Third Quarter 2021 Investor Letter

Review

The third quarter was the first down quarter of the year for equities as declines in September outpaced modest gains in July and August. Growth stocks fell the most, as concerns about high valuations and possible interest rate increases pushed them lower. Cyclical shares held up relatively well, as did dividend paying shares. Bond prices (as measured by the Barclays Aggregate) held up well in September and were roughly unchanged for the quarter.

By most measures, the market is now in a correction, the first since the pandemic began in February 2020. As noted in our September 2021 special letter, the market so far this year has mostly ignored a list of worrying trends including rising inflation, a continuation of the pandemic and various geopolitical concerns. During this time, it has instead been driven higher by increasing earnings, momentum, and extremely accommodative monetary and fiscal policies. In recent weeks, the Federal Reserve has signaled it may soon cut back on its program of bond purchases, so the monetary stimulus which has provided so much support for markets will be reduced.

The other big issue during the quarter was the resurgence of the pandemic in the United States. After falling from a high of 250,000 daily cases earlier in the year to under 10,000 by early July, the number of new cases each day surged to 150,000 per day by September. This surge in cases was more regional than previous ones, but it still took an enormous toll. Signs are that it may have peaked for now, but we have learned the hard way that it is impossible to know when it will finally end.

The Paradox of Owning Bonds

Bonds are an important part of the asset allocation of many investors. Traditional investment wisdom holds that a bond allocation, while not expected to provide as high a return as equities over the long term, can benefit a portfolio in several ways. First, it may reduce the volatility of a portfolio. Second, it can provide a level of income. Third, bonds may help preserve capital in a stock market downturn. For these reasons, having a fixed income allocation has traditionally been considered a good thing for many investors.

What happens, though, when following this traditional investment wisdom runs head-on into the oldest investment rule there is, namely don't buy things that are overpriced? The answer is that it gets complicated. By almost any measure, bonds are selling at astounding levels. Interest rates are at all-time lows. Inflation is rising and real bond yields are negative, making the possibility of meaningful returns virtually nil. Owning bonds in today's market, as Warren Buffett has said, provides investors with little more than "return free risk."

Does this mean there is no place for bonds in a portfolio? Not necessarily. The answer depends on an investor's ability (both psychological and financial) to withstand market downturns. An investor for whom a severe market loss would be hard to sustain should still have a fixed income weighting. An investor who has significant assets and no interest in worrying about the stock market may wish to own bonds to keep portfolio volatility to a minimum. But both types of investors should recognize an important point: bond prices are at a level where they should be looked at as a vehicle for capital preservation and very modest income, not as great investments. For these reasons, we recommend buying the highest quality and least risky bonds available.

The Retirement Income Dilemma

Managing retirement incomes to address both income and capital preservation requirements is notoriously difficult. This challenge was noted in a recent interview with William Sharpe, one of the pioneers of modern finance. (Sharpe won the Nobel Prize in 1990 for his work developing the Capital Asset Pricing Model, the tool used by many professional investors to create portfolios which intelligently balance risk and reward.) Now retired himself, Sharpe described the retirement income problem as the "nastiest, most difficult problem in finance." Given that someone with his background finds this problem so difficult, what hope is there for the typical investor or their financial advisor?

One reason the problem is so tricky is because the cost of getting it wrong is very high. To put it bluntly, most retirees do not want to run out of money and be forced to live with their children. In cases where the cost of being wrong is very high, the natural response is to be conservative. That is why we look twice before crossing the street, wear seatbelts, lock our homes at night, etc. We take these precautions even though the chance of a bad outcome on a particular day is low, the cost of being wrong is high. The problem investors face today is that the most conservative solution is one that almost guarantees failure. Staying in cash or short term bonds simply will not meet the needs of most investors. They need to take more risk, but at a time and in an area where they do not necessarily want to.

There is another solution to this general problem which is often employed: insurance. People buy insurance when the cost of being wrong is prohibitive and the buyer would be happy with a result which is average. Consider homeowners insurance. The average person's house doesn't burn down, and people are generally happy to pay a certain amount to insure that, in the unlikely case that theirs does, they will at least be compensated to a level where that will be their result. The same could be said for auto or personal liability insurance. People are willing to pay a premium to avoid the worst case and effectively be guaranteed the average result.

What would an income insurance product look like for retirees? A traditional pension fund is one version. Under a traditional pension plan, if you worked for a certain number of years, you were essentially guaranteed to have a secure retirement. You might not become fabulously wealthy, but you would not need to worry about going through your savings if the pension fund was reasonably well managed. Today, such plans are few and far between, especially in the private sector. Social Security is also such a plan, although for many retirees it is not sufficient on its own to meet their retirement goals. The closest investment product available today which meets this criterion might be an annuity. In theory very much like a pension fund, an investor makes an investment with an insurance company and then receives a guaranteed payment for his lifetime or possibly also the lifetime of his or her spouse.

If annuities could replace the pension fund which most people loved, why aren't they more popular? There are a few likely reasons. First, fees are often very high. Unfortunately, insurance companies look at a long-term investment product such as this and immediately think of ways to add in fees which they hope investors will not notice or understand. This has hurt the performance of annuity products and given them a poor reputation among many investors and advisors. Secondly, low interest rates have made the projected income from annuities less attractive. Because insurance companies offering annuities must purchase bonds to back the annuities they sell, the low rates they currently earn on these investments impacts the rates of return they can offer. Finally, there is often a feeling by investors that if they purchase an annuity and do not live for a long time, that somehow this asset will be a windfall for the insurance company which comes at the expense of the investor's heirs. In a sense this is true from the investor's perspective, although not from the insurance company's standpoint since they will have customers who live both longer and shorter than anticipated.

Our view is that annuities may be part but not all of an investor's portfolio. If they are used, they should be carefully selected and as low fee as possible. In most cases, annuities should not be purchased by older investors since the benefits are more likely to accrue to the annuity provider than to the client.

Thank you as always for being a client. Please feel free to contact us at any time with questions or comments.

Best regards,

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