

Why Bother With Bonds?

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By John Mauldin

Investors, we are told, demand a risk premium for investing in stocks rather than bonds. Without that extra return, why invest in risky stocks if you can get guaranteed returns in bonds? This week we look at a brilliantly done paper examining whether or not investors have gotten better returns from stocks over the really long run and not just the last ten years, when stocks have wandered in the wilderness. This will not sit well with the buy and hope crowd, but the data is what the data is. Then we look at how bulls are spinning bad news into good and, if we have time, look at how you should analyze GDP numbers. Are we really down 6%? (Short answer: no.) It should make for a very interesting letter.

And for the last time, let me remind you of the Richard Russell Tribute Dinner this Saturday, April 4 in San Diego. We have had over 400 of Richard's fans (I guess you could say we are all groupies) sign up. A significant number of my fellow writers and publishers have committed to attend. It is going to be an investment-writer, Richard-reader, star-studded event. You are going to be able to rub shoulders with some very famous analysts and writers. If you are a fellow writer, you should make plans to attend or send me a note that I can put in the tribute book we are preparing for Richard. And feel free to mention this event in your letter as well. We want to make this night a special event for Richard and his family of readers and friends. So, if you haven't, go ahead and log on to <https://www.johnmauldin.com/russell-tribute.html> and sign up today. The room will be full, so don't procrastinate. I wouldn't want any of you to miss out on this tribute. I look forward to sharing the evening with all of you. I am really looking forward to that evening.

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If stocks outperform bonds by as much as 5% over the long run then, for our truly long-term money, why should we bother with bonds? Why not just ignore the volatility and collect the increased risk premium from stocks? That is the message of those who believe in "Stocks for the Long Run" and also from those who want you to invest in their long-only mutual fund or managed account program. Indeed, it is always a good day to buy their fund.

One of my favorite analysts is my really good friend Rob Arnott. Rob is Chairman of Research Affiliates, out of Newport Beach, California, a research house which is responsible for the Fundamental Indexes which are breaking out everywhere (and which I have written about in past letters), as well as the only outside manager that

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PIMCO uses, for his asset allocation abilities. He has won so many industry awards and honors that I won't take the time to mention them. In short, Rob is brilliant.

He recently sent me a research paper that will be published next month in the *Journal of Indexes*, entitled "Bonds: Why Bother?" The publisher of the journal, Jim Wiandt, has graciously allowed me to review it for you prior to it actually being sent out. The entire article will be available when the *Journal of Indexes* goes to print in late April, at www.journalofindexes.com. Qualified financial professionals can also get a free subscription there to pick up the print copy. There is some very interesting research at the website. But let's look at a small portion of the essay. I am reducing 17 pages down to a few, so there is a lot more meat than I can cover here, but I will try and hit a few things that really struck me.

It is written into our investment truisms that investors expect their stock investments to outpace their bond investments over really long periods of time. Rob notes, and I confirm, that there are many places where investors are told that stocks have about a 5% risk premium over bonds.

By "risk premium," we mean the forward-looking expected returns of stocks over bonds. As noted above, if you do not think stocks will outperform bonds by some reasonable margin, then you should invest in bonds. That "reasonable margin" is called the risk premium, about which there is some considerable and heated debate.

Most people would consider 40 years to be the "long run." So, it is rather disconcerting, or shocking as Rob puts it, to find that not only have stocks not outperformed bonds for the last 40 plus years, but there has actually been a small negative risk premium.

In a footnote, Rob gets off a great shot, pointing out that the 5% risk premium seen in a lot of sales pitches is at best unreliable and is probably little more than an urban legend of the finance community.

How bad is it? Starting at any time from 1980 up to 2008, an investor in 20-year treasuries, rolling them over every year, beats the S&P 500 through January 2009! Even worse, going back 40 years to 1969, the 20-year bond investors still win, although by a marginal amount. And that is with a very bad bond market in the '70s.

