Using Bonds Instead of Stocks for Portfolio Income

by Stan Richelson and Hildy Richelson

Article Highlights

- Maximizing consistent and predictable cash flow is the most important factor for individuals with retirement objectives.
- Stock returns are unpredictable, and profits are diminished by taxes, fees and the possibility of poor timing.
- Long-term, high-quality municipal bonds provide predictable cash flows and allow investors to avoid federal, and possibly state, taxes.

We believe that municipal bonds are an excellent investment for those individual investors who wish to preserve their principal and generate a predictable cash flow of tax-free income. We consider this to be the case even though yields on bonds have gone down to historically low rates over the last five years.

Although individual investors generally allocate their assets between investments in stocks and bonds, maximizing consistent and predictable cash flow is the most important factor for individuals with retirement income needs, college expenses or other long-term financial objectives.

Investing in Stocks for Income

Individual investors buy stocks and stock funds (we will refer to both as "stocks" throughout this article) in the hope of maximizing their investment returns as a result of stock appreciation and dividends. The historical return of 9% to 10% is pointed to as their hoped for strategy of success. However, many 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 were due to the dot-com crash in 2000 and the bloodbath in 2008. Two massive stock market crashes in eight years have demonstrated to many investors preparing for retirement or in retirement that stocks offer no guarantees of growing steadily or providing 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% decline in assets when you are no longer working and earning more money? Backtesting your current portfolio against previous crashes is no predictor that your current portfolio will be safe in the future. As financial planner Michael Dubis has pointed out, "Hope is not a strategy." While there is always the possibility of outsized gains on stock portfolios, do you want to bet your retirement on this outcome?

Many stock analysts suggest that stocks are set for a rebound in the next 10 years when the economy resumes rapid growth. However, the economists Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff 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 (GDP) levels exceeding 90% for at least five years. They found that the result of this massive debt overhang was substantially lower economic growth. Plus, 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,

How to Monitor Muni Bonds

We recommend that investors monitor their investments. The first level of review should be a periodic review of your brokerage statement. Look at the names of the issues and determine if you are still confident regarding the issuers. Has there been something in the news to give you concern?

Has there been a change in the ratings? You may have to compare the ratings on your holdings in the past statement to the current statement to see any changes. If you view your statement online, you may be able to look up information by right-clicking on the CUSIP number or visiting the EMMA website at www.emma.msrb.org, both of which are described below.

Your eyes will probably be drawn to the column describing changes in market value. It is a wonderful feeling to see all the valuations up compared to your cost basis. However, you need to remind yourself why you are investing in bonds and what outcome you are working toward.

If you are a bond trader, then your concern is about the day-to-day movement of bond prices, whereas the buy-and-hold investor only needs to determine if they will get their money back when the bonds come due. Generally, news items that are important to the day trader can be cheerfully ignored by the buy-and-hold investor with a long view. Also, remember that there is a cost to waiting, so don't second-guess yourself.

Make friends with EMMA, the acronym for Electronic Municipal Market Access, made available to you by the Municipal Securities Rulemaking Board (MSRB). You can insert the CUSIP number, the nine-character alphanumeric code, for your bond into the search box. After agreeing to the terms of the site, you will be able to review the official statement, trade activity and S&P (Standard and Poor's) and Fitch's ratings. You can also see whether the issuer is posting continuing disclosure notices, including annual financial information and audited financial statements. You may not want to review the statements. However, it is more likely that the fiscally solvent will post these statements. Therefore, a question to ask is: Is this issuer posting financial statements in a timely fashion?

Most important are the event notices found on EMMA that describe actions and situations that affect your bonds. For example, when there is a partial call, it may mean that the rest of the issue may also be called soon, which is of particular importance if you are paying a premium for the purchase of a bond. The event notices will also highlight potential problems concerning the viability of the bonds. For example, the event notices will tell you if there is a suit pending against the issuer or if the issuer is dipping into its reserves to meet bond payments. These notices will tell you if major changes have been implemented that might affect the ability of the issuer to repay the debt.

According to EMMA, this information is only available for issues of $1 million or more, and where more than 35 $100,000 blocks of bonds are sold. That means that you are more likely to get better continuing disclosure on larger issues. If you are buying a bond in the secondary market, always ask whether there is any continuing disclosure or material events.

—Hildy and Stan Richelson

low growth continued. Low economic growth generally does not support a booming stock market.

In addition to the hoped for appreciation of an individual's stock portfolio, there may be dividends. While there are many dividend-paying stocks, many companies do not pay any dividends. Although corporate profits have been high recently, a great deal of these profits have gone into share repurchase programs. These buybacks may or may not work to increase the stock price, but they do nothing for the investors' cash flow from the company.

The dividend yield, or 12-month dividend per share divided by the price, on the S&P 500 stocks as of August 31, 2012, was 1.94%, while the average dividend yield for Dow Jones industrial average stocks was 2.97%. Currently, the highest dividends available are often from troubled companies. Remember, as the price of the stock drops, the yield rises. You may be buying a high yield, but you may lose money on the stock price. Stocks never come due like bonds, which pay face value at their due date.

Once we add up the appreciation (we hope) of the stock portfolio and the dividends, we are not done with our analysis because individuals must reduce these gains by three adjustments: income taxes, fees and bad timing.

Tax rates on dividends and capital gains may increase as soon as next year. In addition, if there are short-term capital gains, they are currently taxed at ordinary income rates, which may also increase dramatically. And then there is the matter of the new additional 3.8% Medicare tax on investment income for certain taxpayers that goes into effect in 2013.

