

Time Is On Your Side, Bonds Are Not

This is a highly condensed version of a blog published in March 2018. For the complete article, please visit the Blog section of our website: <https://keatingwealth.com/time-is-on-your-side-bonds-are-not/>



You've most likely based your retirement planning on an estimate of how long you will live. The good news is that you probably underestimated. The bad news is the same.

American men and women born today have average life expectancies of 76.5 years and 81.3 years, respectively. But these numbers are deceptively low because of people who die young. So by the time you reach your 50s, the averages no longer apply.

The stark reality is that you need to prepare for a retirement period of at least 30 years, and it would be prudent to plan for up to 40 years. You may live to be 100—or older.

The Problem With Fixed Income

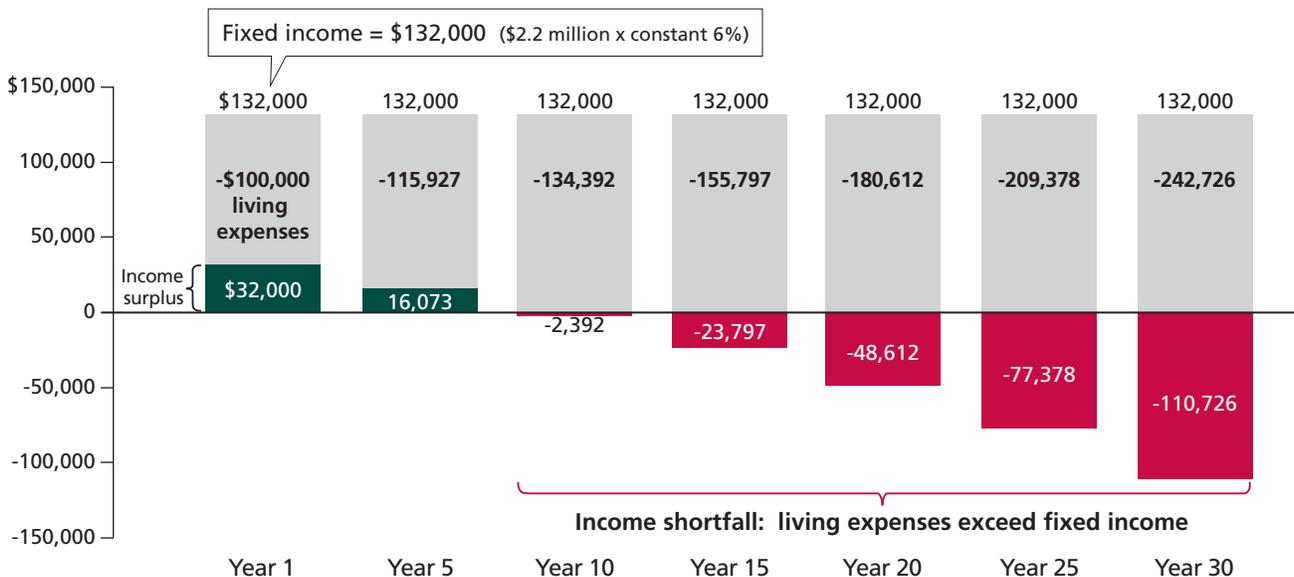
The math for a bond dominated portfolio simply doesn't work for long retirement periods. Consider a married couple in their first year of retirement with a \$2.2 million nest egg, \$50,000 in combined Social Security income, and annual living expenses of \$150,000. They need their portfolio to generate \$100,000 in annual income to fund the shortfall. Further, the couple is attracted to the "safety" and comfort of bonds, where there is no risk of principal.

Let's assume that this couple could invest their savings in high-quality, long-term corporate bonds yielding 6%. The first year, they'd have a significant cushion. Their investment income of \$132,000 (\$2.2 million x 6%) would be a third more than their income needs of \$100,000. So far, so good.

Please see TIME page 4

The growth of living expenses at 3% inflation rate

A fixed income retirement strategy may not sustain your lifestyle through 30 years of a rising-cost life



Valuation Isn't a Market Timing Tool

All price data as of February 2, 2018—the original publication date of the article.

Unlike ethereal investment vehicles such as Bitcoin, equities represent ownership claims on businesses that generate cash flows and can be accurately valued in a variety of ways. We have fundamental metrics, such as revenue, earnings and dividends. We can measure against horizons, both past and forward looking. And we can employ numerous adjustments that eliminate anomalies to produce more meaningful data. But what part should valuation play in asset allocation decisions for the long-term investor? Before we offer an answer to this conundrum, let's get back to basics.

There is now a nearly universal consensus on Wall Street and within the financial media that equities are expensive, or very expensive, and a market correction is inevitable. The pundits all use some variation of the same simplistic analysis to reach this conclusion. And it is true that relative to any *single* metric—whether it be trailing earnings, forward earnings or the Shiller cyclically-adjusted P/E ratio—most measures of equity valuations today are higher than their historical averages. But this is a one-factor analysis in a *two-factor* equation. There is a crucial variable missing: interest rates.