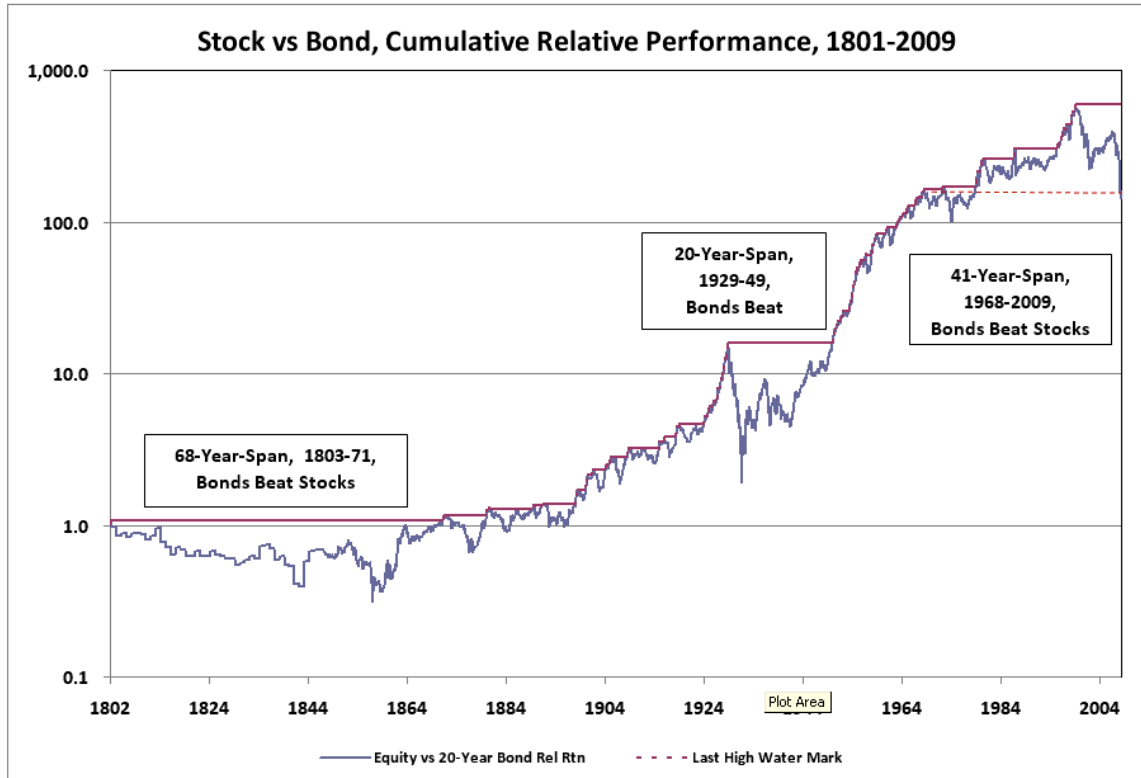
Let's go back to the really long run. Starting in 1802, we find that stocks have beat bonds by about 2.5%, which, compounding over two centuries, is a huge differential. But there were some periods just like the recent past where stocks did in fact not beat bonds.

Look at the following chart. It shows the cumulative relative performance of stocks over bonds for the last 207 years. What it shows is that early in the 19th century there was a period of 68 years where bonds outperformed stocks, another similar 20-year

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period corresponding with the Great Depression, and then the recent episode of 1968-2009.

In fact, note that stocks only marginally beat bonds for over 90 years in the 19th century. (Remember, this is not a graph of stock returns, but of how well stocks did or did not do against bonds. A chart of actual stock returns looks much, much better.



Bill Bernstein notes that in the last century, from 1901-2000, stocks rose 9.89% before inflation and 6.45% after. Bonds paid an average of 4.85% but only 1.57% after inflation, giving a real yield difference of almost 5%. In the 19th century the real (inflation-adjusted) difference between stocks and bonds was only about 1.5%.

In the late '90s, stock bulls would point out that there was no 30-year period where stocks did not beat bonds in the 20th century. The 19th century for them was meaningless, as the stock market then was small, and we were now in a modern world.

But what we had was a stock market bubble, just like in 1929, which convinced people of the superiority of stocks. And then we had the crash. Also, from 1932 to 2000 stocks beat bonds rather handily, again convincing investors that stocks were almost riskless compared to bonds. But in the aftermath of the bubble, yields on stocks dropped to 1%, compared to 6% in bonds. If you assumed that investors wanted a 5% risk premium, then that means they were expecting to get a compound 10% going forward from stocks. Instead, they have seen their long-term stock portfolios collapse anywhere from 40-70%, depending on which index you use.

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So what is the actual risk premium? Rob Arnott and Peter Bernstein wrote a paper in 2002 about that very point. Their conclusion was that the risk premium seems to be 2.5%. Arnott writes:

“My point in exploring this extended stock market history is to demonstrate that the widely accepted notion of a reliable 5% equity risk premium is a myth. Over this full 207-year span, the average stock market yield and the average bond yield have been nearly identical. The 2.5 percentage point difference in returns had two sources: inflation averaging 1.5 percent trimmed the real returns available on bonds, while real earnings and dividend growth averaging 1.0 percent boosted the real returns on stocks. Today, the yields are again nearly identical. Does that mean that we should expect history’s 2.5 percentage point excess return or the five percent premium that most investors expect?”