There are many disclosed fees and undisclosed fees on stock funds. Vanguard founder John Bogle has estimated these fees at 2.5% to 3% in general. Financial expert William Bernstein has estimated that the fees are much higher on small-cap stock, foreign stock, microcap stock and emerging market funds.

Finally, there is the important matter of the possibility of bad timing. It has been well documented that individual investors don't make the returns that have been earned by their stock funds because they move in and out of the funds at less than optimum times. It is all too common for an individual investor to be late in getting into "hot" funds, only to sell after there has been a significant decline. In the 2008–2009 crash, this history of bad timing was repeated. [See "How Investors Miss Big Profits," by Louis S. Harvey, in this issue for more on this phenomenon.]

So, what can we conclude regarding the prospect of a predictable cash flow from a portfolio of stocks to fund retirement or other financial goals? Unfortunately, not very much.

- We can't predict whether there will be gains or losses or the ordering of these gains or losses. For example, if losses were to appear soon after retirement, there may be a financial disaster even if there are substantial gains in the future.
- Dividends, if paid, and capital gains, if earned, will be subject to income taxes, which are currently unpredictable.
- Fees may be high, particularly if invested in small stocks and foreign stocks.
- Since many investors no longer follow a buy-and-hold strategy, bad timing may be increased, and trading costs and taxes will definitely increase if stocks are traded.

Investing in Bonds for Income

By taking a savvy approach to bond buying, you can minimize your taxes, limit your expenses, reduce your risk and increase your predictable cash flow.

Tax-free municipal bonds allow you to avoid paying federal income tax and possibly state and local income taxes as well on the interest income. In addition, you will avoid paying the new 3.8% Medicare tax on investment income beginning in 2013. Muni bond interest is also not subject to the alternative minimum tax (AMT), unless you purchase muni bonds issued for private purposes.

The cost to purchase a bond is called the "spread," which is the difference between the price that the broker paid for the bond and the higher price at which he sells it to you. You can possibly reduce the spread by becoming knowledgeable about the price of the bond in the marketplace. You can now go to the EMMA website (emma.msrb.org) to determine the last prices that were paid for your particular bond [see the box on page 22 for more on EMMA]. If you buy a bond at its initial public offering, you will receive an institutional price—the best possible price. If you hold a bond until its due date, there are no further transaction costs.

With high-quality bonds, defaults are rare, so no significant loss of principal is likely to occur as long as you can hold the bonds until they come due at their face value.

The risk of bad timing is small if you can hold your bonds until they come due because every bond comes due at its face value, no matter what the price fluctuations might be before its due date. If interest rates rise and you do not consume all of the interest, you will have the opportunity of reinvesting some of the income at higher rates. We view this as the upside of bond investing, even though the media will be saying otherwise.

Comparing Stocks and Bonds

After you estimate the gross return that you might earn on stocks, you must make the three adjustments of taxes, fees and bad timing discussed above. In addition, you must also risk-adjust the return on stocks and compare it to the return on a portfolio of individual high-quality tax-free muni bonds. For example, if you were getting a pretax equivalent return of 5% on a muni bond portfolio, and you estimate that you might get an 8% return on a portfolio of stocks, which is the better investment? With the muni bond portfolio, you have the 5% pretax equivalent return locked in and will see a predictable annual cash flow. With the stock portfolio you can be sure to see lots of volatility, plus fees and possibly bad timing, but no predictable outcome. What will the stock portfolio be worth when you are ready to sell it? Clearly, risk matters.

When you consider all the factors discussed above, you will see that even at today's low interest rates, tax-free muni bonds are a good investment option for those interested in preservation of principal and predictability of cash flow. As far as those predictions of an 8% return on stocks are concerned, even if they prove to be correct, profits will be diminished after taxes, fees and bad timing are deducted. (Taxes can be deferred in a traditional IRA—just the withdrawals are taxed—or avoided in a Roth IRA, but costs from fees and bad timing still exist.)

One of the issues not often mentioned is how much of your time you wish to devote to your investments. The volatility of stocks calls for attention. It is hard not to be sucked up into the maelstrom of market news. The question remains: Is following the ups and downs of the stock market how you want to spend your time?

Our Investment Principles

If you are considering an investment in individual muni bonds, our current investment strategy is quite simple to understand and is based on the following principles:

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. Understanding that you really don't know what will happen will keep you open to new ideas and help with decision-making as discussed in our recommendations below.

2. Be realistic.

If someone offers you a 10% 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%, but lose your principal. To put this in perspective, state pension funds earned 1.5% 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.

4. Invest when you have cash.

Knowing that there is a cost to waiting and knowing we don't know what will happen in the future makes it much easier to invest now, even at historically low 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 September 2012, the yield curve was 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.

7. Focus on cash flow and not marking to market.

You can create cash flow for safety and flexibility. The media will encourage you to "mark to market" and record gains and losses in your bond portfolio, focusing on the rise and fall of interest rates. This may be of interest to you if you plan on selling your bonds to buy a new house, for example. However, 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?

Our Strategies

In view of these simple principles, here are the strategies we are currently using:

- 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. 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.
- The tax-free return on this part of the yield curve is about 3.5%, which equates to a 5.2% pretax equivalent return to a taxpayer in the 33% marginal tax bracket.
- For each $100,000 invested in such a bond 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, Federal Reserve Chairman Ben Bernanke knows that they cannot let the inflation genie out of the bottle without destructive consequences. High inflation is not kinder to stocks than it is to bonds. ➤

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