THIS WE BELIEVE – The Paycheck Strategy for Lifetime Investing[i]
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The Paycheck Strategy for Lifetime Investing ("Strategy") is outside of the current investment paradigm of professional investment advisors. While it is a strategy that our parents may have used in various forms many years ago, in its simplest form, it is a viewpoint that has fallen out of favor in today's investment environment.

Instead of focusing on periodic investment gains and losses, we recommend buying individual bonds that pay current interest for their cash flow. We also recommend buying deferred interest (zero- coupon) bonds to provide a lump sum of cash at some specific time in the future. Creating a predictable cash flow will enable you to focus on the important activities or people in your life without worrying that the markets are moving against you and you have to take action. If you have enough job-related income to live on and you do not need the current cash flow from your individual bonds, then the cash flow from your bonds can be reinvested for growth at a compound rate of interest. If you start early in your life your savings will have many years to grow.

Unlike institutions and corporations that may live forever, an individual has a finite life. An individual investor needs to know how much cash he or she will have to live on so they can tailor their lifestyle accordingly. We believe that you should match the due date of your bonds to pay for your known obligations. In addition, you should have cash flow to sustain yourself currently or set aside some or all of your cash flow to increase your principal at a predictable compound rate of return.

Your bonds can come due over the course of years, thereby returning your principal in a laddered succession. Your bond ladder should be custom made for you to meet your financial and life objectives. In 2014, a ladder of longer-term bonds maturing between 15 and 25 years provides the most return.

Our Strategy focuses on creating a predictable cash flow from high quality individual bonds which have a very low credit risk profile. 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 traditional knowledge of the accepted paradigm for individual investors, which focuses on gains and losses from a diversified portfolio in many asset classes.

Our Strategy is simple, transparent, straight forward and easy to understand. However, being outside the accepted paradigm of 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 of our Strategy:

- *Financial Independence is the goal.* The method is to generate predictable cash flow from a portfolio of high-quality individual bonds that you can draw upon if

and when needed to provide a supplement if you are working part-time, and to replace your paycheck when you are no longer working. The buildup of a bond ladder to create a sufficient cash flow underpins retirement planning.

- *Paycheck creation is the method.* Semi-annual interest payments from your portfolio of individual bonds provide comfort as you see the resulting cash flow grow. This is a Paycheck you can count on if you are working part-time, or if you are involved in non-income producing activities. Accordingly, we believe that you should let your cash flow needs drive your investment strategy, not hoped for gains from a diversified portfolio. This is the guiding principle of our Strategy that can help you build the financial foundation for a life you love.
- *This is a Strategy for Individuals.* Institutions can live forever. However, unlike institutions, individuals have finite lives and may not be able to ride out market volatility. The timing of market highs may not coincide with your need to withdraw funds. If there is a timing mismatch, your ability to have enough cash to fund a successful retirement may be compromised.

Trading vs Buy and Hold Bond Investing

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. Brad Barber and Terrance Odean, professor at the University of California, did many analyses of trading behavior of individual investors.[ii] They conclude that individual investors underperform standard benchmarks for low-cost index funds because of a series of behaviors. These include selling winning investments while holding losing investments, even though recent winners tend to do better than recent losers, - holding undiversified portfolios, are overconfident, and lack a persistent focus, among others. While you may think that if you are dedicated to putting in the 10,000 hours Malcolm Gladwell popularized, new studies show that putting in the hours will only help you in fields with a clear structure, like music or chess.[iii]

Investment professionals also fail on the measure of persistent achievement, defined by Daniel Kahneman, the Noel Prize winner in Economics[iv] He writes: "The evidence from more than fifty years of research is conclusive: for a large majority of fund managers, the selection of stocks is more like rolling dice than like playing poker. Typically, at least two out of three mutual funds underperform the overall market in any given year."

Kahneman continues by saying that though there is statistical proof that in an efficient market, individuals, whether professional or not, cannot outperform the market

on skill alone. The results, he says, are more like what you would get from rolling the dice than from skill alone.

