ADVISOR PERSPECTIVES

The Case for the All-Bond Portfolio

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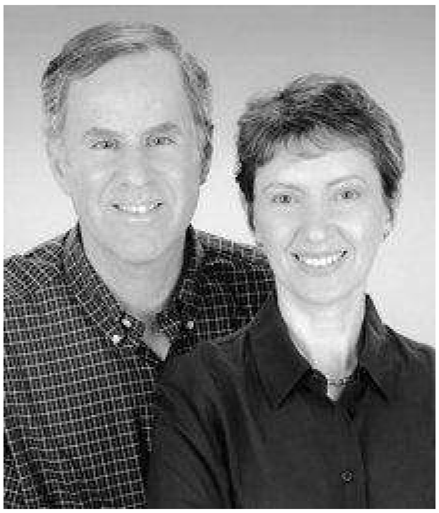

Hildy Richelson and Stan Richelson are bond advisors who focus their practice on the design and management of bond portfolios for high-net-worth individuals. Hildy is President of Scarsdale Investment Group, Ltd., a fee-based advisory firm. They advise clients on the art of buying and selling fixed-income investments. They are co-authors of several books, most recently *Bonds: The Unbeaten Path to Secure Investment Growth*, which was named one of the ten best investing and finance books of 2007 by the editors of Amazon.com. It can be purchased via the link above. As a special bonus, advisors that read the book and take a short test can earn 15 CFP credits.

We spoke with the Richelsons on February 22, 2009.

Congratulations on providing your clients with what must have been a winning strategy for 2008 – an all-bond portfolio. What were the background and history that led you to develop this strategy, and what are its core components?

> We developed our strategy in the mid-1970s, after unsuccessful attempts at investing in equity mutual funds. At that time, we bought aggressive equity mutual funds, and sold them when we thought the market was going down. After three years we came out where we started, basically wasting our time.
>
> Interest rates were very high then. We realized we could achieve our personal goal of financial independence without taking on a substantial amount of risk by utilizing tax free municipal bonds and holding them to maturity. Moreover, we could do an accurate financial plan, since our future cash flows from these investments were highly predictable.
>
> We put together our first book in the md-1980s. Our core principles were in this book and are now in our latest book (on page 306). They can be

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summarized as follows: carefully define your objectives; don't lose any money; if you can't afford the risk then don't play in the market; evaluate every investment on a risk-adjusted after-tax basis; make sure you understand all your investments; focus on cash flow; and carefully understand the risks you are taking.

We have built a successful advisory practice on these principles.

You cite three advantages of the all-bond portfolio (vis-à-vis traditional equity portfolios): lower transaction costs, taxes, and losses due to market timing. What role should passive equity funds have in retirement accounts? And how can you be sure that transaction costs are really lower in bonds than in stocks?

We have believed in the all-bond portfolio for the last 25 years. Beginning in the 1970s, we tried to persuade our clients to consider an all-bond portfolio, at least for the portion of their assets they could not afford to risk.

We buy individual municipal bonds, primarily in the new issue market. There are no transaction costs, no yearly fees (when you own them in your own name), and when the bonds mature you to get your principal without incurring any transaction fees.

If you hold bonds in a managed account you do not get the same advantages as holding them in your own name. Therefore, managers must take extra risk to make up for the fees they are charging.

The problem with equities, including index funds, is that they rely on the greater fool theory – that some fool will buy your stock from you at a higher price than you paid, at some time in the future. That whole belief system – embodied by the catchphrase "stocks for the long run" - may be damaged beyond repair by the time this whole financial crisis is straightened out.

Everyone believes stocks will outperform bonds over the long term. But we have never been comfortable with that truism, and that has led us to advocate the all-bond portfolio.

If you are an endowment, investing for the long run may be okay. But an individual has a finite life, and you can't bet on whether your money will be there when you need it. Advisors get around this by investing for short terms needs – say for the next three years - in cash and short-term bonds and the remainder in stocks. If you are retired and facing this market, it may offer some comfort to know you have money for the next three years.

