A Brief Review of What's Going On

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What is going on?

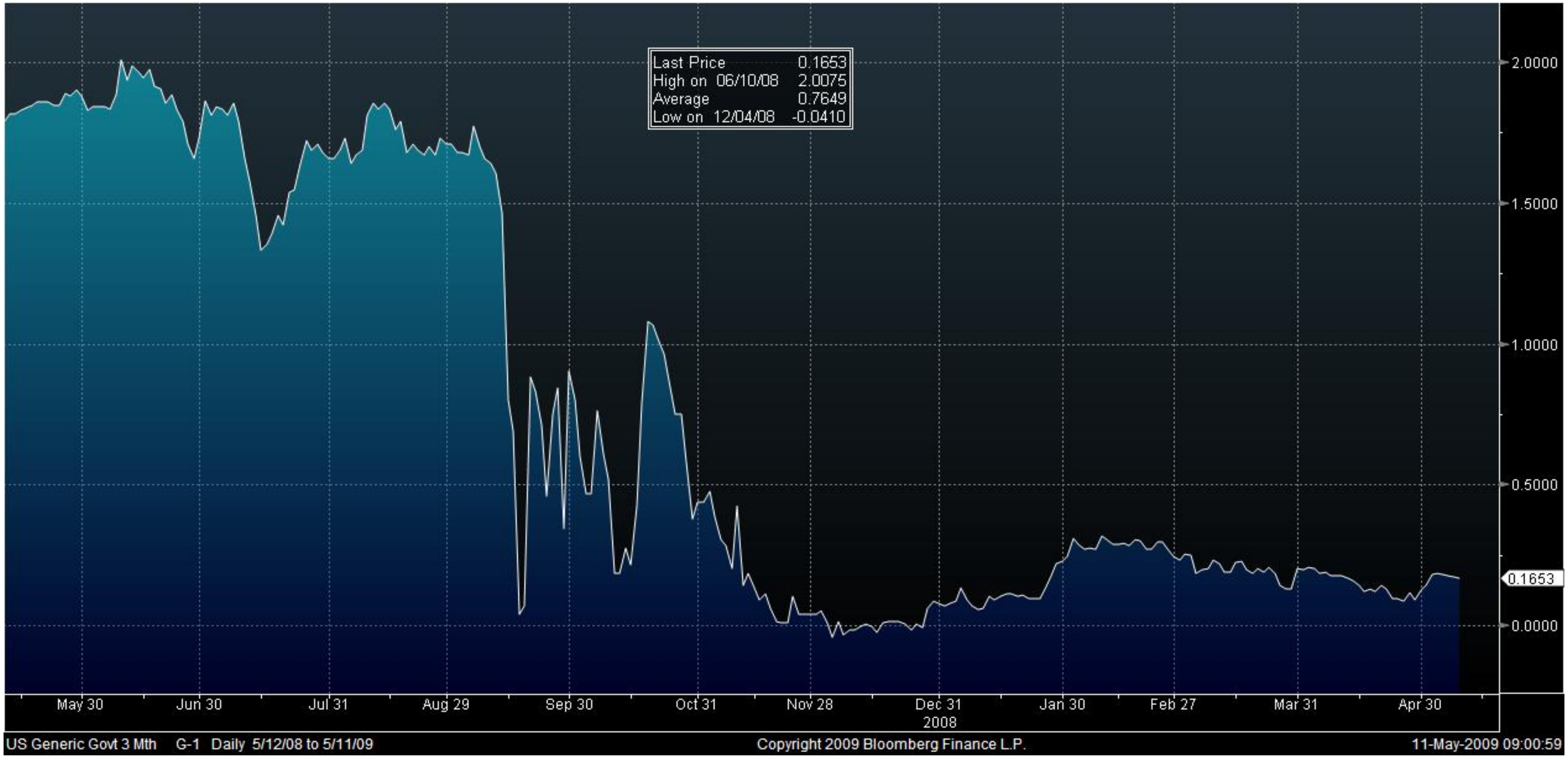
The security of the US Government

A Theory of Asset Prices

A Market in *Dis*-Equilbrium

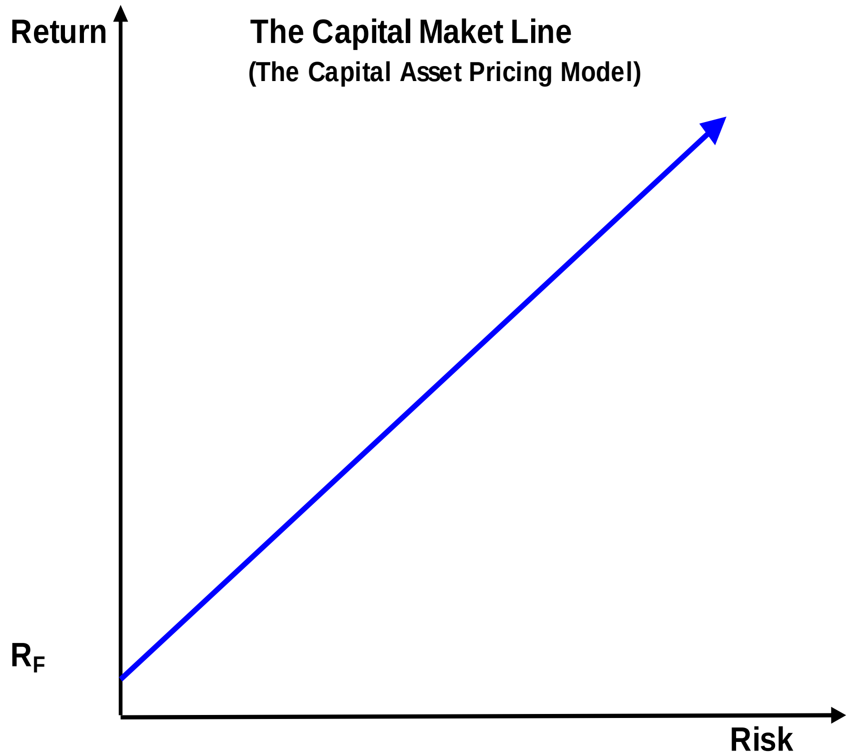
Risk Premiums and Asset Bubbles

Three Month Treasury Bill Yield



- **Yields on 3 month Treasury bills fell <u>below</u> zero—now at 17 bp.**
- **People were willing to pay the US government for taking their money.**
- **Security is king: you are assured of getting your money back.**

