerging markets.

An essential element of an orderly transition of net consumption is free trade. In the near future, perceived threats to global trade such as resource nationalization (See Venzuela, Bolivia) or a failure of multilateral trade talks will likely cause financial market declines. The VIX index may be getting more press coverage as well.



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Global REIT Indexing

I attended a conference in Washington DC in May that addressed investable indexed products. The sponsor of the event was Barclays Global Investors – the largest issuer of Exchange Traded Funds (ETFs). Several topics caught my attention.

The company will be issuing some commodity-linked notes in the near future that will track a number of well known commodity indices. Barclays has already registered these notes with the SEC and they could be available soon. We should also see some fixed income products in the coming months

Another area that may see development is global real estate investing. Real estate has emerged as an essential asset class in most institutional investment portfolios. We've used real estate investment trust (REITs) for client portfolios to provide diversification with good expected returns. As many of our readers know, REITs have far exceeded these expectations over the past four years.

So far, investable REITs here are comprised only of North American real estate holdings. That era may be coming to a close. Earlier this year, BGI licensed the EPRA/NAREIT real estate index from the Financial Times Stock Exchange(FTSE). The data covers 274 stocks in 28 countries and is divided into three families (Europe, Asia Pacific and North America). The company is planning to launch at least two investment products based on these data series. This might serve as a welcome complement to a family's investment strategy.

Adding an international component to a real estate portfolio provides significant diversification benefits. Real estate markets have many elements unique to their locality. There are many structural differences—from ownership to tax issues to market transparency to size and liquidity and lease characteristics—all of which affect the level of inherent structural risk in a market or country. These structural differences, combined with variations among economic cycles, produce relatively low cross-correlations between many global real estate markets. Global REIT Exchange-Traded Funds should receive serious consideration if they are priced competitively when they are introduced.

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