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But it is more than a little distressing to know that you may not have enough beyond those three years.

People forget there have been long periods of time when the market has not gone up. We may be living in one of those periods now.

Investors have become fixated on the 1980s and 1990s as the only relevant period. But it is not clear that stocks will be up in five or 10 years or whatever the relevant time period is. People who need their money are going to be in trouble. There are long periods where markets are flat. Buy-and-hold investors may not experience any gains in their portfolios.

The big problem today for advisors is when a client calls and asks "what shall I do now?" We have talked with other advisors about this question, which is hard to answer. You can say "Don't worry, the market will right itself," or you can ask the client "What do you want to do now?" Neither is a very satisfactory answer.

Safe Bonds is a core concept of your portfolio. Your criteria include "AA or better corporate bonds." It is especially hard today to build a non-Treasury portfolio that applies those criteria. As credit ratings decline and the few "AA or Better" corporate bonds evaporate into institutional portfolios, how can advisors fulfill your criteria? Does the environment induce you to change your criteria? How much reliance should investors place on the ratings agencies in the corporate market?

Let's take the last question first. The traditional corporate AAA rating is not equivalent to a municipal AAA rating. There are two different scales, which was one of the sources of much of the trouble in the sub-prime debt market.

When we evaluate bonds, we want to know what Mr. Market tells us. We look at how many bonds are outstanding for the issuer, the issuer's borrowing history, and whether we are comfortable at a gut level with the issuer. We look at publicly available research on issuers.

We are completely out of the corporate bond market now. But, when we buy corporate bonds, we look at the issuer's outstanding debt and when it is coming due. Some companies have a good name and sound business, but will face huge cash flow problems when they need to roll over their debt.

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Brokers will often pitch the bonds with the greatest credit risk. Those bonds yield the most and trade with the biggest spread, making them more profitable for brokers than more conservative bonds.

Credit quality must be considered in the context of evaluating yield versus risk. For example, we have looked carefully at retail notes issued by corporations, which are often called medium term notes. They are issued every week by different companies. General Motors was one of the first issuers. But if it is so easy for companies to borrow, do you want to lend to them?

Corporate bonds are too dicey now. Most people dismiss the possibility that "this time will be different." But this saying may now be true. Even if this time is not different, it may be difficult enough to say who will survive and in what shape they will be in.

For many years, until about 16 months ago, there were few corporate defaults because issuers were always able to roll over their debt. Now banks are being much more cautious, and there is no liquidity for lending to companies.

There will be substantial defaults this year, and this is already reflected in junk bond market prices.

We are starting to put municipal bonds into retirement accounts, because they are often more attractive than other "safe" bonds. We recently did this for a 68 year old client. When this client makes a distribution from his IRA, he will be happy to have a muni bond providing tax-free income.

In general, though, we buy Treasury, TIPS, agency, and taxable municipal bonds for retirement accounts.

One of the myths you want to dispel is that bonds don't provide growth. Apart from your example of zero coupon bonds, could you elaborate on the growth aspects of a bond portfolio, and specifically comment on where growth in Treasury bonds will come from in light of the fact that the 10 year Treasury bond is approaching the lowest yields since 1946.

We are not buying any Treasury bonds except for TIPS. The yields on Treasury bonds are too low.

From January 1, 2000 to August 1, 2008 our portfolios grew 50% on an after-tax basis. We reinvested the coupons in additional bonds. Our clients realized a 4.5% compound annual rate of return, and that is the

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source of our clients' growth. Nobody was unhappy with their 50% return over that period of time. Plus, they knew what they were going to get, and they can predict this return into the future as well.

In the municipal market, we are always looking for names we understand. We will buy revenue and general obligation (GO) bonds. We stay away from unclear or hard to explain bonds. These are called "story bonds." We like simple bonds that let us sleep well at night.