“As Peter Bernstein and I suggested in 2002, it’s hard to construct a scenario which delivers a five percent risk premium for stocks, relative to Treasury bonds, except from the troughs of a deep depression, unless we make some rather aggressive assumptions. This remains true to this day.”

One other quick point from this paper. Just as capitalization-weighted indexes will tend to emphasize the larger stocks, many bond indexes have the same problem, in that they will overweight large bond issuers. At one point in 2001, Argentina was 20% of the Emerging Market Bond Index, simply because they issued too many bonds. If you bought the index, you had large losses. The same with the recent high-yield index which had 12% devoted to GM and Ford. In general, I do not like bond index funds, and this is just one more reason to eschew them.

So Then, Bonds for the Long Run?

Let me be clear here. I am not saying you should put your portfolio in 20-year bonds, or that I even expect 20-year bonds to outperform stocks over the next 20 years. Far from it! The lesson here is to be very careful of geeks bearing charts and graphs (it will be a challenge for my Chinese translator to translate that pun!). Very often, they are designed with biases within them that may not even be apparent to the person who created them.

Professor and Nobel Laureate Paul Samuelson in late 1998 was quoted as saying, a bit sadly, “I have students of mine – PhDs – going around the country telling people it’s a sure thing to be 100% invested in equities, if only you will sit out the temporary declines. It makes me cringe.”

When someone tells you that stocks always beat bonds, or that stocks go up in the long run, they have not done their homework. At best, they are parroting bad research that makes their case, or they are simply trying to sell you something.

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As I point out over and over, the long-run, 20-year returns you will get on your stock portfolios are VERY highly correlated with the valuations of the stock market at the time you invest. That is one reason why I contend that you can roughly time the stock market.

Valuations matter, as I wrote for many chapters in *Bull's Eye Investing*, where I suggested in 2003 that we were in a long-term secular bear market and that stocks would be a difficult place to be in the coming decade, based on valuations. I looked foolish in 2006 and most of 2007. Pundits on TV talked about a new bull market. But valuations were at nosebleed levels. And now?

I have been doing a lot of interviews with the press, with them wanting to know if I think this is the start of a new bull market. There are a lot of pundits on TV and in the press who think so. I also notice that many of them run mutual funds or long-only investment programs. What are they going to do, go on TV and say, "Sell my fund"? And get to keep their jobs?

Am I accusing them of being insincere? Maybe a few of them, but most have a built-in bias that points them to the positive news that would make their fund (finally!) perform. And believe me, I can empathize. It is part of the human condition. But you just need to keep that in mind when you are thinking about investing in a new fund, or rethinking your own portfolio.

P/E Ratios at 200? Really?

Just for fun, when I was interviewing with the *New York Times* today, I went to the S&P web site and looked at the earnings for the S&P 500. It's ugly. The as-reported loss for the S&P 500 for the 4th quarter was \$23.16 a share. This is the first reported quarterly loss in history. That almost wipes out the expected earnings for the next three quarters. For the trailing 12 months the P/E ratio, as of the end of the second quarter, is 199.97. Close enough to 200 for government work.

But it gets worse. The expected P/E ratio for the end of the third quarter is (drum roll, please) 258! However, taking the loss of the fourth quarter off the trailing returns allows us to get back to an estimated P/E of 23 by the end of 2009. The problem is that you have to believe the estimates, which I have shown are repeatedly being lowered each quarter, and which I expect to be lowered by at least another 25% in the coming months.

Now, much of that loss is coming from the financials, which showed staggering write-offs of \$101 billion, \$28 billion coming from (no surprise) AIG alone. Sales across the board are down almost 9%, with 290 companies reporting lower sales.

This quarter the estimated consensus GDP is somewhere between down 5% to down 7%. Last quarter we were down an annualized 6.3%. That would be two ugly quarters back to back. It is hard to believe earnings for nonfinancial companies are going to be all that much better.

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Side note: The economy did not contract at 6.3% in the 4th quarter. That is an annualized number. The quarter actually contracted at about 1.6%. If we go a whole year with a 6% contraction, that would be truly horrendous. We would blow right on through 10% unemployment. While it is possible, we should start to see somewhat better numbers in the second half of the year, although I still think they will be negative.

