Scarsdale Investment Group, Ltd.

The All Bond Newsletter

September 2009

Ditch the Casino of Hope and Fear

Summary:

- We tend to anchor our investment choices on information that supports our hopes, needs and wishes.
- We focus on information that confirms those choices, not objective reality.
- We discount information that is not consistent with our investment choices, but live in fear of a bad outcome.
- Safe bonds provide highly predictable cash flows and outcomes. Can you anchor on that?

Part of our behavioral makeup is making financial decisions based on inaccurate or incomplete information. For example, suppose you were offered two investment choices: a volatile investment that might return 10 percent or more per year; or a more conservative investment returning 4.5 percent per year. Both might not meet your future retirement needs. Which one would you choose? Behavioral economists would say that we "anchor" our decision on the investment that speaks to our hopes, needs and wishes, even in the face of logical and substantial evidence to the contrary.

Does it agree with me?

We have a further tendency to focus only on information that supports our decision. This is called "confirmation bias." When our thinking slips into this mode, we tend to gloss over inconsistencies and risks and look only for information that confirms our view. For example, a prospective client who we will call Jim, a Florida litigator by trade, gave Stan a copy of an offering proposal for a fund that had a very consistent long-term record of returning more than 10 percent per year. Jim asked Stan to review it. Stan suggested that Jim pass on the opportunity because the fund had no independent custodian. Stan explained that without an independent custodian, there would be no independent party verifying that Jim's assets were actually there. Jim explained that he was told that a custodian was expensive, just complicated things, and got in the way. Stan replied: "Yes, that is what custodians are supposed to do!" Jim decided to invest with the fund because he thought the hoped-for 10 percent was better than the 4.5 percent that he could get with safe individual tax-free bonds. Years later we discovered that Jim had put his money with Bernie Madoff. You know the end of this story!

And your assumptions?

The concept of confirmation bias is elaborated in a book titled *WHY Smart People Make Big Money Mistakes and HOW to Correct Them: Lessons from the New Science of Behavioral Economics* by Gary Belsky and Thomas Gilovich. They suggest if we come at this idea from the other direction it can be called "disconfirmation disinclination." In English, this means that we avoid focusing on anything that challenges our assumptions. For example, it had to be quite evident to smart investment bankers that if they packaged mortgages and sold them without risk to themselves, then there would be little reason to keep the mortgage packages healthy. This was obvious to anyone inside the mortgage game. However, once the financial market executives saw the money to be made, the banks and brokerage houses swallowed their own advertizing and purchased their own toxic brews. Seeing the demand for the securitized loans, it became very difficult, even for insiders, to turn away.

"Hope is not a strategy"*

Once we become aware of our tendency to "anchor" on an investment objective, we can see the result of "confirmation bias" by looking at the outcome of conventional investment advice. After experiencing the brutal reality of the 2007-2009 losses in the stock market, many investors are beginning to realize that relatively safe "plain vanilla" bonds actually present a fundamentally different, more secure way of investing and planning for the future.

*Michael A. Dubis, financial planner

Individual Bonds: In a class by themselves

Buying and holding high grade individual bonds to maturity is not a trading strategy. It is instead a loan to a financially secure borrower that results in a highly predictable future cash flow to the lender. By using a buy and hold to maturity approach, you simply remove yourself from the "casino of hope and fear" that characterizes trading strategies for individual investors. In the last 7.5 years our muni-bond portfolios, composed of only highly rated individual tax-free bonds, have generally increased by 50 percent in the aggregate. That is simply a compounded yearly return of 4.5%. No losses! Can you 'anchor' on that?

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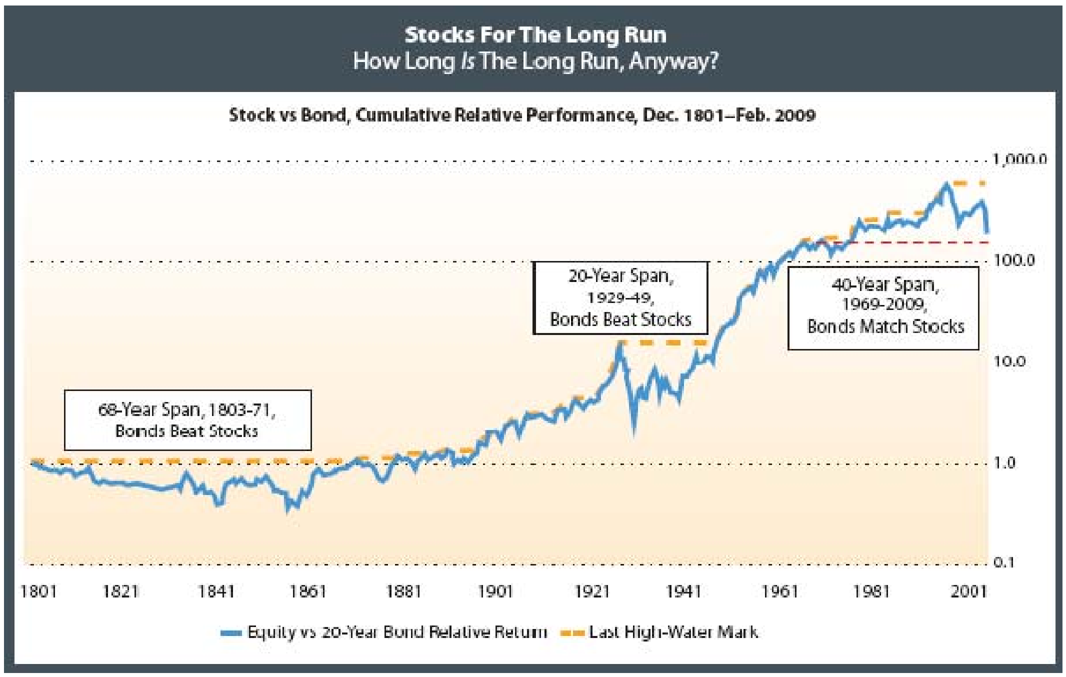
Stocks for the Long Run?

Summary:

- Bonds have outperformed stocks for long periods of time.
- The risk premium is defined as the amount investors hope to earn on stock above the risk free rate on Treasury bonds.
- The risk premium for stocks has been zero for long periods of time, including the past 40 years according to Arnott.

Robert Arnott challenges the point of view that over many decades stocks outperform bonds. The amount investors hope to earn from stock above the risk free rate on Treasury bonds is called the "risk premium." Even we were surprised to learn "… that the 40 year excess return for stocks (the risk premium), relative to holding and rolling ordinary 20-year Treasury bonds, is not even zero." Arnott's chart showing the historic advantage of bonds over stocks is presented below:



Source: Standard & Poor's, Ibbotson Associates, Cowles Commission and Schwert.
Graphic courtesy of Journal of Indexes, found in Robert Arnott, "Bonds: Why Bother?" May/June 2009, pp. 10-17

Hildy & Stan Richelson are bond experts and authors of 4 bond books, including their recent best-seller "Bonds: The Unbeaten Path to Secure Investment Growth, Bloomberg Press, 2007

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