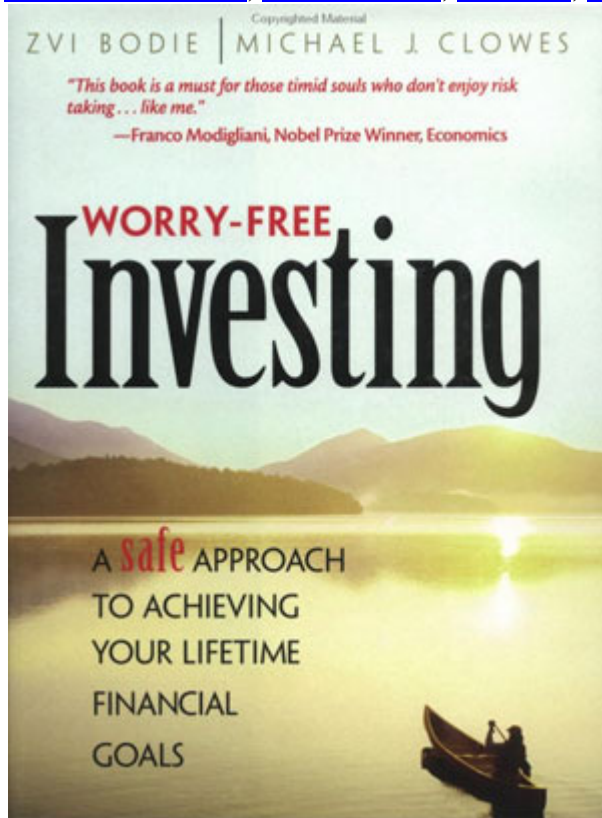


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Worry free investing: Bonds for the Long Run?

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As the short column in FP Weekend relates, finance professor Zvi Bodie believes investors can secure their retirements worry-free without investing in the stock market. His preferred investments are inflation-linked bonds, known in Canada as Real Return Bonds or RRBs.

This is of course a dramatic contrast with the Stocks for the Long Run author, Jeremy Siegel, who we interviewed last week.

I almost wonder if Bodie -- who once engaged Siegel in a debate on this topic -- might better have titled his book "Bonds for the Long Run." Be that as it may, here are the edited highlights from my 90-minute telephone interview with Zvi Bodie. Note that there is no audio version of this, despite a blurb to that effect on Saturday's paper.

Jonathan Chevreau: Have you changed your view on inflation linked bonds since Worry Free Investing first came out?

Zvi Bodie: No I've not changed my views and at the end of this month a UK edition of Worry Free Investing will come out, coauthored with a friend there. Everything has been changed to adapt to the UK environment but they too have inflation protected or as you call them Real Return bonds.

JC: Which are called TIPS in the United States?

ZB: Right, Treasury Inflation Protected Securities, and also I Bonds.

JC: Yes, tax-free inflation bonds. It would be great if the government would introduce those in Canada.

ZB: Yes, Graham Cook, who is now a full time financial advisor in Canada, would like to see

that happen. But TIPS never really caught on in this country.

JC: Even though Canada introduced them before the U.S.?

ZB: Yes, RRBs started in Canada in 1994 and the first issue of TIPS in the U.S. was in 1997. In fact, I invested my own retirement money in Canadian RRBs and got [disadvantaged] because of the currency.

One point: in this country [USA], TIPS are available only to individuals in retirement plans [like the IRA], only in the form of mutual funds.

JC: Americans can't buy them directly, as they can in Canada?

ZB: Only if your plan has a brokerage. When you hold TIPS in a mutual fund it becomes just another risky asset; this is the great irony; in order for TIPS to be really safe; to use them to lock in some spending target you have to be able to match the maturity of the bond to your spending goal. But you can,t do that with TIPS mutual funds.

JC: Plus you lose some yield to the management fee on the mutual fund?

ZB: Yes but who do you think has imposed this restriction?

JC: Fund companies lobbying, I'm sure. But tell me how TIPS connects with life cycle investing.

ZB: In the theory of investing, or the science if you want to call it that, there are certain basic principles. If you think first of all in terms of a single safe asset and a single optimal well diversified risky portfolio which we call the market portfolio, this idea of a risk/ reward tradeoff in terms of a straight line that connects 100% in safe assets versus as you go along the risk/reward frontier to riskier stuff; you get higher expected returns but greater risk.

JC: The efficient frontier and [Harry] Markowitz?

ZB: It goes beyond Markowitz: he had only risky assets; his efficient frontier was not a straight line; it was a sort of an envelope curve because all assets were risky in his model. It was actually Jim years later who added a safe asset and derived the separation theorem. When you have a safe asset then all investors can be offered exactly the same risky asset portfolio which they combine with the safe asset. This is the mutual fund separation theorem.

JC: You argue in Worry Free Investing that ordinary investors don't need to take stock market risk?

ZB: Yes, correct. What I did in Worry Free Investing was take the key ideas from the textbook [Investments], a very successful text book used in in all the top 30 business schools. It's celebrating its 20th anniversary and is now in its 8th edition.

