

January 13, 2012

The High Price of Safety

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Ask five people what “risk” means when it comes to investing, and you’ll get five different answers.

If you ask an academic, she’ll tell you that risk equals volatility – the more an asset’s price bounces around, the more risk it has. Ask Warren Buffett, and he’ll say that risk equals the chance of permanent capital impairment – the odds that an asset will decline in price and never recover. Ask the portfolio manager of a large mutual fund, and he might talk about career risk – if his performance lags his peers for a couple of years, he might get fired, no matter how likely his bets are to pay off over the long haul. And if you ask many individual (and institutional) investors, they’ll likely define risk in terms of pain -- the further an asset drops in price, the worse they feel, and the more likely they are to sell the asset in order to make the pain stop.

What's interesting is that all these perspectives (except Buffett's) look at risk in terms of the path an asset takes to reach its goal, rather than in terms of whether that goal is actually achieved. This seems odd to me, since most money is invested for a purpose -- paying a pension obligation, funding a future college education, or providing for a future retirement. Wouldn't it make more sense to define risk as the likelihood that the goal will be achieved, rather than as whether or not an asset bounces around a lot en route to funding that goal?

Redefining Risk

This is a serious question, not a rhetorical one. Scarred by high volatility and disillusioned by a decade of flat stock markets, investors are pulling money out of equities and pouring money into bonds at a truly incredible pace. Over the past three years, \$172 billion has been withdrawn from U.S. equity mutual funds, while \$628 billion has flowed into bond funds. Ten year U.S. treasuries yield less than 2%, and yields on six-month German sovereign debt are actually negative -- investors are willing to deliberately lose a small amount of money lending to Germany because they're so fearful of potentially losing even more.

In my view, this is very risky behavior, because the odds that today’s buyers of high-quality bonds will achieve even the most modest investment goals are vanishingly small. The price of safety has been driven so high that buyers of seemingly safe investments are courting far more risk than they think.

For example, let’s assume (generously), that inflation remains at its current 3% rate for the next decade. If you went into the market today and purchased \$1 million worth of 10-year bonds issued by such worthies as Microsoft, Wal-Mart, Abbott Labs, or J&J – yielding around 2.5% on average – you would lose about \$80,000 over the next decade, after inflation. That’s quite a steep price for safety.

On the other hand, if you purchased the common stocks of these four companies, the shares stayed flat for the next decade, and they increased dividends at a materially slower pace than they have over the past several years, you would make over \$50,000 after inflation. (That's assuming no reinvestment of dividends. If you reinvested, you would make \$67,000 after inflation.) None of these stocks have particularly high current yields – but they are all very likely to increase their dividends at rates higher than inflation, and that's what makes such a big difference in their potential long term returns.

Changing Your Perspective

Watching your portfolio bounce around from month to month due to the (in)action of Eurocrats and bureaucrats is not easy – it's only human to get nervous when markets drop 5% in a few days due to political wrangling in D.C. or dithering in Brussels. Setting aside a decade of lackluster equity returns is also hard – again, it's human nature to project historical returns into the future. And intuitively grasping the huge impact on long-term returns of an income stream that both compounds and grows – relative to a fixed income stream – is not something we're naturally wired to do.

So, most investors are taking the easy path, and buying safety despite its extraordinarily high price. But you don't have to do the same. If you can resist the temptation to look at your portfolio every day, volatility won't affect your emotions as much. If you can remind yourself that future returns depend on current prices, not on past performance, you'll see that the next decade's returns may look very different than the last decade's returns. And if you think carefully about the erosive power of inflation over time, you can see that what looks safe for the next year or two may look very different over the long haul.

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