Scarsdale Investment Group, Ltd.

All Bond Portfolios

Financial Advice Lite: Money

December 17, 2014

We are always on the outlook to see how bonds are presented in the media. I picked up the December 2014 issue of Money magazine. The big headline was "Make More Money in 2015." Since I am always interested in that, and I know you are too, I decided to explore their recommendations with respect to bonds.

Boring Bonds – Not

The first mention of bonds I found was the following quote: "People want gold in case all hell breaks loose. It feels safer than BORING BONDS." [My capitalization] This was a statement the editors at Money felt important enough to quote in a large black perimeter box as an explanation for why the financial planner, Bridget Sullivan Mermel, preferred investing in gold rather than any kind of bonds. That bonds are 'boring' is presented as a fact and as a disadvantage, but it is really only her feeling about bonds. It is her assessment, an ungrounded statement. It is not a statement about which she has provided evidence. It is neither a fact that bonds are boring, nor that they are a poor investment. She might have written that I find bonds boring or bonds are boring to me which is more accurate; but such statements do not provide a quotable punch. And, why is boring a reason not to invest in bonds?

Do you ever try to discuss the concept of an all bond portfolio with people you know? If this Money posting represents the general level of investment thinking, it is no wonder other investors don't understand what you are talking about when you try to describe the benefits of a bond ladder. Why would investors not embrace the idea of creating a replacement paycheck using bond interest payments as the foundation?

Daniel Kahneman, the Nobel Prize winning author, asks you to think about thinking in his book Thinking: Fast and Slow. He asks, how does your mind habitually contradict itself, distorts data and mislead you? Mermel's statement quoted above is an example of what Kahneman would call System 1 thinking –taking a short cut instead of performing a deep analysis. Should labeling bonds as 'boring' be enough to turn you away from bonds? Would it incline you to buy an ‘exciting’ investment like gold that had its worst year in 2013 since 1981? Is it exciting or upsetting to watch the value of your investment in gold ricochet down?

Think about how the label ‘boring’ makes you feel, and then think deeper about your financial objectives. What are you really trying to accomplish? Perhaps ‘boring’ is good when it comes to investments. Every six months your high quality bonds pay interest. When the bonds come due, you get your principal back. Should you reject an investment because someone labels it “boring”? Kahneman’s type 2 thinking would suggest that you should analyze an investment’s financial and tax consequences to determine whether it is good for your portfolio.

<u>When bonds lose, they lose a lot less (than stocks)</u>

A common argument for investing in bonds is that they are an investment that “zigs when stocks zag,” as in the 2007-2009 bear stock market. In the article “Beware of Safe Stocks,” by Penelope Wang, in the December 2014 issue she explained: The worst year for equities was a drop of 43%. For fixed income, it was only an 8% slide.” Ms. Wang expresses the generally held opinion that you have to keep trading every investment. Ms. Wang doesn’t take into account that bonds provide regular income and the principal is paid to you when the bonds come due. It doesn’t matter if the prices of bonds are zigging and zagging because you will get the face value of your bonds back at maturity. You do not need to trade bonds. Bonds are not like stocks. You do not have to rely on someone else to buy what you have to get your money back. Bonds are self-liquidating.

<u>Ladder Your Bonds</u>

In the same issue of Money magazine, an investor asked “Can I build a bond ladder with ETFs?” Josh Garskof, Kerri Anne Renzulli, and Sarah Max recommend laddering defined maturity and target dated funds that hold ETFs. However, though they may contain some bonds, these funds are not bond equivalents because they don’t pay interest, and they may contain bond derivatives rather than individual bonds. Furthermore, the bonds included in these funds are generally lower grade bonds: corporate bonds and high- yield bonds that you would generally not buy individually because of their credit risk.

The bonds held by the defined maturity and target dated funds have to be sold or redeemed in the year the fund is to return your principal to you. Income from these funds will decline in the last year as the fund assets are sold and moved into cash. Some financial advisors may suggest that you sell early in the year to insure a continued income; however, if many investors decide to do that it will depress the value of the fund. If interest rates are rising after you buy the funds, you may take a loss on the bonds in the fund if they are sold. You will incur trading expenses as well as regular fund fees and transaction costs in the year of the liquidation of these funds.

The authors then explain that it takes less money to ladder with an ETF because “you’d need $10,000-plus to buy each individual bond for a traditional ladder.” This is misinformation. You can purchase a tax-free municipal bond for as little as $5,000. If you plan on purchasing bonds for your retirement account or need bonds that are taxable to boost your tax bracket, you can purchase bonds with denominations as low as $1,000, and if you purchase zero-coupon (deferred payment bonds) a bond purchased may cost you as little as $650 dollars. Through www.TreasuryDirect.gov you can also purchase EE- Savings bonds for as little as $25, I-Savings bonds with a $50 minimum and Treasury Inflation Protected Securities (known as TIPS) for $100, or less if selling at a discount.