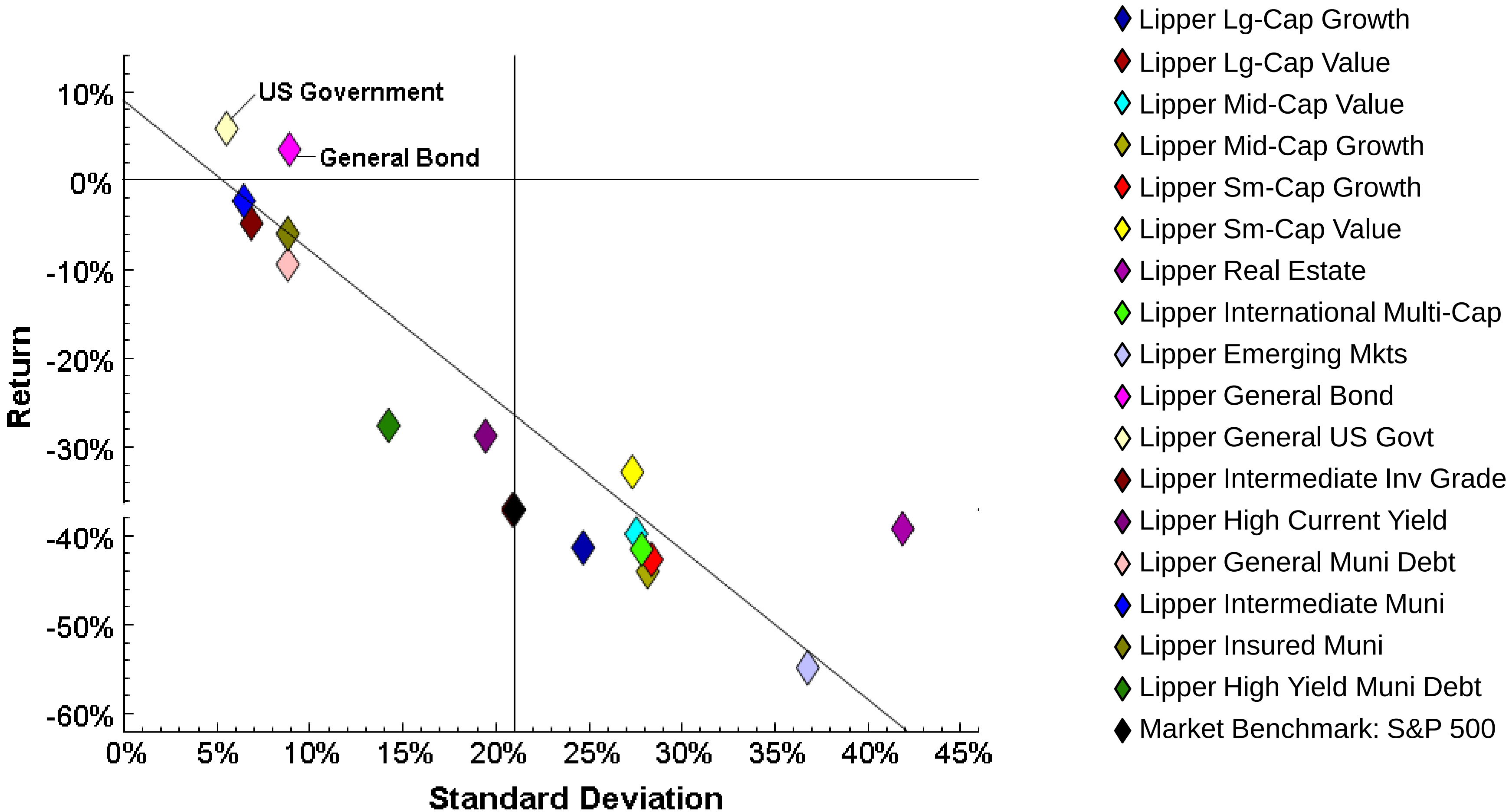
The Capital Market Line—A Theory of Market Equilibrium



Source: William Sharpe, "Capital Asset Prices: A Theory of Market Equilibrium," Journal of Finance, 1964

The CAPM was the first asset pricing model *and the first theory of market equilibrium.* It remains true today. In equilibrium, higher returns are associated with greater risk.