The reason it's significant is that book is universally regarded as the state of our knowledge in investment as a science. What was so striking to me is that in the practitioner literature and the stuff for the masses they contradict what's in the text book. So my original motivation for writing Worry Free Investing was to try and get the truth out there.

JC: The truth that you don't have to take stock market risk?

ZB: Exactly -- the big lie the investment industry is propagating. There are several, but one is that there is no such thing as safe investing. You'll read it at every so called investor information web site. They'll say if you want safe assets, they are safe only for the short term. For the long run, they say, there is no such

thing as a safe investment. The reason I wrote Worry Free Investing was I wanted to tell investors that's not true. There IS a safe long run investment. There didn't use to be but now every major government with no default risk is issuing long term bonds that are indexed for inflation. So how can the industry keep saying there's no such thing as a safe investment?

JC: Another lie is that active management adds value?

ZB: Yes. I'm not in the market any more. I was 100% in it in the early 80s when the P/E ratio of the S&P500 was 8 at the time. It was like the opposite of irrational exuberance. The 70s was a pretty bad decade for equities. The market was down 50% in 1974-75. In 1975, when I wrote my MIT dissertation on hedging against inflation, the one big point in my thesis was that everyone thought equities was what you should rely on in inflationary times. And equities had just topped out when inflation shot up.

JC: What's your view of inflation right now?

ZB: There's no reason to think it will accelerate. The mean of my long run inflation forecast at the moment is 3% but there is a significant standard deviation around that. I would not be terribly surprised if inflation heated up; at the same time it could stay below 3%. So it may be lower or higher.

JC: What investments are good inflation hedges?

ZB: I don't view either stocks or gold as inflation hedges. The only genuine inflation hedge is something guaranteed and that is inflation linked bonds.

JC: How about REITs?

ZB: My answer is no. Can I rely on REITs to go up in proportion to inflation? No. Do I think they are positively correlated with inflation? There is a very slight positive correlation but an investment is not a good hedge unless it's highly correlated.

JC: Aren't stocks portrayed as inflation hedges?

ZB: That's another one of the big lies. There's no evidence to support that; in fact it goes the

other way. This was the subject of my [doctoral] dissertation.

JC: How about pensions and annuities?

ZB: Annuities we used; I was never a fan of the traditional Defined Benefit plan in the U.S. because it never had cost-of-living adjustments.

JC: Unless you work for government?

ZB: Yes. There is a huge difference between an annuity that is linked to the Cost of Living and one which is not. An annuity not linked to inflation is an extraordinarily risky proposition. It's a long term instrument -- especially a deferred annuity which is what you accumulate in a Defined Benefit pension plan. Look at what happened to people who retired in the 1970s on a fixed income. They might have had a decent retirement plan at first but over the years -- the 1970s basically -- the consumer price index more than doubled.

JC: Assuming employers didn't renege on the pension promise.

ZB: There was little reason for employers to renege. As interest rates went up, the pension liability went down. That's another way of saying the workers got [shafted] because of inflation: It drive up nominal interest rates.

Then in the 1980s there was a wave of plan terminations from companies that wanted to get the surplus out. So I've never been a big fan of traditional DB plans. I thought they were extremely risky.

JC: What did you like better?

ZB: At the time I was pushing for something like like TIAA-CREF; pension plans that cover people like me at private universities at very low cost. They pursue an index strategy. TIAA is a guaranteed insurance product and CREF is the mutual funds so you can split your money between a TIAA kind of participating annuity contract. In a sense there is a minimum guaranteed return on investment and to the extent the portfolio does better they declare special dividends. I've always been in favor of TIAA CREFF coming out with an inflation-linked product: an annuity for retirement; TIAA is a more conventional type of participating fixed annuity but I thought TIAA could do better if they actually made loans that were linked to the CPI and then issued annuities linked to the CPI. That idea did not make much headway till the U.S. treasury started issuing TIPS in 1997 but then what TIAA did was instead of issuing annuities linked to the CPI they put TIPS into mutual fund form and issued variable annuities linked to the performance of TIPS portfolios. That's not what I had in mind.

Interestingly, the very first variable annuity contract ever issued was by CREF in the 1950s. I think that's a fine way to take risk if you want to take risk for a chance of higher returns but I don't think that should be the starting point for retirement income plans.

The starting point should be what if I don't want to take risk?

JC: In short, Worry Free Investing?

ZB: Yes. It's perfectly okay for people to give up some of that guaranteed return in order to get a shot at a higher rate. But those people have to understand they could also wind up getting less. That's what risk means. Variable annuities are essentially mutual funds with an insurance wrapper around them. You get the impression that in the long run if you invest in equity-linked annuities you'd get a higher rate of return with no greater risk. That's the big lie.

JC: Tell me about life cycle investing and the role of equities.

