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Balance Sheet Bond–fire

By E. Peter Tiboris, CFP®, and Christopher Bremer

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As tens of millions of baby boomers enter retirement, many believe they should allocate a preponderance of their life savings in instruments where income is fixed (aka, bonds or fixed income). The convention "own your age in bonds" was financially justifiable when it was developed decades ago, however, the joint life expectancy of retiring couples today is far more than it was. Further, in the fixed income world today, there are two significant challenges: one secular (10 years or longer), the other cyclical. On the secular front, yields have been in a broad decline for 40 years. The U.S. 10-year Treasury yield peaked at 15.8 percent in September 1981 and has been in a steady decline ever since (today around 1.4 percent). The cyclical challenge currently is that real yields are negative. The real yield is simply the current risk-free rate minus the rate of inflation.

Mashing increased life expectancy along with secular and cyclical factors together, the result is a cocktail that is undeniably destructive to wealth and will put the comfortable retirement of many at risk. That should be somewhat intuitive if you define money correctly. The only sane definition of money is purchasing power—not currency. Today, with inflation on the rise, real yields negative, and little prospect for returns beyond that, bond investors are lighting their purchasing power on fire.

Most of the prospective clients who walk into our offices share two common goals:

1) Live a comfortable and worry-free retirement.
2) Pass as much as possible to family and charity.

Those prospects, by and large, are woefully under allocated to diversified equities for a myriad of reasons. They anchor to the convention that when one retires, they should allocate to bonds because they are "safe." They are frozen by the bombardment of the financial media's talking points designed to keep their eyes glued to advertisers. They are convinced that equities can't go higher and question whether the historic record can be used to inform decisions

ahead. In other words, they use the four most dangerous words in investing: "this time is different" (credit to legendary investor Sir John Templeton).

The goal of this commentary will be to demonstrate that from a relative perspective, given the two goals above, the primary risk to a retiring couple today is an arbitrary allocation to fixed assets. However, if your thesis is "this time is different," it's important to address the fundamental reason why an efficient market rewards a risk premium to equity investors.

"Today, with inflation on the rise, real yields negative, and little prospect for returns beyond that, bond investors are lighting their purchasing power on fire."

Equities offer a premium return over bonds. Period. According to data published by Robert Shiller, the average real (net of inflation) rolling 10-year excess return of stocks over bonds going back to 1871 is 4.33 percent, and the average since 1946 is 4.88 percent. However, the historical equity risk premium over bonds is not true because over history it has been true. Without a premium return in equity investments, the greatest economy in the world would not exist as we know it.

We all have had friends approach us to invest in their next great startup idea. They come to us because no bank lends to an idea. It lends to mature businesses with assets and cash flow—by definition, those businesses carry less risk. Startup businesses can only raise money via equity (or debt that converts to equity) because 90 percent of them fail. By that very nature, the premium return on equity investment comes from the risk of investing in something that is far less certain. Amazon could never have started without a world that rewards a premium return for equity investment. What about Apple? Or Tesla? Find a company that has changed the world starting as a transformational idea with borrowed money. We don't know of one. Nothing that the Federal Reserve, politicians, and/or (insert the talking point of the day) does changes that fundamental truth.

That distinction in equity investments extends to mature companies as well. If you buy a bond from Amazon, you stand ahead of equity holders in the capital structure. You have certainty in your interest payment and reasonable security in the return of your principal. While the price of the bond may fluctuate based on movements of interest rates, with a financially sound company your dollar loaned is worth a dollar at maturity. However, as a loaner you do not participate as Amazon changes the world. The owner participates in that progress even as their dollar fluctuates in price around the news of the day. Equity ownership is riskier than bond ownership, and hence the equity is expected to pay a premium over the debt.

Our job as advisers is to help clients formulate a plan that drives the most critical decision in the pursuit of optimal real-life investment returns: the relationship between equity and fixed assets. Most advisers take the easy path—they pander to a client's emotional proclivity for "safe" investments by constructing expensive portfolios of bond funds that are packaged with more risk than commonly understood. The industry at large doubles down and designs complex products that create the illusion you can have your cake (something that is safe) and eat it too (with higher returns). If you are ever curious what financial alchemy in the retail space

looks like, add a 200-page structured note or equity indexed annuity prospectus to your weekend reading. It's hard to see how any client can be expected to truly understand their inner workings.

As established prior, the premium return on equity investment is a natural law of our world. However, it's important to understand how it applies to portfolio decision making. While the investment community forecasts expected returns in various asset classes, the numbers themselves are not as critical applying relative advantage of owning versus loaning to portfolio decisions.

We can use Monte Carlo simulations to help understand that relative advantage. Monte Carlo is a mathematical tool used to tackle a wide range of problems in virtually every field such as finance, engineering, supply chain, and science. It is used to model the probability of different outcomes that cannot be easily predicted due to the intervention of random variables. In these simulations, the worst outcomes start with highly negative consecutive equity returns in the beginning of retirement. In examining the best and worst case for a retiring couple using varying asset mixes, the results comparing 500 different return paths are compelling, and for most clients unexpected.

One would expect that in a multi-decade retirement plan with a world of worst-case equity returns, a higher allocation to bonds would produce better outcomes. When looking at the results of hypothetical portfolio outcomes at life expectancy, in all findings the 10th percentile (50th worst) result vacillates remarkably close in a portfolio of 30 percent equities when compared to a portfolio of 70 percent equities. However, the 90th percentile (50th best) is magnitudes better in the latter. From that perspective, isn't it appropriate to redefine the conventional understanding of portfolio risk? Table 1 is based on the following assumptions:

- Current age: 54
- Retirement age: 65
- Current net asset value: $13,120,077
- Present value of expected retirement spending: $500,000
- Present value of retirement spending as percent total current assets: 4.0 percent
- Annual savings until retirement: $500,000
- Inflation: 2.25 percent

Table 1: Hypothetical Married Couple Retiring at 65; 500 Trials, Portfolio Values at Age 90

	Portfolio Outcomes	
	30% Equities / 70% Bonds	70% Equities / 30% Bonds
90th Percentile	$38,650,099	$109,510,343
50th Percentile	$14,746,284	$31,141,502
10th Percentile	$0	$2,283,388

IMPORTANT: Time horizon plays a critical role in these results, and there are other factors to considering when allocating assets. The projections or other information generated by the Monte Carlo Probability Analysis regarding the likelihood of various outcomes are hypothetical in nature, do not reflect actual investment or life results, and are not guarantees of future results. Results may vary with each use and over time.

We are not advocating for portfolios without bonds. All clients should have fixed assets in a planning framework to help weather inevitable bear market periods—that reserve helps equities in realizing their full potential. However, the asymmetry in worst/best outcomes in our Monte Carlo testing of retirement portfolios supports our assertion that an arbitrary allocation to fixed assets impacted by inflation is the primary risk to a multi-decade retirement and legacy investment portfolio. Most everything else is just noise.

Disclosure: All investments carry some level of risk. No investment strategy can guarantee a profit or protect against a loss.

Monte Carlo simulations assess the likelihood that you will have sufficient assets to generate a level of income adequate to cover your anticipated expenses during the