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Using an all-bond-portfolio approach for tough times

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In today's tough times, we believe that investment advisers can best preserve their clients' wealth by investing in an all-bond portfolio. We understand that this is antithetical to the current received knowledge that investors should diversify widely and hold their course through rough waters.

However, the financial seas are being roiled by a combination of a falling stock market, the worst real estate decline since the 1930s, the U.S. dollar's long-term decline, astronomical oil prices and the threat of serious inflation. In this environment, another course of action should be considered.

Investors are told to put their faith in the holy name of diversification, and they will be saved. But why diversify into multiple asset classes to reduce risk when in-vestors would be much safer if they bought only safe bonds?

When we refer to bonds for this article, we mean only the safest bonds, which we define here as Treasuries, U.S. agencies, Treasury inflation protected securities and high-grade munis. We are speaking here about strategies for individual investors, not institutions.

What we are proposing for this environment is a highly concentrated bet on bonds, the safest investment class in which individuals can invest. We believe that in rough times, individual investors should put their money into those investments that they do not have to watch and worry about, so that they can go on with their lives. We detailed our philosophy in our recent book, "Bonds: The Unbeaten Path to Secure Investment Growth" (Bloomberg Press, 2007).

We are told by none other than Professor Roger G. Ibbotson of Yale University in New Haven, Conn., that historically, stocks have re-turned about 10% and bonds 5%. Everyone has thus concluded that stocks are a better investment than bonds. However, we respectfully disagree. There is more to the story for individual investors. Individual in-vestors never got an historical return of 10%, because their stock returns were reduced by three elements.

First, federal, state and sometimes local income taxes must be paid on the gains.

Second, there are fees and ex-penses. William Bernstein examined fund management fees and reported the following in the April 2001 issue of Financial Planning: The average actively managed large-cap fund has annual fees and expenses of about 2%. The average small-cap and foreign fund has annual fees and expenses of about 4%. The average micro-cap and emerging-markets fund has annual fees and expenses of almost 10%.

Third, the most costly element of all may be bad timing in the buying and selling habits of individual investors.

Thus, the historical return that individual investors received after these three categories is probably around the return on tax-free individual municipal bonds. If these bonds are bought and held to maturity, they attract no tax, there are only minimum fees and no bad timing. After risk-adjusting stocks and safe bonds, the bonds are clearly a more desirable investment in these tough times.

Why take the risk of stocks in this environment?

If the typical individual investor actually earned a historical return of substantially less than 10% after the three categories of reductions, why would anyone believe that a 10% return or more would be earned in the future? Moreover, even if the three elements that reduced the 10% return in the past are ignored and an investor believes that a 10% return was earned in the past, what is the basis for planning for a 10% return in the future? The present and the future are clearly very different than the past.

Thus, no one knows what stocks will earn in the future. If there are losses followed by gains, individual investors may not have enough time to recoup their investment losses before retirement.

Investors' main gripe with bonds is that their yield is too low. How can they retire on a 4% to 5% return? But even if individual investors receive a gross return of 10% on stocks, they may not earn any more than the return on bonds after the three elements of taxes, fees and bad timing reduce their returns. And keep in mind that investing in stocks may result in losses. The belief that diversifying into five or 10 asset classes will outperform bonds is merely a hope, not an economic fact.

When the investment community talks about investing in bonds, it is usually in the context of total return — buy low and sell high. We believe that this approach is inappropriate for individual investors. For individual investors, the most important issue is not the gross return, but their cash flow after taxes, fees and expenses. Individuals want and need to have a predictable cash flow to enable them to have liquid assets in an emergency, to provide a safety net to deal with job risks, fund anticipated costs and to enable them to contemplate a safe and secure retirement.

How important to individual investors is safety and security in these troubled and tough times?

In tough times and with high individual stress, we think that safety and predictable cash flow is very valuable and may be the equivalent of higher yields in importance. When clients say that 5% won't enable them to retire, it may be the job of the financial adviser to nag his or her clients to save more. How can an adviser promise higher returns that no one can predict will actually occur?

Consider this: If you concluded that in the upside case, after taxes and expenses, a client's return might be about 6% or 7%, but alternatively, the client might have significant losses, would you consider a much larger allocation to bonds?

Inflation is raised as the specter that will destroy bond investors. However, inflation is a pox on all investments, particularly stocks. During the horrible inflation of the 1970s in the United States, stocks crashed in 1973-1974. In 1973 stocks lost 14.6% and in 1974 stocks lost an additional 26.5%. Moreover, be-tween 1966 and 1981 stocks essentially provided no positive return.

The only safe way to deal with inflation is to save more money. We always stress to clients that if inflation results in rising interest rates, this is very desirable. Rising interest rates provide a great advantage if you have a bond ladder because you can reinvest the interest earned and principal that comes due each year in higher-yielding bonds.

Since 2000, our bond investments have increased by almost 50% without incurring any significant risks — that is, a compounded rate of return of 5% for eight and a half years, assuming the interest is reinvested in additional bonds.

Here we are singing the praises of individual bonds, not bond funds. Bond funds are not bonds; they are quasi-equities, because bond funds do not come due. Thus, bond funds have a significant risk compared to individual bonds because individual bonds can be purchased to create a bond ladder. In addition, there are more expenses and possibly high fees and taxes associated with bond funds, particularly actively managed bond funds.

In this market, we find that tax-free munis make sense for the taxable accounts of almost all of our clients. We buy Treasury, Treasury inflation-protected securities and agency bonds for our clients' pension and individual retirement accounts.

Nassim Taleb's recent book, "The Black Swan: The Impact of the Highly Improbable" (Random House Inc., 2007), describes the unfortunate consequences of unpredictable events. Bell curves and standard deviations don't take into account the risk of the black swans, so they can't be trusted. Investors should be even more careful these days because of the appearance of even more black swans than usual — consider, for example, the real estate collapse, structured investments that didn't work and oil that's $145 a barrel.

We believe that many clients fall into two cases. If a client is of modest means he or she can't afford to risk any of his money in the current market and should invest in money market accounts and short-term Treasuries because they may need their money at any time. If the person is wealthy, why should they take the risk of losing a great deal of money in this volatile market when they can be safe and have a significant cash flow from their bond investments?

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