Finance 101 taught us that equity prices are determined by the present value of future dividends. And capital always has a choice among different asset classes. Valuations, therefore, are dependent on interest rates. All else being equal, higher interest rates mean lower valuations and vice versa.

Therefore, even with the recent sharp rise in interest rates, we propose that equities are not unreasonably valued. Here's why:

- ◆ On Feb. 2, 2018, the S&P 500 closed at 2,762.13.
- ◆ As of Feb. 2, 2018, the consensus 12-month forward earnings estimate for the S&P 500 is about \$156 (\$155.70 in calendar year 2018; \$171.89 in calendar year 2019). (Source: FactSet)



- ◆ Based on this estimate, the forward 12-month P/E ratio for the S&P 500 is 18.0x, or 0.7 standard deviation above the 25-year average of 16.0x. (Source: J.P. Morgan)
- ◆ Over the last 25 years, the average yield of the 10-year Treasury has been about 4.6%, compared to 2.85% on Feb. 2, 2018. (Source: J.P. Morgan)

Based on these facts, we conclude that with the interest rates used for discounting dividends recently higher but still closer to *half* their 25-year average, the roughly 2 percentage point premium between today's forward earnings multiple and the 25-year average is perfectly reasonable.

With projected forward earnings of \$156, the earnings yield (or inverse of the P/E multiple) of the S&P 500 is about 5.6%—not quite double the current 10-year rate of 2.85%. To complete the return picture for equities, add in the dividend yield of 1.8%, for a total of 7.4%. With the Fed's target inflation rate of 2%, the inflation-adjusted or real yield comparison is 5.4% for equities versus 0.9% for Treasuries. In this context, the hysteria about valuations is unwarranted.

Certainly, interest rates may continue to rise. In light of the recent cut in the corporate tax rate, among other factors, it's also possible that earnings and estimates may continue to rise in 2018. Analysts sharply increased their earnings estimates in January. Contextualizing valuation always requires consideration of both variables.

The average annual drawdown for equities is 14%. And there hasn't been any 10% correction since February 2016—two full years ago. Based on historical frequency, we're statistically overdue for a bear market—a stock market decline of at least 20%. Between 1947 and 2017, the S&P 500 had 11 such declines, about one every 6.4 years, with an average peak-to-trough decline of 34%. The last bear market for the S&P 500 was a 57% drop over the 17 months

ending March 9, 2009. The average person will experience eight bear markets in a 40-year working career and six more in a 30-year retirement. This is what it means to be an equity investor.

Shiller's CAPE ratio was close to 30 at the start of 2017, and many stock market gurus proclaimed equities overvalued. And yet, the S&P 500 index returned 19.4% in 2017 (21.8% including dividends).

According to recent data from Charles Schwab, since 1958 through the end of 2017, the correlation between trailing P/E ratios and the S&P 500 price performance one year later is a meaningless -0.24 (on a scale of -1.0 to 1.0, representing perfect negative to positive correlation, respectively). Statistical noise.

So here are two iron rules worth remembering:

1. No valuation metric can reliably forecast the future.
2. No one can consistently time the market, because it requires two exquisitely-timed decisions: when to get out and when to get back in.

Since valuation isn't a tool for timing the market, long-term equity investors simply need to tune it out, stay the course, and remain fully invested in a broadly diversified portfolio of domestic and international equities. Declines are temporary—a

blip in one's investing career, but the uptrend in equity prices is permanent. Buy and hold.

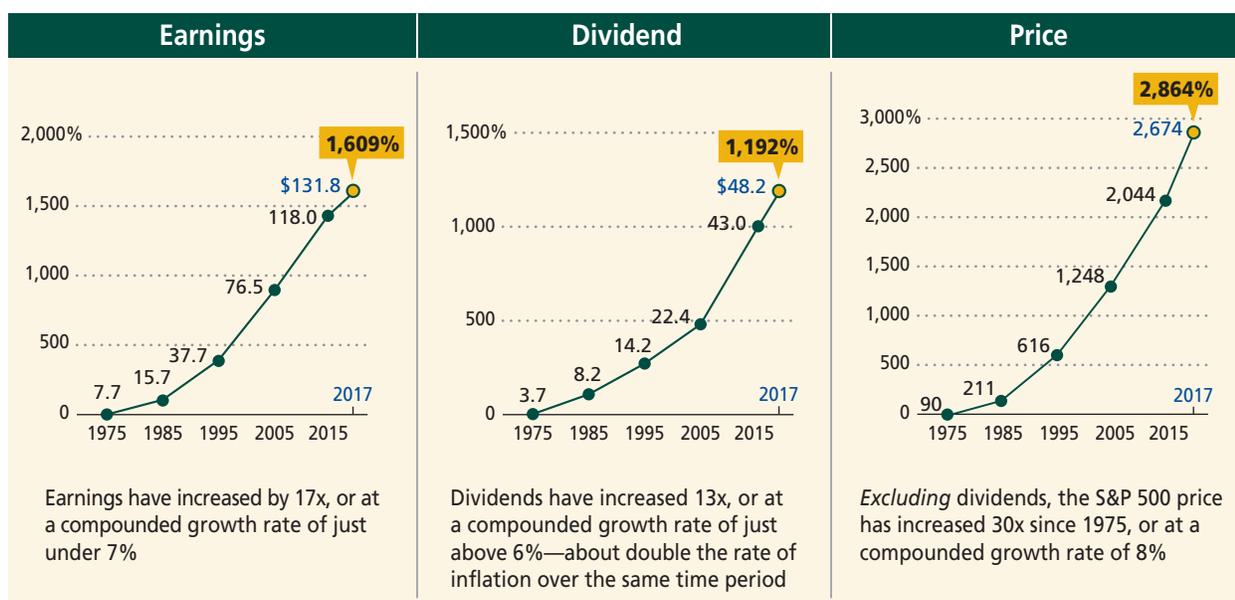
The earnings of the S&P 500 have risen steadily over time, compounding at about 7% since 1975. Dividends have been compounding at about 6% over the same time period.