Though the stock market has had an overall upward trajectory over the last five years, there have been many downdrafts leaving individual investors with major losses of one third to half their assets. Within recent memory there were crashes in 1987, 2000 and 2008. The stock market is now at an all-time high, with many pundits saying that we are at the calm before another stormy market drop.

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 often justifies high annual fees. The reality may be different. For example, you might lose your job when the economy turns down and to generate cash, you might have to sell some of your stocks at the worst possible time.

Financial Independence

The important goal of a reliable paycheck for individual investors is obscured by the focus on gains and losses inherent in all trading strategies. Paycheck creation will enable you to know when you are approaching financial independence, the ability to live on your interest income from a portfolio of bonds. You need merely to look at your yearly predictable interest paycheck rather than the current value of your portfolio.

Those who were invested in high quality individual bonds saw no reduction in their investment paycheck, or in the value of their bonds after the crashes in 1987, 2000 and 2008. However, we know that bonds will fluctuate in value, though the cash flow from individual bonds will remain the same. Some pundits will say the failing of bonds is that rising interest rates will result in losses. We respond by saying that if you are reinvesting some or all of the income, rising interest rates are the upside case. Would you rather reinvest at higher or lower yields? And remember, unlike any other asset class, individual bonds are self-liquidating, i.e., they come due at a specified date.

Bond investors often achieve their financial independence by being portfolio people. That is a person who draws cash flow from a number of sources. For example, you might have income coming in from a pension, part-time work, bonds, and social security. Investing in bonds may enable you to delay taking social security at an early date. The cash flow from the bonds would substitute for the social security income. It is well known that if you can delay taking social security until the normal retirement age of 66, or 67 if you were born in 1960 or later, your benefit increase would be a predictable 8 percent per year, much more than any other conservative investment.

High Quality Plain Vanilla Bonds

High quality plain vanilla 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.

Fees, however, can be generally quantified. Jack Bogle, 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.[v] 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.[vi] Seemingly small or hidden fees can add as much as 1% annually and would reduce a $100,000 investment by nearly $30,000 over 20 years.[vii] Morningstar estimates, for example that "the average large stock funds earned 4.5% a year in the 15 years to June 30th, 2013, but the average investor earned just 2.59%, due to high fees."[viii]

Bond Ladder

A bond ladder of high-quality individual bonds customized for your specific situation is the foundation of the Paycheck system because there is a predictable cash flow and a predictable return of principal. Ever year you could have a bond coming due, returning the face value of 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 other sources of income and bring you within a foreseeable range of financial independence. If not, you should consider the possibility of generating some earned income and a reduction of your cost of living to a place of equilibrium, predictability and comfort. As William Bernstein, an investment advisor, explains, "The purpose of investing is not simply to optimize returns and make yourself rich. The purpose is not to die poor."[ix]

[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, Bloomberg Press, 2011 and on our website: www.allbondportfolios.com.

[ii] Brad M. Barber and Terrance Odean. “The Behavior of Individual Investors,” in *Handbook of the Economics of Finance, ed.by Constantnides, Harris, and Stulz, pp. 1533-1569, 2013.*
[iii] Drake Baer. “New Study Destroys Malcolm Gladwell’s 10,000 Hour Rule, www.*BusinessInsider.com,* July 3, 2014.
[iv] Daniel Kahneman. *Thinking fast and Slow,* New York: Farrar, Straus and Giroux, 2011, p. 214.
[v] Jack Bogle. “The Arithmetic of ‘All-In’ Investment Expenses,” F*inancial Analysts Journal,* Volume 70, Number 1.
[vi] U.S. Securities and Exchange Commission. “Variable Annuities,” www.investor.gov, SEC Pub. No. 154, February 2014
[vii] U.S. Securities and Exchange Commission. “How Fees and Expenses Affect Your Investment Portfolio,” www.investor.gov, SEC Pub. No. 164, February, 2014.
[viii] Buttonwood. “The costs of actively managed funds are higher than most investors realize,” *Economist.com/blogs/buttonwood,* February 22, 2014, p.62.
[ix] “No Easy Answers: The conundrum of asset allocation,” *The Economist, July 19, 2014, p.63*