Mark-to-Market Slip Slides Away

But it is quite possible that the financial stocks see an improvement in earnings this quarter. The US Financial Accounting Standards Board (FASB) changed the mark-to-market rules last week, which many (including your humble analyst) thought was needed. First, they suspended the mark-to-market rules for assets in distressed markets. Second, they widened the definition of “temporary” impairments of troubled assets, which will “allow banks to write up the value of some troubled assets if these have been hit by falling markets without (yet) suffering any significant credit losses.” (www.gavekal.com)

Here’s the important part. The board decided to make the new changes effective immediately, prior to full board approval on April 2.

As my friend Charles Gave noted, this will allow banks to write up their paper, and it happens before Treasury Secretary Tim Geithner starts putting taxpayer money at risk. Expect to see a pop in valuations. It will be interesting to see if Citi and B of A post profits this quarter.

(I should note that the International Accounting Standards Board sent out a scathing press release. I guess from that we should assume that European banks will not be so fortunate as their US counterparts.)

In theory, as I understand it, the information will still be there, but the way it will be recorded will not be reflected in the profit and loss statement. I understand that this is a very controversial proposal, and I expect many readers will disagree. The key is whether or not the information is available to investors and how the proposals are put into actual practice. If there is abuse, and regulators should be all over this, then the old rules must quickly go back into place.

This could put some strength back into financials, at least until the commercial mortgage and credit card problems start having to be written off. At the least, it could make for another solid rise in the stock market until we start to get what I expect to be very bad 1st and 2nd quarter earnings.

Housing Sales Improve? Not Hardly

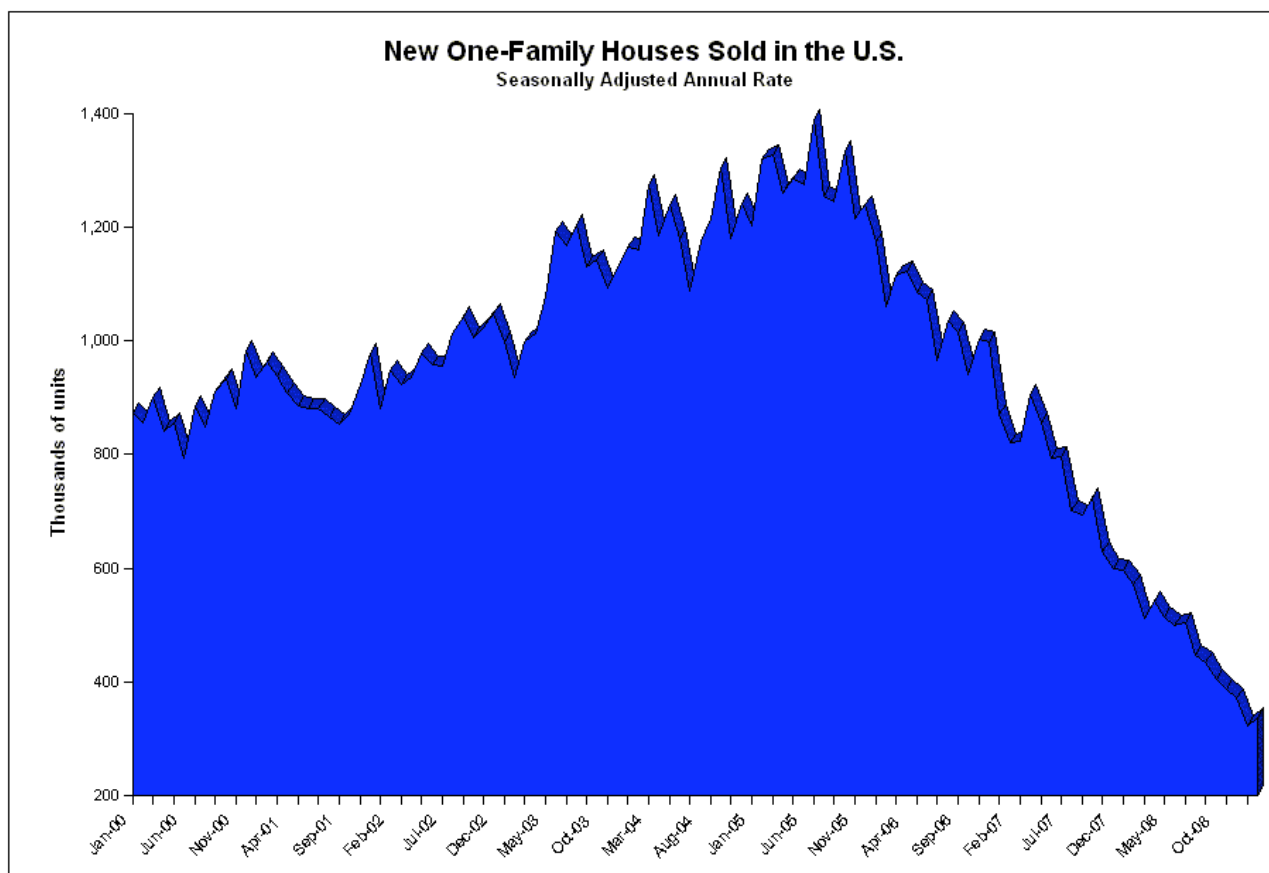
I opened the *Wall Street Journal* and read that new home sales were up in February. Bloomberg reported that sales were “unexpectedly” up by 4.7%. I was

