BONDS

Scarsdale Investment Group, Ltd.

All Bond Portfolios

How to Deploy the Metagame in Bond Investing

Hildy & Stan Richelson
August 9, 2017

The metagame is described on the FarnamStreetBlog website as "…playing a different game than your competitors. A game they can't play." The metagame is a strategy that involves understanding the structural or unconscious reasons that things are the way they are." Shane Parrish's team provides two examples of the metagame executed by Warren Buffet and Bill Belichick:

Warren Buffett uses the metagame to his advantage by taking public companies private. This enables Buffett to use long-term strategies that are available to private companies to promote their success. A public company by contrast must focus on quarter-to-quarter earnings gains to support their stock price.

Bill Belichick, among the greatest coaches in NFL history, traded away Jamie Collins, arguably the best defensive player on the Patriots, to the Cleveland Browns for a compensatory draft pick. His metagame was sacrificing a star player for the benefit of a well-integrated and coordinated team, a trade few coaches would dare to make.

We at Scarsdale Investment Group, Ltd. play a different metagame than other investment advisors and use a unique strategy. Most of Wall Street and financial advisors focus only on gains and losses through the trading of securities. Our strategy, which deals with buying and holding the highest quality individual bonds, is based on the generation of CASH FLOW from high quality bonds. Our strategy is simple to understand, straight forward to use and powerful. Our paycheck strategy is designed only for you, the individual investor.

Institutions can't use this strategy because they must "mark-to-market". This means that institutions ignore cash flow and report periodically on the gains and losses made by their investments. While mark-to-market makes sense for reporting on equities, it doesn't make sense for evaluating the performance of high-quality individual bonds for individuals.

The key to our metagame is that individual investors have no requirement or need to rely on gains and losses on their bond portfolios if their objective is cash flow and they will hold their bonds until they are called or come due. Crucially you are protecting your baseline needs by generating cash flow, while protecting your assets. You do not have to be an expert in diverse investment fields because you have homed in on a narrow crevice of the investment world – high quality individual bonds.

Bond Funds and ETFs

We address the reasons why we prefer individual bonds and not [bond funds](#) or [exchange traded funds](#) in other articles on our [website library](#). Also of interest is an article on the PIMCO website that explains why investors seeking a passive, index approach to municipal bond funds or ETF investing are misguided.[i]

> Passive portfolios don't prioritize tax efficiency and a highly fragmented muni market makes index replication costly and inefficient. Index-based approaches may also expose passive investors to outsize credit risk and may be pressured into buying low and selling high.

The municipal market is closer in nature to the Oriental rug market than the stock market, with many issues of diverse size and quality making indexing a nightmare. PIMCO prefers active funds that trade. However, if you chose the path of buying and holding high quality individual municipal bonds, you can avoid the pitfalls of both the active and passive funds.

Other Income Creating Alternatives

Annuities are often recommended for cash flow creation. However, you give away your principal forever if you buy one. You are dependent on the health of the annuity company for your payment. If you want your principal back you must try to sell the annuity at a discounted value.

Some stocks provide dividends that a company must declare annually. Dividends can be adjusted at a company's discretion. The most important difference between stocks and bonds is that bonds come due and fixed income provided by bonds is just that – fixed. Individual bonds are either called or they pay out their principal at their maturity date. Stocks never come due and thus are always speculations as to their future value. When you invest in stocks or any other asset class except high quality bonds, you leave your chips on the table until you close your position. If your stocks have appreciated then you face a conundrum: do you sell the stock and pay Uncle Sam or keep the stock and hope that it will continue to appreciate in the face of journalists penning forecasts of stock market corrections, adjustments, and doom.

Conclusion

We believe that the metagame that individual investors should play when they are planning for their retirement should be around individual bonds and cash flow. When you create your financial plan the focus would be on your needs rather than wants, and would result in a plan that would include a life time budget and a realistic plan for funding it. When doing retirement planning we believe that the most important question you should ask with respect to your portfolio is as follows:

How many dollars of reliable cash flow will my portfolio provide each year?

If you invest in individual high quality bonds, you will know the precise answer to this question.

Institutions promote an approach to investing that might be right for them, but wrong for you – the individual investor. If your strategy requires trading, financial institutions' staffs are pleased because it is a money maker for them. Article after article shows that frequent trading does not surpass a buy-and-hold strategy after fees, taxes and bad timing.

If your investment strategy requires that you mark-to-market you are making this bet: That interest rates will go down and the price of the bond will thus go up. If interest rates go up, the value of bonds goes down. Why a professional money manager should be hero if interest rates go down and a goat if interest rates go up makes no sense. No one has been successful in calling the direction of interest rates consistently over time.

In fact, if you play the metagame by focusing on cash flow, rising interest rates are to your benefit. If interest rates go up, you can reinvest interest coupons and bond proceeds when your bonds come due at a higher rate.

Consider one further thought regarding the state of the market where stocks are at an all-time high: What will be the outcome of your investment in stocks after the payment of taxes and fees? Is the worry of bad timing keeping you up at night? We address these key questions in the first chapter of our latest book entitled: Bonds: The Unbeaten Path to Secure Investment Growth, Bloomberg Press. John Wiley, 2nd edition 2011.

[i] David Hammer, Sean McCarthy and Samuel Weitzman. "Avoiding Passive Pitfalls in Municipal Strategies, PIMCO, July 2017.