We worry about defaults in states like California. But we are confident that if a default happens, bondholders will come out more or less whole. In the 1970s, New York City was in default on its bonds for two weeks. They created the Big MAC agency, and bonds were refinanced by extending maturities and lowering coupons. It was not the end of the world. Such outcomes are possible in California and other states.

A good water and sewer bond is better than many GO bonds. We look for bonds backing essential service projects. The less essential the project, the greater the risk. Hospitals are essential, but anything associated with health care tends to be pretty risky, mostly because of the vagaries of external regulation. [Ed. Note: See our recent article on the municipal bond markets.]

Other than low cost – which you identify as a key criterion for "good" bond funds – what else should advisors look for when selecting an actively managed bond fund? Are there any bond funds you are now recommending?

The only time we recommend bonds funds is when a client needs and wants to buy foreign, emerging market, or exotic mortgage-backed bonds. These bonds are much too complex for investors or advisors to buy on their own. Plus, foreign and emerging market bond returns can get killed due to currency movements. If we can't persuade our clients not to invest in these bonds, then we invest in these kinds of bonds through a bond fund.

When we explain the issues, our clients usually decide not to invest in these bonds.

The other situation where funds are appropriate is when clients can't afford to buy-and-hold, because they need liquidity.

Evaluating bond funds requires looking inside the box. For example, we looked at a fund from one of the largest mutual fund companies, and

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found that it owned highly risky tender option bonds. The only way to undertake this level of diligence is to examine the fund's semi-annual report. Unless advisors are willing to look closely at the funds they buy, they are better off in individual bonds.

Some retirement plans, such as 403(b) plans, have very limited choices. Even worse, the choices within these plans can be horrible. One of our clients came to us with such a situation – a plan where 90% of the offerings were expensive equity funds, and the only fixed income options were corporate bonds and TIPS. We put all her money in TIPS.

You encourage readers to "do it yourself" and avoid bond funds. Individual investors have a propensity to reach for yield either by going into long maturities or going down in credit risk. You spend a great deal of time discussing the latter, but not the former. What are your thoughts on maturities and how do you prepare the individual investor for volatility in a bond portfolio?

We have a careful discussion with all our clients about their investment time horizon. We warn them about inflation and that interest rates may go up. We explain that their statements may give the appearance that they have lost money. They must be able to buy-and-hold, in which case they will earn the full yield to maturity on the bonds. Then they can ignore the volatility.

Clients often don't realize that portfolio maturities shorten over time as individual bonds approach their respective maturities. Also, clients fail to understand the flip side of inflation, which is the opportunity to reinvest at higher rates. If clients stay in short-term securities because of a fear of increasing interest rates, they may end up earning one or two percent. Maybe inflation doesn't come, and they roll over their short term investments. But there is a real cost of waiting.

In the 1970s, some investors made the mistake of buying six month CDs and rolling them over to higher rates, instead of locking in non-callable Treasury bonds with much higher yields. They watched as rates went down from 16 to nearly two percent.

Everyone worries about inflation and not about reinvestment risk.

Interest rates have been going down since 1982. Reinvestment risk has been a problem as long as we have been investing.

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Another core concept is that bonds are "easy to buy at a fair price." Yet, except for Treasury bonds and sometimes agencies, the feedback we get from advisors is that spreads in lots less than 50 bonds can be Draconian and wipe out a significant amount of market yield. What is the best way for advisors (and investors) to get the best transaction execution, especially in the municipal market?

Advisors can use a rule we call the "Power of Three." Use three brokers, and bounce ideas off of each one. The problem is that finding bond brokers is not so easy, because brokers don't want to wait 10 years for bonds to mature and the next opportunity to sell you a product. We personally use a network of brokers that we found over many years.

An advisor we know purchased corporate bonds for a client. She bought GM, Chrysler and Ford and other high yield junk bonds for them from one particular brokerage house. If she were using more than one broker she might have gotten different feedback.

Advisors should always remember bond salespeople can be very pleasant and nice, but don't assume they are your friend and acting in your best interests. We have been writing for years about the conflicts of interest in the bond brokerage business.