Lipper Peer Categories 2008 returns*

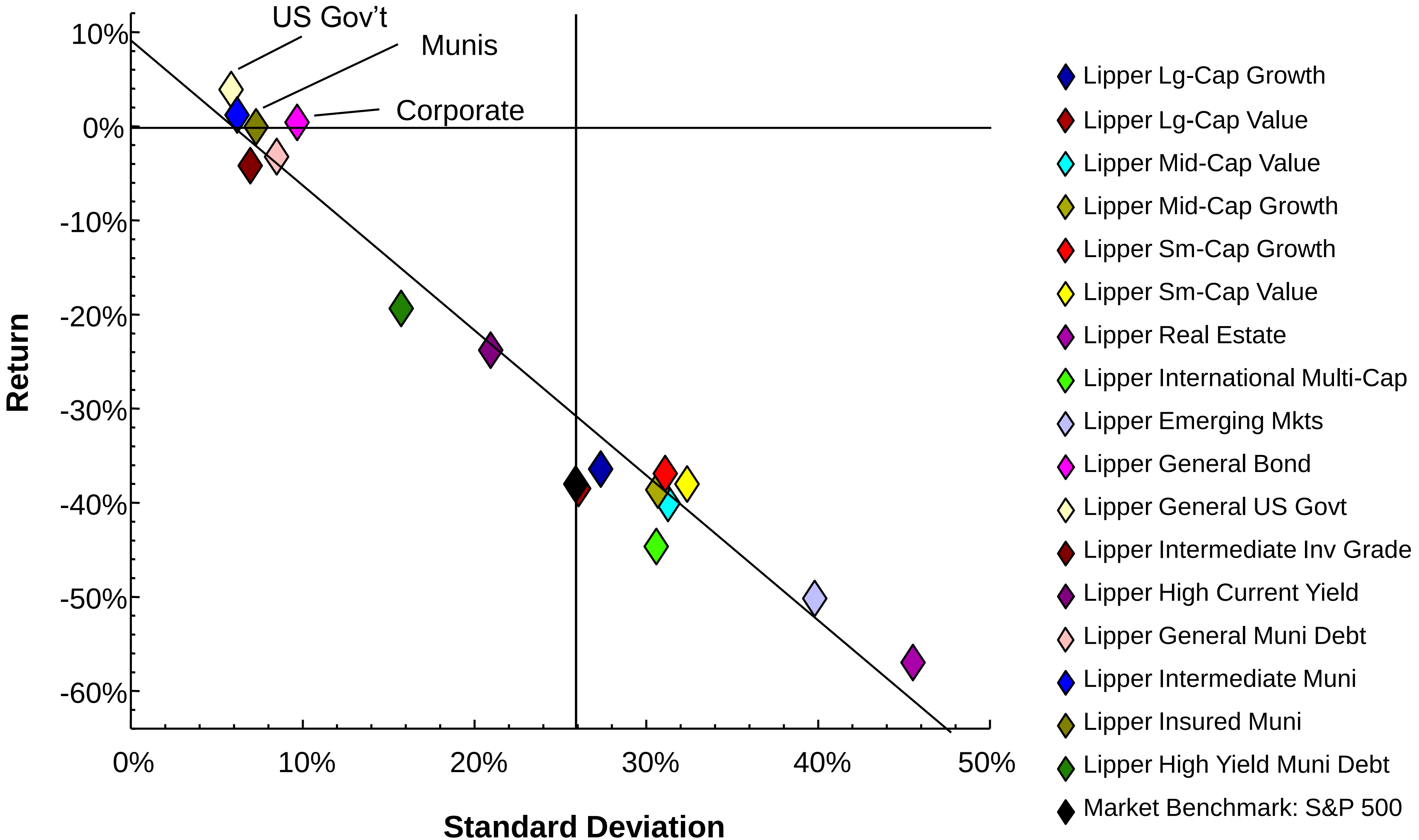


This is a risk/return plot for all of the Lipper product categories during 2008. It is the exact opposite of Bill Sharpe's CAPM. Unless we intend to prove Bill Sharpe wrong (and win our own Nobel Prize) we must recognize that the financial markets are in a Dis-Equilbrium.

Source: Lipper / Standard & Poor's

* January 2008 – December 2008

Lipper Peer Categories: Returns April 2008-March 2009



We are still in a Dis-Equilibrium, but the financial markets are slowing turning.

Source: Lipper / Standard and Poor's

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Another Quick Look at the Financial Markets: The Equity Risk Premium

The Equity Risk Premium (ERP) is the additional return that investors must earn to hold stocks over bonds.

- It is a forward looking calculation that measures whether the stock market is over or undervalued.
- The ERP is ***implied*** by current market valuations—it is not directly observable—but you can "back out" the ERP using current stock market valuations.

How do you calculate the ERP?