ZB: The central element in life cycle investing is human capital: your ability to earn a living. That is the principal asset most people have. If you're talking not of the wealthy but the masses in these retirement saving schemes, for them the key consideration in asset allocation should be how much risk are they exposed to simply by virtue of their human capital?

When you're young the basic fact is most of your wealth is your human capital; what's in your portfolio is typically very small versus your human capital. Say your human capital is risky; my son in law for example is a hedge fund manager. His human capital is like holding stocks. Should he invest his portfolio in stocks? I'd say hell no. He should hold put options.

You could claim though it's not true for sure that for most people participating in 401k plans, their human capital is like a bond. If true, then they should invest in equities. But what is the conventional wisdom? That when you're young you can afford a lot of risk. The conventional wisdom is based on a fallacy; it is that if you have a long time horizon then the risk of equities evens out over time. That was proved a fallacy in the mid 1960s. If you spread risk across uncorrelated assets then yes you get diversification of risk but over time there is no diversification because the good years don't necessarily cancel out the bad.

JC: How does this affect target date funds?

ZB: They're all based on the same fallacy. What they do is if a kid goes to college 18 years from now, in the beginning they have 80% equities and over 18 years they will reduce the dollar percentage down to 40%. The thinking is -- and here is the fallacy -- that in the early years they can afford the risk and get those higher returns, then over time lock them in by getting out of equities. But what if in the early years there are losses?

JC: Isn't there protection in dollar-cost averaging?

ZB: Well, that's a separate argument and there's a fallacy there as well. Target date funds don't depend on dollar cost averaging. The clearest case of the fallacy is putting in a lump sum up front. Then the market goes down -- what do you do? You reduce exposure to equities so now you're locking in losses.

So life cycle funds are a joke -- they're anything but good. But I'm glad this came up; it's the reason I organized that conference and this book is a monograph based on that conference [in Boston] a year ago. I had Paul Samuelson as the keynote speaker. These life cycle funds are

committing exactly the fallacy Paul warned about and has been writing about every since. Read his opening speech and you'll see it right there. Forty years ago I pointed out this fallacy of time diversification. Now all these funds have committed the same fallacy.

I don't call them life cycle funds; they call them that; I call theirs target date funds because those funds implement this very naïve strategy that is not dependent on how the market evolves. It's not a dynamic strategy that says if the market goes down maybe we should increase our exposure to equities. What they're saying is independent of whether the market is going up or down. What you're going to do is based on age -- every year the fund is going to reduce its exposure to equities by 1% and raise its exposure to bonds by 1%. So you start out at 25 with 40 years to retirement and have 90% of your money in equities and 40 years later half your money is in equities and the rest is in fixed income. That is what is Fidelity is doing in its target date life cycle funds.

Paul Samuelson and Bob Merton published classic articles in 1969 simultaneously on life cycle consumption and investing strategy. It's nothing like what these funds are doing. Fidelity set up its own research institute to produce the stuff they want the public to hear. At the research foundation of the CFA Institute we have 125 actuaries and economists because this is the science of investing. Unfortunately, most of what we have to say contradicts what the industry is saying. You will be the guy that breaks the story.

It's a little bit like the debate about dietary supplements. The truth is the vast majority don't need them: you just need to eat a reasonable diet. That's the scientific evidence; however google nutritional supplements and read the literature and you'll discover the vast majority of says you do need to take daily vitamins. So who do you believe? You believe the scientists. My answer is most of the literature is written as promotional stuff by folks trying to sell you supplements.

It's exactly parallel to the investment industry. The simple truth is the vast majority of people saving for retirement should just be given an inflation-indexed Defined Benefit pension plan that's portable. That should be the default option. They will have to save a significant amount of money if they want to retire at 65, and for a simple reason. They're going to live a long time. The investment industry tells people they can just save less and invest it in stocks and as long as they have a long time horizon they will earn a higher return. The simple scientific truth is you can't get a higher rate of return without taking risk. Let me put it in present value terms; you can't lower the Present Value of those future benefits you want to have by investing in stocks rather than in inflation linked bonds. The only thing you can do is trade off risk for reward which means you don't lower the present value of the cost but now have a shot at doing better than might but also expose yourself to the risk of doing worse.

What could be simpler than that? The investment industry wants to obscure that. When I debate with whoever, they say "Prof Bodie if I accept your proposition I couldn't afford to retire. I say wait, if you invest in equities you may not even be able to afford the standard of living you have now because stocks can go down as well as up. They don't want to look at that. Maybe you plan to retire early but whatever made you think you could work for 30 years and not the next 25?"

JC: But 65 is the retirement age in many western countries.

ZB: 65 was a brief episode in history. Through the coming of social security and private pensions a certain cohort of people were able to retire at 65. It won't be true going forward. With a life expectancy of 85 or whatever we expect the system to provide retirement income from 65. That's nuts.

JC: But since Jeremy Siegel is practically a 100% stocks guy and you're almost 100% in bonds, why not saw it down the middle and go half stocks and half Real Return Bonds – almost like the classic balanced fund?

ZB: Fine but there will be more risk.