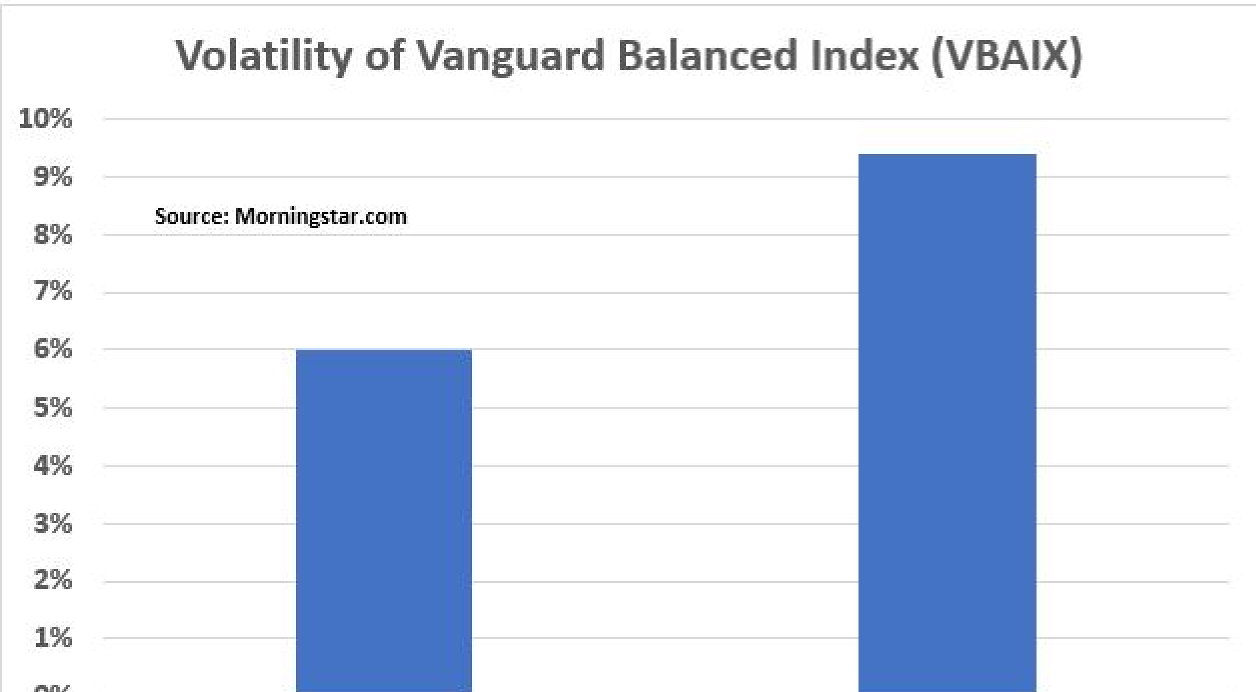
The most recent quarterly letter from Grantham, Mayo, van Otterloo (GMO) contains an interesting argument about bonds. Over the past five years, bonds have provided great performance, but also



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10%.

Inker, author of the letter, argues that if an investor, over the last five years, had wanted to target a volatility of 10% -- the historical long-term volatility of a balanced portfolio ? **such would have entailed a leveraged portfolio of 143% stocks, 96% bonds, and -139% cash.** Moreover, levering up a balanced portfolio 139% would mean achieving returns of more than 7% annualized over cash, according to GMO?s asset class return forecast. But Inker isn?t advocating using such leverage, as so many ?*risk parity?* portfolios do. This situation amounts to a free lunch that Inker doubts will persist into the future. I**t?s possible that risk and risk premia have fallen so that levering up to achieve returns is less dangerous than it used to be.** But it?s more likely that the recent ?easy? environment is a temporary one in Inker?s opinion. As he puts it:

> *?Even if the natural volatility of the economy has fallen over time and even if policy response is better than it was 80 years ago, neither markets nor economies are all that well-behaved. Stability breeds instability, as Human Minsky pointed out 40 years ago.?*

Why do stocks usually have a premium over bonds?

To arrive at his conclusion, however, Inker recounts some recent history, reminding readers of the basic difference between stocks and bonds along the way. **First stocks are riskier to buyers than issuers.** Companies can go bankrupt, after all, and the equity is usually worth nothing in that instance. But, according to Inker, that ?*idiosyncratic risk?* is not why stock investors have achieved such a premium historically. The other reason why stocks typically offer a long term premium over bonds is that equity losses occur at exactly the moment it is most painful to own them. After all, stocks usually go down when the whole economy goes down. So, if you have a stock-heavy portfolio, your portfolio is likely to tank exactly when you lose your job, compounding your misery. However, if fears of economic downturns have diminished, then the risk premium that stocks usually have over bonds might dry up. **It wouldn?t make sense for stocks to offer higher long term returns in an environment that suddenly became safe and free from recessions.** And Inker argues that?s what happened right before the Financial Crisis. Riskier assets were poised to deliver lower long term returns than less risky assets. And as much of a shock as the crisis was to this point of view:

> *?The rapid recovery corporate cash flow in the aftermath and the consequent lower levels of distress than previous cycles experienced have served to assuage investors? economic concerns.?*

The passage of time from the last crisis has also convinced today?s investors that they could withstand a new one regardless of how they behaved last time. **Not only have fears of economic downturns receded, but it has seemed easier than ever to protect portfolios.** High quality bonds did their job in the last crisis *(provided you held enough of them)*. Recessions help high quality bonds in two ways: deflation makes existing coupons more attractive, and central banks lower rates. **What has made bond performance (*and bonds? low correlation to stocks)* so astonishing in recent years is that bonds have posted great returns in the absence of a recession.** Bonds are not supposed to behave quite this well and in quite this uncorrelated fashion from stocks in non-recessionary environments. **Don?t look for that negative correlation to continue, and don?t try to juice your returns by levering up a balanced portfolio.**