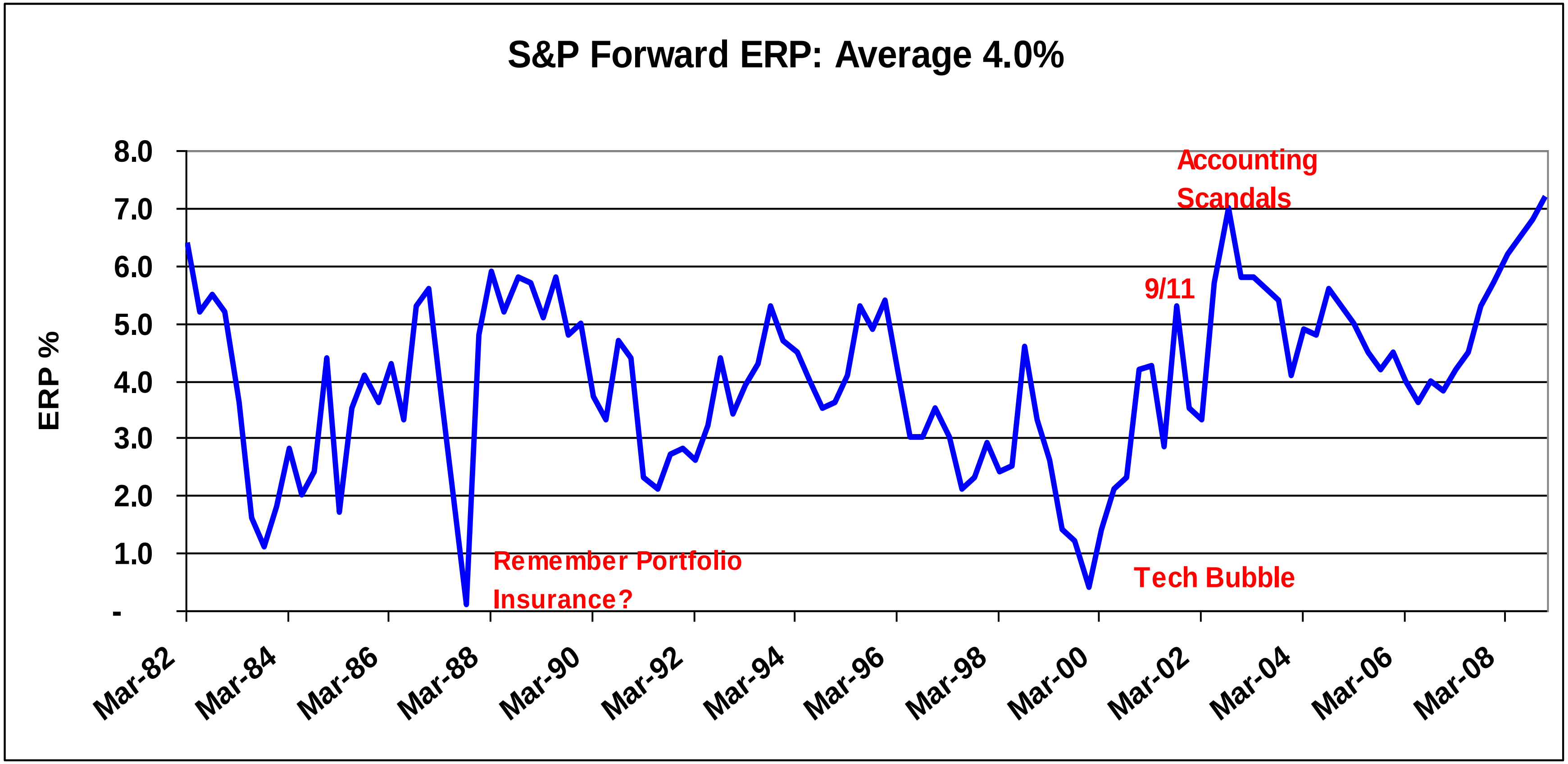
1) Forecast future earnings for the stock market.
2) Then it becomes a present value calculation:

a) Determine the discount rate necessary to equate:

b) discounted forecast earnings = current stock market value.

3) Subtract the return of the 10 year Treasury bond from the discount rate calculated in Step 2.
4) The remainder is the **ERP**—that additional premium for holding stocks over bonds.