Let's say someone wants to fund the college education for their child (i.e., a 17 year time horizon) through a 529 plan. What strategy would you recommend?

We wrote a case study for our book about funding our daughter's education, where we strongly recommend against 529 plans. Instead, advisors should use tax free bonds with maturities corresponding to when tuition payments are due. These can be zero coupon or coupon bonds. Using municipal bonds avoids the problems of the "kiddie tax." [Ed. Note: The kiddie tax refers to children's unearned income which can be taxed at the parents' rate.]

Advisors need to ask whether their clients can afford to lock up their money for 17 years, or whether they might need it themselves. Buying individual municipal bonds offers that option, whereas 529 plans do not (without paying a penalty). Clients need to acknowledge that their children might also want to start a business instead of going to college.

Look at what has happened to the poor students who put money in 529 plans over the last decade – whether in stock or bond funds. Their stocks

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have lost money, and their bond funds may spike downward just when they need to take out their money.

One of our clients insisted on a 529 plan for his grandson. We found one plan offered guaranteed investment contracts (GICs) or CDs. It was hard to find because the controlling theory is that stocks will always go up, so most plans are built around equity investments.

What are you getting from a 529 plan? Shelter from a presumed capital gains tax? Maybe that gain won't be there and benefits will be wasted. The government gives you something but attaches a lot of strings. Plus a lot of these plans come with high fees.

Let's take another example – someone just entering the workforce (i.e., a 50 year time horizon) looking to fund their retirement account. What asset allocation would you recommend? Should any money be in equities?

We still like bonds over equities. When you have a long period of time, you have many years for compounding. This is always the recipe that works. Over 30 or 40 years, you earn an enormous amount through compounding and reinvestment, even if yields aren't great.

Moreover, you can actually do a financial plan. Advisors can compute how much money clients will have over a 30 or more year timeframe. With a bond portfolio, clients can't fool themselves by overestimating returns on stocks. The key is to save money, even if it means living more modestly. Clients will feel better in times like these.

In 1993, Joe Dominguez and Vicki Robin wrote the book *Your Money or Your Life*. Their message was that your life can be run by your money, or you can control your life and live in the way you choose. It was a book about downshifting, and it may catch fire again. It was very popular 15 years ago on the west coast, but it never made it to the east coast, and certainly not to Wall Street.

Joe and Vicki recommend that you invest in safe bonds. It is the only place we have ever seen this kind of strategy. Downsizing was not a life style or strategy people were interested in.

Late last year, bond yields (10 year Treasury bonds) went below stock market dividend yields for the first time since 1958. Do you attach any significance to this? Specifically, does this imply that stocks might now be riskier than bonds (to justify their higher yields)?

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Today, 10-year Treasury bonds are yielding 2.75 percent and 30 year bonds are at 3.50 percent. The Dow Jones dividend yield is 4.59 percent (and if you exclude the companies not paying dividends it is 4.75 percent). The companies in the S&P 500 are going through dividend reductions, and many companies currently paying dividends may not be able to sustain them. A recent *Bloomberg* article explained why dividend reductions indicate equities are overvalued.

Bonds are not perfectly safe investments. We would all like that, but there is always a balance between risk and reward. When advisors reach for higher yield, they must ask why the yield is higher.

We read an article yesterday in the weekend Wall Street Journal, which reported that investors are throwing Hail Mary passes because rates of return in the market are low and they have lost so much money. This is a terrible idea. Investors should be thinking about reducing - not increasing – risk..

What is your own personal asset allocation? Is it 100% bonds?

For the last 30 years it has been 100 percent bonds. All our taxable funds are in municipal bonds, and all our pension assets are in Treasury bonds, TIPS, taxable munis and agency bonds.

TIPS are the only plain vanilla hedge against inflation. We buy them when we can, specifically now when clients have extra money to invest. TIPS are not the perfect hedge, and advisors must be very cautions to not buy them at too high a premium. Although you can't lose more than the face value with TIPS, you can lose built in appreciation when you buy them at a premium.

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