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## Issue of Concern: Face to Face with Daniel J. Fuss

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Daniel J. Fuss, vice chairman of Loomis Sayles & Co. LP, Boston, still travels the world at age 71, tirelessly researching economies, fixed-income markets and issuers as manager of the \$3.1 billion Loomis Sayles Bond Fund. The fund is Loomis Sayles' flagship bond fund. He has no intention of slowing down, saying he enjoys his work too much. Mr. Fuss was named to the Fixed Income Analysts Society's Hall of Fame in 2000 in recognition of his contributions to the advancement of fixed-income analysis. He was named mutual fund fixed-income manager of the year in 1995 by Morningstar Inc. He joined Loomis Sayles in 1976 as vice president and managing partner; in 1991 the Loomis Sayles Bond Fund was formed with Mr. Fuss as manager. In the past year, he has become concerned about the impact of hedge fund activities on fixed-income markets and investors through the carry trade. He spoke recently with Mike Clowes, P&I's editorial director.

### Q What is the carry trade?

A The carry is the difference between one's borrowing cost and the return one can earn on an investment. It's best typified by a fixed-income dealer financing his inventory by borrowing overnight at the repo rate, and his inventory has a somewhat longer yield. Feeding off that would be borrowing at the shorter end of the yield curve by shorting a two-year Treasury yielding, say, 3%, and investing in high-yield bonds at, say, 7%. The difference is four (percentage points) and that's pretty good, particularly if you are leveraged, say, 10-to-1, so your theoretical extra return becomes 40 (percentage points). Sometimes you borrow long and invest long. You might short a 10-year Treasury and invest in high-yield bonds, leveraging that.

### Q Why is the carry trade important?

A Because it affects liquidity in the market. The argument for the carry trade is typified by hedge funds; it's not just hedge funds, although I would say lately they are dominant (and) the dealers are less active. Say you short a 10-year Treasury at 4.25 and invest in high-yield bonds at seven, your difference is 2.75; you may choose to leverage that to get your return up. That brings enormous liquidity to the market. And the longer it goes on, the more it compresses the difference in yields. This is one factor bringing the spread on high yield-bonds vs. Treasuries down. I think it was (Federal Reserve Chairman Alan) Greenspan who said a couple of years ago about hedge funds: don't get too ambitious to regulate them because they do bring a lot of liquidity to the market.

### Q But they can cause mischief?

A In 1994 a number of the hedge funds — and there were a lot fewer in those days — were borrowing at the

short end and investing long, and the Fed caught them off guard by raising rates. The cost of their borrowing went up a bit, but the value of the long positions dropped. So they were getting sliced and diced, and they had to sell their long positions and pay off the loans. In the process of selling they drove down the long positions even more. And 1994 was the year (fixed-income managers) managed to report negative returns for the first and second quarters in short- to intermediate Treasury portfolios, where it's a real trick to get a negative return.

**Q Is that why the Fed is being more open in what it's doing?**

A Yes. I think so. This time the Fed is more concerned about that. They're telling you in advance very clearly that they're going to raise rates. Now last winter, when they first started saying this, about the end of March, people believed them. They hadn't raised rates yet, and you started to get an unraveling of the carry trade.

**Q How do you know the carry trade is unraveling?**

A The hedge funds, or the leveraged investors, don't call you up and tell you. There are some indicators you can watch, the net long and short positions in the bonds that are most commonly used.

**Q What other concerns do you have?**

A The other thing that has become a worry in recent years is that people, after the experience of 1998 with Long Term Capital, decided if they were going to invest in high-yield bonds, or even just corporate bonds for more yield, bigger carry, they had better make sure they had liquidity. When liquidity goes out of the market there is no bid, they can't liquidate, they get killed. So they put the money into mutual funds, often through omnibus accounts.

**Q So it affects mutual fund investors and other fixed-income investors?**

A Right. Most of the mutual fund investors by that time had a pretty decent sense that they had some of these people in them. The high-yield funds are more disadvantaged by that. We knew there were some in the Bond Fund. The Bond Fund is big and liquid and it wasn't a worry. In our little high-yield fund, we have a list of everyone in there and we don't allow omnibus accounts, so we are protected.

**Q But the mutual funds have to stay more liquid because of this possibility, and that affects performance.**

A Right. That's the problem, particularly with high-yield funds. You can keep your liquidity where it hurts less. For example, the Loomis Sayles Bond and Strategic Income (funds) are both multisector funds, so a portion of the liquidity is kept on, say, the U.K. sterling curve, where the rates are really up there. Or with us, for a while, the Australian curve, and still, the New Zealand curve, where the yields are high and you don't have the income give-up.

**Q Is there one area about which you are particularly concerned?**

A The one thing that has really gained my attention, causing me to manage my accounts differently, is this enormous leverage, and the possibility that it could go out on a bumpy route rather than gradually. The situation can be exacerbated by the funds of hedge funds. I'm not too worried about them in the U.S., but I am overseas. Funds of hedge funds use a diversified approach that makes sense. But there's not too much excess return there. So they may leverage up to get more return, and the underlying hedge funds are leveraged. There's a lot of leverage in the system. Outside of the U.S. you can even go to a bank and borrow the money to invest in a hedge fund.

Hopefully, as our central bank raises rates, the liquidity will ease .... It probably won't go away because even at

the end of the day if the short rates go to three (percent) and the 10-year goes to 5.25 (percent), that's still a pretty nice spread. People can manage that and they'll stay in the business. But what happens if the yield curve in the U.S. flattens? Then you are left with the difference between Treasuries and high yield, and for that to justify the kind of risk you have with the carry trade you are going to need more (yield spread) than you have right now. You probably need four (percent) to five (percent) minimum.

**Q What is your outlook for the economy this year?**

A Longer term I'm really bullish, but we have an adjustment going on, an adjustment in exchange rates between the major reserve currencies. Things look good. Employment is coming back. The unemployment rate is down to a very reasonable rate by historic standards. But there is inflation in the system and it's starting to push its way through.

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