Why Buy Bonds in A Low Interest Rate Environment?
Stan Richelson, *Scarsdale Newsletter, 8/6/12*

For financial advisors who promote the sale of stocks, an 8 percent annual average return is a given, even if that return has not been realized recently. For some pundits, it is always the right time to buy stocks.

In *The New York Times,* Jeff Sommer[i] lays out the usual case for why stocks are currently a good investment and bonds a bad investment. Sommer's article is based on a new position paper by Seth J. Masters, chief investment officer of Bernstein Global Wealth Management, entitled "The Case for the 20,000 Dow." Here are the major arguments for currently investing in stocks rather than bonds as stated by Sommer:

1. Investors may have lost their taste for stocks because of market volatility, violent ups and downs.
2. Stocks over the next 10 years may be less risky in some respects than United States Treasury bonds because the world has faced dire conditions before and the stock market has bounced back.
3. Bonds are now extraordinarily overvalued and stocks are undervalued. As a consequence, stocks are extremely likely to outperform bonds over the next 10 years. Bonds have extremely low yields. Stocks are well below their long-term average for U.S. and global equities based on conservative assumptions about market conditions. Masters projects an 8% median annual return for U.S. and global stocks.

The Case for Bonds

We believe that although the yield on bonds has gone down over the last 5 years and is historically at a low rate, bonds are still an excellent investment for investors who wish to preserve their principal and generate a predictable cash flow of tax-free income. We will look at the arguments set forth above and respond to them.

It is true that investors have lost their taste for stocks not so much because of the volatility, but because of the substantial losses that they have incurred. These losses are due to the Dot-Com crash in 2000 and the blood bath in 2008. Two massive stock market crashes in 8 years have demonstrated to investors preparing for retirement or in retirement that stocks can't be trusted to grow steadily and to provide the required predictable cash flow when needed over a long period of time. A retirement fund must be designed to last for 20 to 40 years. How do you deal with a big crash and a 30 to 50 percent decline in assets when you are no longer working and earning more money? No one objects to volatility when it results in big gains on stocks.

Sommer suggests that stocks are set for a rebound in the next ten years. However, the economists Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff[ii] have a much different view of future economic growth in the U.S. due to our massive debt that has built up over the last four years. They studied 26 episodes of public debt overhang in advanced economies since the early 1800s, characterized by public debt to Gross Domestic Product levels exceeding 90 percent for at least five years. They found that the result of this massive debt overhang was substantially lower economic growth and the average duration of this reduced economic growth was 23 years. In addition, they reported that even when the country had continual access to low interest rates, low growth continued. Low economic growth does not generally support a booming stock market.

Furthermore, the comparison of stocks is always made to Treasury bonds, and sometimes even to Treasury bills, the shortest term and most risk free investment. However, Treasuries are just one part of the bond market. And even the category of Treasuries is quite broad and includes Treasury bills, notes, bonds and Treasury Inflation Protected securities (TIPs). Because of the low rates on 10 to 20 year Treasuries, we are not currently recommending Treasuries. On August 7, 2012 the return on the 10 year benchmark Treasury bond was 1.63%. Treasury bonds offer the lowest yield of any kind of bond because they are actively traded and considered safe from default.

We do recommend a bond ladder of 15 to 23 years consisting of very high quality tax-free municipal bonds, especially for investors in higher tax brackets. The tax-free return here is about 3.5% which equates to a 5.2% pre-tax equivalent return to a taxpayer in the 33% marginal tax bracket. Keep in mind that if the US Congress does nothing, marginal tax brackets may increase.

For investors who own no individual bonds currently, we are recommending a bond ladder of 15 to 23 years, because that is where an investor can get the greatest return on invested dollars. For each $100,000 invested in such a ladder, there would be a predictable tax-free cash flow of about $3,500. Even if interest rates were to change, the cash flow payable by the bond ladder will not change because the bond coupons will not change.

The fact that the stock market has bounced back from substantial losses when economic conditions have improved is a rather weak argument for a number of reasons:

What has happened in the past is not predictive of the future because the future is different than the past. The prediction of 8% compounded stock returns based upon the past may be wishful thinking in our present environment. Of course, no stock strategist has ever predicted a loss on a stock portfolio.

It is not clear that there will be substantial economic improvements in the near future from today's economy.

Many of the so-called defensive stocks today are richly priced. Investors are worried about the next financial meltdown and are willing to pay a premium - as much as 30 percent as of August 3, 2012.[iii] These investors fear that there may be substantial losses rather than near term future gains.

Finally, here is the most important point to our strategy. The general way that all analysts evaluate the stock market or the bond market is to record gains and losses. Thus, if interest rates go up, a loss is recorded in the bond portfolio. However, as we suggested above, our strategy is based on cash flow, not gains and losses. Thus, in our way of looking at the bond market, rising interest rates are the upside case because as interest payments come in and as bonds come due or are called, the cash flow would be invested at a higher rate of return.

We offer a final thought about comparing stocks and bonds. We believe that to correctly compare stocks and bonds, you must reduce the return on stocks by income taxes, which have a delayed effect, fees that are often hidden and bad timing and judgment, about which much is being written.[iv] And after you make these three adjustments, you must risk adjust the return on stocks and compare it to the return on a portfolio of high quality individual bonds. When all this is done, you will see that even at today's interest rates, tax-free muni bonds are an excellent investment. And that prediction of an 8% return on stocks, even if it happens, will be greatly diminished after taxes, fees and bad timing are deducted (let alone the abuse of your stomach).

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[i] Jeff Sommer. "The Long-Term Argument for Dow 20,000," *The New York Times.* July 22, 2012, BU12.

[ii] Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff. "Debt Overhangs: Past and Present," *NBER Working Paper No. 18015*, April 2012.

[iii] Ben Levishon. "Stocks: The 'Safety' Dance," *The Wall Street Journal*, April 3, 2012.

[iv] Daniel Kahneman. *Thinking Fast and Slow. pp 212-216.*