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intrigued, so I went to the data. As it turns out, sales were down 41% year over year, but up slightly from January.

But if you look at the data series, there was nothing unexpected about it. For years on end, February sales are up over January. It seems we like to buy homes in the spring and summer and then sales fall off in the fall and winter. It is a very seasonal thing. If you use the seasonally adjusted numbers, you find sales were down 2.9% instead of up 4.7%. But the media reports the positive number. Interestingly, they report the seasonally adjusted numbers for initial claims, which have been a lot better than the actual numbers. Not that they are looking to just report positive news, you understand.

Plus, as my friend Barry Ritholtz points out, the 4.7% rise was “plus or minus 18.3%”. That means sales could have risen as much as 23% or dropped 13%. We won't know for awhile until we get real numbers and not estimates. Hanging your outlook for the economy or the housing market on one-month estimates is an exercise in futility, and could come back to embarrass you.



But that brings up my final point tonight, and that is how data gets revised by the various government agencies. Typically with these government statistics, you get a preliminary number, which is a guess based on past trends, and then as time goes along

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that data is revised. In recessions like we are in now the revisions are almost always negative.

There is no conspiracy here. The people who work in the government offices have to create a model to make estimates. Each data series, whether new home sales, employment, or durable goods sales, etc., has its own unique sets of characteristics. The estimates are based on past historical performance. There is really no other way to do it.

So, past performance in a recession suggests higher estimates than what really happens. Then, the numbers in the following months are revised downward as actual numbers are obtained. But the estimates in the current months are still too high. That makes the comparisons generally favorable, at least for one month. And the media and the bulls leap all over the “data,” and some silly economist goes on TV or in the press and says something like, “This is a sign that things are stabilizing.” It drives me nuts.

Ignore month-to-month estimated data. The key thing to look for is the direction of the revisions. If they are down, as they have been for over a year, then that is a bad sign. Further, one month’s estimates are just noise. Look at the year-over-year numbers. When the direction of the revisions is positive and the year-over-year numbers are starting to stabilize, then we will know things are starting to turn around.

La Jolla, Copenhagen, London, etc.

April is a travel month. Next week I am going to a presentation in Irvine on the state of stem cell research, which I must admit fascinates me. Then I’m in La Jolla for my Strategic Investment conference, co-hosted with my partners Altegris Investments. Then home for a week. Easter weekend, all seven kids will be home. Then the next week I go to Copenhagen for a board meeting; and I will be in London, Thursday April 16 to meet with my European partners, Absolute Return Partners, and clients. The next weekend I go back to California for a conference, and then the next week I’ll be a day or so in Orlando, where I’ll speak at the CFA conference on the state of the alternative investment industry.

While I’m in London, I need to drop by and buy a pint for David Stevenson, a columnist for the *Financial Times*. Seems that he was asking his readers for nominations for best financial websites. For whatever reason, he decided I deserved a special award: “Best online commentator goes to US analyst John Mauldin, whose weekly letters at www.frontlinethoughts.com are required reading for all the big City-based bears I encounter.” It’s nice to be appreciated.

At the end of May (29-31), I will be in Naples, where I will be doing a seminar with Jyske Global Asset Management and Gary Scott. I will try to line up a web site where you can see whether you would like to attend.

It’s after midnight and time to hit the send button. The day simply vanished on me, although I did get to the gym, at least. I am working hard, but somebody turned the dial down on my metabolism.

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Have a great weekend. It is spring in the northern hemisphere, and the azaleas in Texas are awesome this year. Make sure you stop and enjoy nature a little this spring (or fall, for you blokes Down Under).

Your getting more skeptical of data as I get older analyst,

John Mauldin