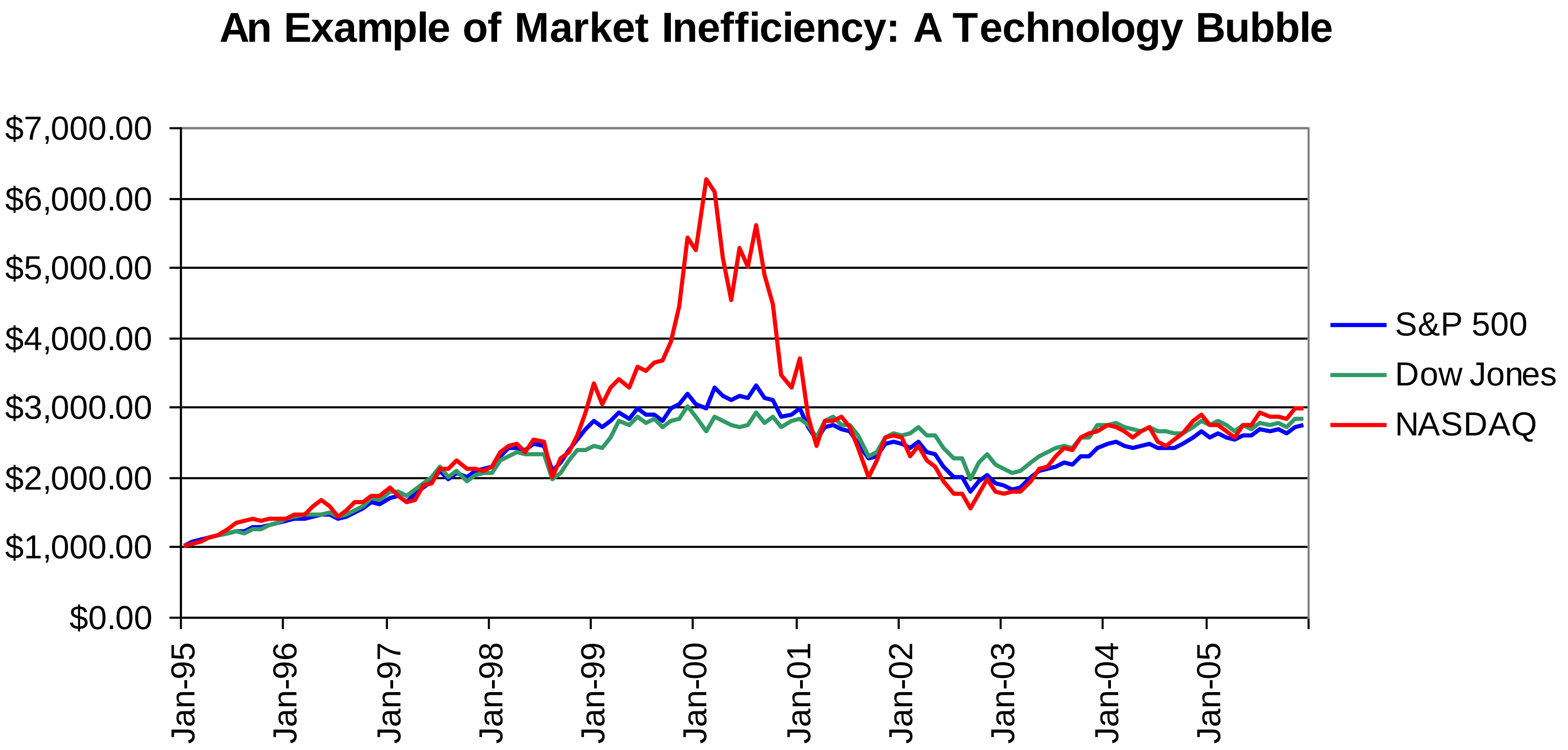
The Equity Risk Premium:
One thing for certain—it is not constant



Notice that the ERP approached zero twice—the portfolio insurance fallacy of 1988 and the height of the tech bubble in 2000. The ERP cannot be zero—stocks are fundamentally riskier than bonds. When the ERP gets too high or too low, stock valuations are out of line with the Treasury bond market.

Source: Anson, Mark. "Business Models in Asset Management Part II." *Journal of Investing*, Winter 2007.

Just a Postscript: What an Asset Bubble looks like



Source: Mark Anson, The Handbook of Alternative Investments, copyright 2006.

References

Mark Anson, "Active vs. Passive—The Debate Continues," Nuveen White Paper, February, 2009.

Mark Anson, "Business Models in Asset Management, Part II," The Journal of Investing, 2007.

Mark Anson, The Handbook of Alternative Assets, John Wiley & Sons © 2006.

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