Conclusion

Money magazine is informative, but it is at best a starting point for deeper thinking about how you want to invest your money. It caters to what Kahneman would call Type 1 thinking. To protect yourself and your assets, you should delve deeper to understand whether what they are suggesting is good for you.

Financial Advice Lite: Money December, 2015

Dear Readers,

I thought you might enjoy reading some of the comments in response to our article "Financial Advice Lite: Money," as well as our responses which we have appended to the article. We look forward to your thoughts.

May you have a Happy New Year and a healthy and prosperous 2015.

Hildy, Stan and Peter

SF: The article referred to in your recent posting suggests that boring is bad in the connotation of investing one's assets. I think just the opposite is true and after almost 30 years of investing in munis I believe the more boring the better. I only wish muni bonds were as boring as they were 20 or so years ago when there were few defaults, except in lower rated, highly speculative single purpose issues. What's better than minis being so boring that all you do is buy highly rated issues in a laddered portfolio and forget about them, sleeping blissfully while your principal earns tax-free income. Nothing wrong with boring. If the author of that article doesn't want boring, she can always go to a casino. Plenty of action there, just like there is in the stock market. Me, I'll take boring.

Hildy: Thank you for your note, SF. Yes it would be wonderful if we lived in more stable times. It just means that we have to purchase higher quality bonds for the long run.

PJ: I was surprised that you did not include an I-bond reference but they probably make too small of an impact since the maximum denomination is $10,000. I see them as attractive near risk-free first option to consider especially with the tax impacts deferred until redeemed.

JS: Hi, I like it. At the end, the EE savings bond can be purchased for as little as $25 and the TIPS for as little as $100 or slightly less depending if it is selling at discount.

Hildy: Thank you for your comments. Here is a revised sentence to meet your concerns:

Through www.TreasuryDirect.gov you can purchase EE-Savings bonds for as little as $25, I-Savings bonds with a $50 minimum and Treasury Inflation Protected Securities (known as TIPS) for $100, or less if selling at a discount.

DW: As one who ladders bonds, I'm interested in your views of the "ideal" length of a ladder. What would you advise a senior soul who - hopefully – will leave a ladder of bonds to heirs who may have a preference or a need for cash and would be impatient about waiting for maturities?. Is it better to continue with laddering and take a risk that bond sales could be at a discount or switch over time to ETFs or mutual bond funds which would have immediate liquidity?
Another factor could be that there are several heirs and divvying up bonds would be problematic. I wonder, how would an experienced estate executor solve this issue?

Hildy: My first reaction is to wish you a long and prosperous life so that your long bond ladder becomes a short one.

That said I would hope that you continue buying individual bonds for yourself. There is no telling how long you will live. At least if you purchase your own bonds you know the quality of what you are purchasing and you will not be paying annual fees currently. A bond fund or ETF is not a bond equivalent. You can take a loss as easily on bonds funds and ETFs as you can on a bond. At least when you own bonds, every year the maturities are one year shorter.

What attorneys do is contact someone who knows bonds and asks them to divide the bonds as equally as possible among the possible heirs. This is something we do on occasion.

FP: What would a 5 to 10 year bond ladder look like now – December 2014?

Hildy: We do not currently recommend short ladders because the yield curve is still steep and there is no way to predict how long the yield curve will retain its current shape. If you look at Japanese interest rates, it could be 20-years or more before we have higher interest rates. In fact, the interest rates we have currently are more the norm.

Many financial advisors recommend short ladders because they are interested in deploying the money elsewhere. Money in longer bonds is called 'dead money' because the brokers cannot churn it. They hope to redeploy it into other investments.

That said, if you wanted a ladder between 5 and 10 year maturities, in 2020 you could get a range of 2.2% to 2.3% on Brokered Certificates of Deposit, taxable municipal bonds 2.1-2.4%, corporate bonds are also in that range.

In 2024 you can get a range from 3% to 3.2% on Brokered Certificates of Deposits, in the high 2s on Exxon Mobil and Treasury bonds and Federal agency bonds, and up to 3.2% on taxable municipal bonds.

From our perspective, there is no sense in describing a bond ladder for you because bonds that are available today are not available tomorrow. This means that unlike stocks which are available every day, individual bond offerings are only offered on the day they appear for sale. Many bonds are more like Oriental rugs rather than broadloom carpet. Bonds have generally understandable characteristics, but they might be arrayed slightly differently in each issue.

The question I do not hear you asking is: What is the cash flow I will have from this bond portfolio? People who are investing in bonds are usually doing this to create some kind of cash flow to live on or to supplement their income. I do not know your exact situation. Have you asked the question: What kind of income will I get from a short bond ladder?

Hildy: Dear readers - we welcome your thoughts and comments and look forward to hearing from you.