Thus, it should not be remarkable that growing earnings and dividends have manifested from time to time as new highs in companies' stock prices—and the indices comprising those companies—compounding at 8%. Similarly, there is nothing to infer from a single stock market index reaching a new record high, in and of itself.

Behavioral Takeaway

Narrow framing involves making decisions without considering all the implications. Regardless of the methodology used for valuing equities, there is always some measure or stream of cash flows—such as dividends or earnings—that must be discounted by some interest rate. In its simplest form, it's a **two-factor** model. Valuing equities solely relative to a historical average crucially ignores the variable of interest rates. Such one-dimensional, narrowly framed thinking has caused many investors to make costly errors attempting to time the market.

S&P 500 Increases Since 1975



Source: Standard & Poor's

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Next, consider that their living expenses will increase 3% per year, the historical average inflation rate over the last 90 years. At this rate, their cost of living will double over 25 years, and what costs \$100,000 today will cost \$242,726 in 30 years. The erosion of purchasing power is slow, insidious, constant...and all but invisible on any given day.

For about the first 10 years, the couple would have enough income. But as the chart on page 1 illustrates, after year 10, the couple's living expenses would dramatically outstrip their annual fixed income of \$132,000.

Redefining Risk in Terms of Purchasing Power

We all know how to define risk and safety in terms of principal—the risk that we'll lose our money and the assurance that we won't. But with three- and four-decade retirements, investors must think as much about the risk of outliving their money as the risk of losing it. We must define risk *not just in terms of principal but in terms of purchasing power*.

When it comes to accretion of purchasing power, one asset class outshines all others: equities. Over time, equities—not bonds—have been the best way

to preserve and grow purchasing power. Since 1926, equities have delivered a 7% return after inflation for large-company stocks—more than double the 3% real return for bonds.

In modern three-decade retirements, where the maintenance of purchasing power becomes a fundamental objective, growth of income is crucial. Since 1975, the S&P 500 dividend has increased 13x (from \$3.7 to \$48.2 in 2017), or at a compounded growth rate of just about 6%—about double the rate of inflation over the same period.

The following chart assumes a \$10,000 initial investment in both stocks and bonds at the beginning of 1976. It also assumes that the dividends or interest payments are taken as income, *not reinvested*.

In the first year, bonds generated interest income of \$745, and stocks provided dividend income of \$461. Fast-forward to 2014, where bonds generated \$253 in income and stocks generated \$4,452—**17x more**. Moreover, the ending principal value of a \$10,000 initial investment in bonds was \$11,232. **For stocks, the ending value of a \$10,000 initial investment was \$228,283—a difference of 20x.**

To be sure, we're not advocating for an all stocks, all the time approach to asset allocation. But when it comes to financial planning for retirement, time is on your side; bonds are not.

As dividends increase, so does the potential for income

Even with dividends taken as income, an investment in stocks produces growth in principal and income

Growth in Income from Stocks and Bonds: 1976 – 2014				
	Initial Investment	First Year Income	Final Year Income	Ending Value (Price Return Only)
Bonds ¹	\$10,000	\$745	\$253	\$11,232
Stocks ²	\$10,000	\$461	\$4,452	\$228,238

17x greater

20x more

Source: Lord Abbett. ¹Barclay's U.S. Aggregate Bond Index. Annual dividend income (S&P 500) and interest income (Barclays Aggregate) on \$10,000 invested in the respective indexes, 1976–2014, since inception of the Barclays Aggregate. No reinvestment of dividend or interest income. ²S&P 500 Index.

5251 DTC Parkway, Suite 200
Greenwood Village, CO 80111



www.keatingwealth.com
(720) 408-5250

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