Scarsdale Investment Group, Ltd.

All Bond Portfolios

Navigating Your Retirement: Bonds Actually Outperformed Stocks

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The received knowledge is that stocks have historically outperformed bonds and stocks will continue to outperform bonds in the future. But what if the facts are actually that bonds have historically outperformed stocks for the last 20 years and, in addition, for very long periods of time in the past? Would you then consider investing in bonds?

The underlying assumptions are that stocks will always outperform bonds and over time stocks will always go up. The first is not true and the second is unknowable.

We believe that the erroneous assumptions that stocks will always outperform bonds and stocks will always go up, may lead to substantial financial losses and ultimately a failed financial plan. The erroneous assumptions may be particularly harmful for those near or in retirement.

The Actual Facts: Stocks vs. Bonds

For the last 20 years ending December 31, 2019, stocks have not outperformed bonds.[i]

In addition, for many long periods of time bonds have outperformed stocks[ii]:

1803 -1871, 68-year span, bonds beat stocks.

1929-1949, 20-year span, bonds beat stocks.

1968-2009, 41-year span, bonds beat stocks.

Depending on who is counting and how they count, arguments can be made that bonds may outperform stocks or vice versa. On the one side is Professor Edward McQuarrie, a professor emeritus at the Leavey School of

Business at Santa Clara University, arguing that over the history of our country bonds outperformed stock in any ten-year period by 38.7%, and he sees this as a 4 in 10 possibility for the next decade.[iii] From his perspective, holding on long enough does not mean that stocks will end up on top.

Professor Jeremy Siegel's position, using a different data set, argues for stocks for the long run. He argues stocks will outperform bonds by 5-6 percent going forward in the next decade.

Rob Arnott, chairman of Research Affiliates, argues that stocks may beat bonds, but only by 1.3 percent, based on his calculations that the market is overvalued 92 percent of the time since 1881, among other calculations.[iv]

Despite these facts, we do not promote investing in bonds because of our prediction of future performance. Future performance is by definition unknowable.

We have a different strategy for investing which is particularly applicable to those investors near or in retirement. *Invest for Cash Flow, Not Market Appreciation, to Secure your Livelihood.*

<u>An Alternative Investment Strategy</u>

We believe that individual investors should consider the following investment strategy:

First, determine how much of your portfolio you wish to keep safe in the highest quality individual bonds and how much of your portfolio you wish to invest in risk assets such as stocks, real estate, commodities, options, etc. Remember that in 2000 and 2008, stock portfolios lost about 50% of their value. The stock market has been extremely volatile for the last several months. And despite the Corona virus, the stock indexes are approaching their all-time highs.

With the allocation of your portfolio that you wish to keep safe, buy a laddered portfolio of the highest quality individual bonds. We believe that the most important factor in the current volatile market is to PROTECT YOUR PRINCIPAL.

Buy these individual bonds with the intention of holding them until each one is called or comes due. Pay no attention to price movements since all bonds will be called or come due at their face value at some future time.

Rely upon the cash flow from the bonds to guide your financial plan.

What if You Need a Higher Return?

When bonds outperform stocks, it is the result of the prices of bonds rising. While that may seem like an unmitigated good if you are a trader, long-term investors seek to create a monthly cash flow from the interest payments produced by the bond portfolio. When bond prices rise and interest rates drop, it is much more difficult for an investor to create sufficient cash flow to take withdrawals without dipping into capital.

If your financial planner told you that you could take a 4 percent draw from your portfolio and your bonds were earning 4 to 5 percent per year, you were able to take the cash flow from your bonds and live the life you dreamed. At a 1 to 2 percent return, if you continue to withdraw at the same rate, you might find that your cash flow no longer supports your withdrawals. You might find that you will have to withdraw principal instead of income, thus curtailing the portfolio's longevity and throwing your retirement plans into disarray.

Faced with the need to generate more income, there are plentiful advertisements from banks and brokerage houses encouraging you to reach for yield by investing in riskier assets. When you consider such an investment, it may seem to you less risky because you know that you cannot live on the proposed income generated by bonds. However, the newspapers periodically report on an investor who was making such a great return that they went all-in, only to find that the investment took a bad bounce and they lost all their money. Losing half or more of your principal is a real possibility with many investments.

For example, an investment in Exchange Traded Notes, (ETNs), which are leveraged to augment market movements, lost Mr. William Marks all his money due to the impact of the corona virus on the economy. He started trading them after the 2008 crisis, trying to play catch up on his investments. He was scoring 18 percent a year, until the 67-year-old man found himself suddenly bankrupt.

> Banks and brokerage firms advertised ETNs as offering a payout both steadier and more lucrative than plain-vanilla investments such as bonds or index tracking funds.[v]

Unfortunately, for Mr. Marks and many others, buying the packaged products Wall Street engineered to give investors higher returns than plain vanilla products, to find they were only a delayed recipe for disaster.

How to Select Investments for Your Portfolio

Here are a series of questions that you can use to evaluate the investments that you are being offered.

- What are your objectives?
- What is proposed? Is it understandable?
- Is it similar to, or the same as, plain vanilla investments?
- Will the proposed investment:
    - Further your objectives?
    - Protect your principal?
    - Create cash flow?
- How can you/ do you evaluate the degree of risk?
- Is there a potential conflict of interest in the information presented?
- Have you reviewed independent sources of information to understand the complexities of the investment? Did your eyes glaze over?

Conclusion - A Possible and Simple Solution

Protect your principal as the most important consideration with respect to the allocation of your portfolio which you wish to keep safe.

We recommend buying high quality individual bonds to create a knowable cash flow.

Buy your individual bonds with the intention of holding them until each one is called or comes due. Pay no attention to price movements since all bonds will continue to pay their fixed coupon rate until they are called or come due at their face value.

Rely upon the cash flow from the bonds to guide your financial plan.

P. S. We recommend that you read *Once in Golconda by* John Brooks. Very timely. The book talks about 'diversity politics' on Wall Street, the stock market and its players in the United States between 1900 and 1938. It helps to put the current stock market in perspective.

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[i] Jeff Sommer. "Bonds Beat Stocks Over the Last 20 Years." *The New York Times.* May 1, 2020.
[ii] Robert Arnott. "Bonds: Why Bother?" *Journal of Indexes*, May-June 2009.
[iii] Mark Hulbert. "Will Stocks Trail Bonds Over the Next Decade?" *The Wall Street Journal.* June 8, 2020.
[iv] Arnott, op. cit.
[v] Akane Otahi and Sebastian Pellejero. "Bankrupt in Just Two Weeks! Individual Investors Get Burned by Collapse of Complex Securities," *The New York Times*, June 1, 2020.