OUR STRATEGY FOR BONDS IN TODAY'S LOW INTEREST RATE ENVIRONMENT

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We believe that muni bonds are an excellent investment for those who wish to preserve their principal and generate a predictable cash flow of tax-free income, even though yields on bonds have gone down to historically low rates over the last 5 years. In this article we share our perspective on investing in stocks versus bonds, our investment principles and our current recommendations for bond investing.

Stocks versus Bonds

Investors saving for retirement and those in retirement have lost their taste for stocks because of the substantial losses that they have incurred. These losses are due to the Dot-Com crash in 2000 and the blood bath in 2008. Two massive stock market crashes in eight years have demonstrated to investors preparing for retirement or in retirement that stocks can't be trusted to grow steadily and to provide the required predictable cash flow when needed over a long period of time. A retirement fund must be designed to last for 20 to 40 years. How do you deal with a big crash that results in a 30 to 50 percent decline in assets when you are no longer working and earning more money? Back testing your current portfolio against previous crashes is no predictor that your current portfolio will be safe in the future.

Many stock analysts suggest that stocks are set for a rebound in the next ten years when the economy resumes rapid growth. However, the economists Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff[i] have a much different view of future economic growth in the U.S. due to our massive debt that has built up over the last four years. They studied 26 episodes of public debt overhang in advanced economies since the early 1800s, characterized by public debt to Gross Domestic Product levels exceeding 90 percent for at least five years. They found that the result of this massive debt overhang was substantially lower economic growth and the average duration of this reduced economic growth was 23 years. In addition, they reported that even when the country had continual access to low interest rates, low growth continued. Low economic growth does not generally support a booming stock market.

Our Investment Principles

Our current investment strategy is quite simple to understand and is based on the following principals:

1. **Come from a place of not knowing**. This is a powerful (and honest) place to stand, knowing that you really do not know what the future will bring. We don't

know whether interest rates will be going up or going down or staying at the current rather low rates. We do assume that rates will change, but we don't know when. If we are in the Japanese pattern of low interest rates, it may be years before interest rates rise significantly. We do know that interest rates will fluctuate, but we do not know the range at any particular time. Understanding that you really don't know will keep you open to new ideas and knowledge.

2. **Be Realistic**. If someone offers you a 10 percent return, don't just look on the sunny side to see how that return will benefit you. Instead look at the risk you are taking to the principal you are investing. Just because you 'need' a certain return to maintain your lifestyle, does not mean that the offered return will provide it. You may get your 10 percent yield, but lose your principal. To put this in perspective, state pension funds earned 1.5 percent last year on their invested capital.
3. **There is a cost to waiting**. We do know that if we stay in cash, waiting for the possible rise in interest rates, we lose, unless interest rates rise substantially in the near future. There is a cost to waiting. If you keep your money in cash or in the lowest short-term interest paying bonds, your money is not growing. There is no money earned for compounded growth. It may take years of higher returns just to catch up to the annual compounding of current returns. See our article "The Short-Term Route to Long-Term Failure."
4. **Invest when you have cash**. Knowing that there is a cost to waiting and knowing we don't know makes it much easier to invest now, even at low historical interest rates. The U.S. government is being rather unkind to savers and retirees by keeping rates low. Reinhart and Rogoff call this 'fiscal repression' and it sure does feel repressive to us.
5. **Create a bond ladder to fit your particular needs**. If you have a bond ladder in place, rising interest rates will enable you to reinvest your interest income and your principal when it comes due at higher rates. It is for this reason that we look forward to rising interest rates. If your plan is to have your money earn income that you fully consume, then you will have no funds for reinvestment - the source of growth.
6. **Be guided by the yield curve**. The press reports that the bond market is rising or falling. These reports generally do not differentiate among the different maturity segments of the bond market. The yield curve is a graphic summary of interest rate returns by year that reflects those differences. Generally the press discusses the Treasury yield curve, though there are yield curves for each segment of the bond market. In August 2012 the yield curve is very steep and has been for a number of years. This means that you earn a lot more interest when purchasing longer-term bonds instead of very short-term bonds. Yield curves change over time and our strategy changes as well. Our basic principle is that we wish to stay as short as possible, while maximizing the return. Create cash flow for safety and flexibility. We

don't "mark to market" and record gains and losses in our bond portfolios when interest rates go up and down. Since we plan to hold our bonds to maturity, these day-to-day fluctuations don't matter to us. Marking to market is an institutional requirement, but is not in the interest of individual bond investors. Individual investors should focus on one big point: PREDICTABLE CASH FLOW. With respect to their portfolios, individual investors should ask this key question: **How many dollars of cash flow will my portfolio produce on a consistent basis without substantial risk to my capital?**

Recommendations

In view of these simple principles, here is what we currently recommend:

When the yield curve is steep as it is now, we invest longer-term.
We recommend buying individual bonds coming due in 15 to 23 years consisting of very high quality tax-free municipal bonds for those investors in a high tax bracket. The tax-free return here is about 3.5% which equates to a 5.2% pre-tax equivalent return to a taxpayer in the 33% marginal tax bracket. We make this recommendation based upon the current yield curve for tax-free muni bonds. This is where an investor can get the greatest return on invested dollars. For each $100,000 invested in such a ladder, there would be a predictable tax-free cash flow of about $3,500. **Even if interest rates were to change, the cash flow payable by the bond ladder will not change because the** bond coupons do not change.

It is not clear when there will be substantial economic improvements in our economy or the world economy. Interest rates may stay down for some time. No one knows if and when the U.S. government may decide to reflate the economy and create inflation to jump start the economy. However, Bernanke - helicopter Ben - knows that they cannot let the inflation genie out of the bottle without destructive consequences.

How to Compare Stocks and Bonds

We believe that to correctly compare stocks and bonds, you must reduce the return on stocks by making three adjustments: 1) income taxes, which have a delayed effect, 2) fees that are often hidden and 3) bad timing and judgment, about which much is being written.[ii] We have addressed this issue briefly in our article "Achieving Financial Independence," and plan to write more about it soon.

After you make these three adjustments, you must also risk adjust the return on stocks and compare it to the return on a portfolio of high quality tax-free individual Muni bonds. For example, if you were getting a taxable equivalent yield of 5 percent on a muni bond portfolio, and a 5 percent return on a portfolio of small capitalization stocks, which is the better investment? With the muni bond portfolio you have the 5 percent locked in and will see an annual cash flow. With the stock portfolio you can be sure to see lots of volatility, but no predictable outcome. What will the stock portfolio be worth when you are ready to sell it? Clearly risk matters.

When all this is done, you will see that even at today's low interest rates, tax-free muni bonds are an excellent investment for those interested in conservation of principal and predictability of cash flow. And those predictions of an 8% return on stocks, even if it happens, will be greatly diminished after taxes, fees and bad timing are deducted (let alone the abuse of your stomach).

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[i] Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, "Debt Overhangs: Past and Present," *NBER Working Paper No. 18015*, April 2012.
[ii] Daniel Kahneman, *Thinking Fast and Slow,(New York:Farrar, Straus, Giroux, 2011), pp 212-216.*