Scarsdale Investment Group, Ltd.

All Bond Portfolios

THIS WE BELIEVE – The Paycheck Strategy for Lifetime Investing

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It is quite trying as professional investment advisors to implement an investment strategy (our "Strategy")[i] that is outside of the current investment paradigm. Promoting our Strategy puts us in opposition to most of the traditional views around investing. Instead of focusing on gains and losses, we recommend buying bonds that pay current interest for their cash flow. The bonds can come due over the course of years, returning your principal in a laddered succession. Need money in five years, buy a bond coming due in five-years. Looking for a higher yield, purchase bonds maturing in fifteen years instead. You define how the tailor-made bond ladder is constructed.

Our Strategy focuses on creating a predictable cash flow with very low risk for a nominal fee. This is a lonely place for us to stand and view the investment world. If our Strategy is of value, it then calls into question the accepted paradigm for individual investors, which is to diversify into ever riskier assets in the hope of gain, while not focusing on the impact of potential losses.

Our Strategy is simple, transparent, straight forward and easy to understand. However, being outside the accepted paradigm (The Balanced Portfolio), it may be difficult to accept as the best and most stress reducing path to attain financial independence. Here are the principles:

- *Financial independence is the goal*. Financial independence is based on adequate and predictable cash flow. We believe that you should let cash flow needs drive your investment strategy, not hope for gains from risk assets.

- *Paycheck creation is the method.* Paycheck creation is the method to achieve financial independence. The generation of predictable cash flow that you can draw upon if and when needed will provide a supplement if you are working part time, and can replace your paycheck when you are retired.
- *High quality individual bonds are the source.* The vehicle to financial independence is constructed from high quality individual bonds to create a sufficient cash flow to underpin your retirement planning. A bond ladder provides comfort as you see the resulting cash flow grow. This is a Paycheck that you can count on if you are working part-time or if you are retired and are involved in non-income producing activities.
- *Predictability is the result.* You may not be able to ride out market volatility like an institution. The timing of market highs may not coincide with your need to withdraw funds. If the market declines at the beginning of your retirement, your ability to have enough cash to fund a successful retirement may be compromised.

Trading vs Buy and Hold Bond Investing

The financial industry focuses on trading strategies, hoping for asset growth that may or may not materialize when you need to draw upon your assets for living expenses. Anticipation of high returns justifies high annual fees that are often inserted in pages of legalese so you are not even aware of what you are paying.

Mark to market accounting is for institutions, not individuals. Institutions must “mark to market” which means they must record gains and losses on their portfolio periodically. We believe that individual investors need not and should not be distracted by mark to market accounting when they are building a bond portfolio. The focus on trading leads to buying investments at market tops and selling at market lows. When you see stock market highs, it is reported that the Dow Jones Industrial Average returned minus -5.97% in 2018. Including dividend reinvest, the Dow Jones returned -3.48% in 2018, despite market highs. Over a 30-year period the average investor earned a 3.66% return, even though the S&P 500 had an average return of 6.73%.

The true goal of a reliable paycheck for individual investors is obscured by the focus on gains and losses inherent in all trading strategies. Bonds self-liquidate, meaning they are called (i.e. repurchased by the issuer) or they come due. Paycheck creation will enable you to know when you are approaching financial independence. You need merely to look at your yearly predictable interest paycheck rather than the current value of your portfolio. In 2000 and 2008 the value of many portfolios was reduced by 50% or more. However, those who were invested in high quality individual bonds saw no reduction in their investment paycheck.

High Quality Plain Vanilla Bonds

Putting aside how and why to measure performance, we believe individual investors who are planning their retirement should create a paycheck from bond interest payments. We believe they should buy and hold high quality plain vanilla individual bonds in a bond ladder.

High quality plain vanilla bonds usually pay interest twice a year. Interest, along with any return of principal, is automatically swept into a money market fund. You can let the interest accumulate until there are sufficient funds to purchase another bond, or schedule a regular disbursement of the payments. In this way, bond interest payments can replace a traditional paycheck because it is predictable.

These High quality individual bonds are a superior investment to equities and other risk assets when you take into account income taxes, investment fees and bad timing, and then risk adjust the performance however measured. When diversified portfolios are compared with individual bonds, the pundits do not take these factors into consideration, even on an estimated basis.

Impact of Fees

Fees, however, can be generally quantified. Jack Bogle, the founder of Vanguard, has critically looked at the costs of owning actively traded funds. He adds up investment management fees, trading costs, the drag of holding cash, sales costs, and the tax treatment of capital gains, all of which can add up to 2.66% per year.[ii] The Securities and Exchange Commission is also focusing on the impact of fees. Annual fees for investment advisory services and extra fees from banks and brokerage houses also add up. There are insurance product fees for optional features (riders), in addition to any mutual fund fees within the insurance product. Seemingly small or hidden fees can add as much as 1% annually and would reduce a $100,000 investment return by nearly $30,000 over 20 years.[iii]

Bond Ladder

A bond ladder of plain vanilla individual bonds customized for your individual situation is the foundation of the Paycheck strategy because there is a predictable return of principal. Every year you could have a bond coming due, returning the face value to you, as well as regular interest payments. For example, if you owned $10,000 Oklahoma State Water Resources Board Revolving Fund bonds due April 1st, 2025, the $10,000 would be returned to you on the due date. Meanwhile, every year you would be paid the interest on the bonds semi-annually. You need not incur any fees or trading costs once the bonds are purchased. This Paycheck will supplement your social security and bring you within a foreseeable range of financial independence. If not, you might consider the possibility of generating some earned income and a reduction of your cost of living to a place of equilibrium, predictability and comfort.

Our Purpose: Assist individuals in the creation of a predictable paycheck (cash flow from interest payments) by creating high quality plain vanilla bond portfolios.

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[i]The concepts of "plain vanilla bonds", "the all-bond portfolio" and bond ladders referred to in this short note are explained in detail in our latest book: ***BONDS: The Unbeaten Path to Secure Investment Growth,*** 2nd edition, John Wiley (Bloomberg Press), 2011 and also on our website: www.allbondportfolios.com
[ii]Jack Bogle. "The Arithmetic of 'All-In' Investment Expenses," Financial Analysts Journal, Volume 70, Number 1.
[iii]U.S. Securities and Exchange Commission. "Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio," June 26, 2019. https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-how-fees-expenses-affect