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Bonds Look Like Sure Losers With Rates This Low

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The biggest factor affecting future rates-of-return on any investment is the price you pay for it. Buy good assets at a reasonable price or cheaper and you're bound to do well if you hold it long enough, so long as a paradigm-shift, a change in the way the world works doesn't destroy the asset's value. This can include expropriation of private property by a previously business-friendly government, or the failure to adapt to change by individual companies or industries.

In each case, the ability of the asset to generate cash for the owner is forever impaired and losses become permanent. In the US stock market, think buggy whip manufacturers in the 1890s, newspaper publishers a century later or more recently, highly levered investment banks.

So long as you avoid getting killed by a paradigm-shift, and don't grossly overpay, you'll be all right as an investor if you're patient. Overpaying for an asset, even a quality one, is an entirely different situation and can result in a very long wait indeed before you're OK.

In the case of stocks, you might wait a market cycle or longer. Most quality tech stocks remain below their highs from the last great bull market. Wonderful companies like Cisco Systems, EMC, Intel and Microsoft are today lower than they were in February 2000, by some 40-70%. It's a lesson in what happens if you buy a scary expensive asset: though many of these companies have grown their businesses at an impressive double-digit clip during the last 13 years, the growth wasn't fast enough to compensate for a P/E ratio contraction from 50 times earnings to 10-12X.

In the case of other asset classes, it could take even longer to get your money back if markets move against you. Bond trends are generational because the debt cycle is so long. The current bull market in bonds is over 30-years old and the previous bear market in bonds also lasted some three decades. In the case of investment grade real estate, illiquidity adds a further painful possibility.

Concern with overpaying for investments is something to always be vigilant about. Given so many markets are at all-time highs, it is particularly timely to review the investment landscape and do some simple back-of-the-envelope

type analysis. This analysis assumes there will be a reversion-to-the-mean movement in prices at some point in the next decade. In other words, historic relationships will be restored.

Equities: We are clearly in a powerful stock market rally. We've seen prices increase by over 20% in six months and 100% in the past 4-years. Some are heralding a new long-term bull market though it's just as likely the bear has simply been hibernating. Only time will tell who's right. Meanwhile, we can use simple math to see if the stock market is scary expensive or not.

The current median of estimated P/E ratios of stocks with earnings is roughly 17.5X and the dividend yield is 2.5%. This is according to the most recent data from Value Line. Assume corporate earnings and therefore dividends grow by its long-term historic average of 5% annually over the next decade. Further assume P/E ratios drop to 14X, its historic average.

In ten years, the total return for stocks under this example would be about 5.9% per year. That's roughly twice the yield quality 10-year corporate bonds are currently paying. If these assumptions are valid, then stocks in general are reasonably attractive for the patient long-term investor, particularly in comparison to bonds.

Bonds and other traditionally "safe" investments: We will not always be in a zero interest rate world. Someday the training wheels will no longer be needed for this muddle-through economy. Count the Congressional Budget Office as among those who believe this. In fact, the CBO projects that 10-year Treasury bonds will be yielding 5% by 2019. Basically they're assuming bonds will revert to their historic relationship to inflation.

Assume the CBO is roughly correct. Then simple math points to bonds and many other assets tied to the cost of money crashing by some 30-40% at some point over the next six years or so.

A long-term Treasury bond currently yields 3% and pays $30 of interest for every $1,000. If the 10-year bond yields 5% in 6 years, a conservative assumption is that the long-term bond yield would rise to at least 6%. If you own the bond that pays $30 of interest, the market in this example would turn it into a 6% yielder by reducing the principal value of the bond to $620. Simple math: the yield-to-maturity of a 24-year bond with a 3% coupon selling at $620 is 6%.

Long term Treasuries are not the only vehicles exposed to interest rate risk. Preferred stocks, REITs, utility stocks and other assets tied to the cost of money will also be greatly affected. This simple reversion-to-the-mean analysis should give you pause if you own these types of assets. We have records going back to when King Henry VIII of England legalized money-lending and we know that interest rates have never been lower in recorded history, even during the deflationary 19th Century. That's another way of saying bonds have never been more expensive.

I believe fixed income investors must redefine what constitutes safety in a zero-interest-rate world because the truth is, in such a world traditionally "safe" investments are scary expensive and therefore not safe.

The author currently owns Cisco Systems and Microsoft Corp.

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