Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly, and we're back with Tom and Brendan this week for episode 390, getting into almost Ted Williams area.

Brendan: 406.

Casey Mullooly: So we got a ways to go, but we're getting up there. So we just wanted to talk about what's been going on, what we're being asked about over the last couple of weeks. And one of those areas has been bonds. And Brendan, I know that you put up a good blog post on the website this week, which we'll link to in the show notes. And one of the questions that you covered in that blog post was whether or not bonds still diversify your portfolio when interest rates are on the rise, like they have been over the last couple of weeks here.

Casey Mullooly: We talk often about the role that bonds play in a portfolio. Mainly that is to tamper down the stock side volatility. Just want to break that down and see whether or not bonds still do that job as a buffer to the volatility in a stock portfolio when interest rates are still rising.

Brendan: Yeah. And I kind of leaned down on some numbers that Colin Roche did breaking down bonds in rising and falling rate environments to answer that question. He actually did this post back in 2018. I don't know if people remember, but that was also a rising rate environment that we were in for two and a half, three years at that point. If you do remember and you were investing, then we all got our t-shirts. I survived the rising rate environment of 2015 to '18, and we're still here to talk about it. But his point was the expectation may be for bonds in the portfolio is distorted by bond bull market from 1980 to 2017. We basically had rates going one direction being down, which lends a tailwind to bond prices as a result.

Brendan: That's where the 60 40 portfolio really came into its own. And people have then said over the years that when we enter a different interest rate regime, meaning rates going up in the other direction, that people with bonds to diversify their stocks are going to be surprised or they're going to feel pain. I think based on expectations, maybe folks will be surprised, but what Colin looked at was the period of time from 1940 to 1980, when rates were going up and bonds still did a pretty good job diversifying stocks during that period of time.

Tom: We also had a higher average annual rate of inflation during that 40 year window as well.

Brendan: Yeah. And a point that Colin made and that we make all the time to folks is inflationary periods are obviously not going to be great for fixed investments like bonds, but we don't own bonds to keep up with inflation. That's the stocks side of the portfolio's job. The bonds are there to diversify the stock risk, meaning stocks are going to be volatile, and if you want those returns you've got to be able to get through the down period. So that's why you have the bonds in there. Just for comparison sake, that period of time from 1940 to 1980 bonds earned 3% per year, while interest rates were going up. From 1980 to 2017, bonds earned like 7% per year, while rates were going down. And so clearly Colin made this point, I agree. Bonds didn't do as well during that period when rates were rising, but contextually within a portfolio, they still diversified stock risk. You still got a pretty decent return on a blend of stocks and bonds with far less volatility than being 100% in stocks, which many people just aren't willing to sign up for, and I don't blame them. You don't need to.

Casey Mullooly: Right. He actually looked at the standard deviation, which brought me back to stats 101 in college, but standard deviation is basically the level of variance within a portfolio. And in both rising and falling rate environments, the standard deviation of the bond side of the portfolio cut the standard deviation of the stock side basically in half in both of those environments. Their standard deviation from 1940 to 1980 was 8.84 and from 1980 to 2017, it was 9.1.

Brendan: Interesting to note, too, that stocks at least as measured by the S&P 500 did quite well throughout this entire period. I mean, again, we're talking over longer periods of time, so that's the expectation, but we forget that too. I think that people get panicked in the short term about rising rates impacting the market. They certainly will on a day to day basis and they feed through to things that people use to value stocks, to value companies. I mean, interest rates are pervasive. They touch many areas of our financial lives, but 1940 to 1980 stocks did 11% per year. From '80 to 2017 they did 11 and half percent per year. So it didn't seem like they happened to care much what interest rates were doing in the interim.

Brendan: And so, yeah, I mean, you had stocks doing their part of keeping up with inflation in that earlier period, 1940 to 1980, when inflation was high, or at least keeping you in the game in terms of not completely having your purchasing power eroded. Bonds were doing their job during that period of time too, because stocks, as they do in every decade in history, had their stretches where they were down and down in big ways from every decade from 1940 through to present.

Tom: One thing that always kind of rubs me the wrong way, I'm not going to say I'm ticked off about it, but it's easy to throw a blanket over a period of time and say interest rates only went in one direction from 1980 through 2017. And the reality is that's not true. There were several periods without even looking where we had higher inflation and the fed was tightening and everything worked out just fine. I hate to gloss over it and just say everything's going to be fine, but everything's going to be fine. In 1990, we had 5% inflation and the fed was raising rates and it raised it right into a recession. And then in 1994, Greenspan kind of pulled the rug out from under everybody with rate hikes in February of '94 all through the year and the stock market was flat for the year.

Tom: And so I tend to think sometimes people take the reaction, whether it's in the bond market or in the stock market on a daily basis, it's shoot first and ask questions later. Because a lot of times we find that there's a headline that runs across a tape that says this could happen in the future and people take it as gospel. Then we find out a day later, two days, a week later, gee, that didn't really come to be.

Casey Mullooly: Well, do we think that's what's happening now? I mean, in times past, I know you have more experience than us, but when the fed has been raising rates, has it been priced in as quickly as it seemingly has been over the last couple of weeks here? Or is that the fed saying they're going to do more hikes down the line and that increases expectations in the short term, which basically accomplishes their goal for them?

Tom: Yeah. I think that part of this is the people are interpreting what the fed is saying and they're trying to make their bed based on what they think is going to happen. And so they have these kind of running odds maker scores, and we've all seen them. And the prevailing thought right now seems to be that there's going to be three 50 basis point hikes in a row at the next three fed meetings. What if there isn't? Do we unwind all of those trades that all those people did? I mean, that's ridiculous.

Brendan: Or what if there are, and it's already completely priced in? We have no idea. And even if we did know for sure how it was all going to play out, we could still get a trade wrong as a result if we're trying to bank on what other people are going to do in reaction to that information in real time, whether it be what we expect or what we don't expect to happen.

Tom: I can't stress that enough for the listeners of the podcast and our clients, we are focusing on your future, not necessarily what the headlines are going to give us or what's going to happen. We want to land the plane on the runway, your runway in terms of what you are going to need down the road in the future. And we're not going to be driven by headlines.

Casey Mullooly: Right. Kind of along those same lines, and this was another point that you touched on, Brendan, in the same vein as the bonds still diversifying when rates are on the rise, the best predictor of a bond's return is the starting yield or the coupon that it has now.

Tom: And I wish more people really understood that. Can you just kind of walk through that?

Brendan: Yeah. I mean, it's at least something that was brought to my attention by a handful of financial bloggers, all citing the late Jack Bogle, who I think had a pretty good grasp on this stuff.

Casey Mullooly: Founder of Vanguard, for those who don't know.

Brendan: Yeah. When you're looking at something like treasuries or investment grade corporate bonds, you can look at at returns historically based on where they started from and the best predictor of that is the starting interest rate, meaning that, sure, you're going to have some price fluctuations along the way like what we're experiencing now with bonds. In a significant way, at least relative to our expectations from bonds, they're moving around a lot right now because of what's going on. But ultimately if we're getting higher interest rates, it's a good thing for the forward returns of somebody who wants to have a balanced portfolio in retirement. For somebody who wants to be 50/50 or 70/30 or to have some bonds.

Brendan: I think that as most people get to the age where they're going to be taking distributions from their account, basically everybody's going to get to being some sort of a balanced investor, once they're fully out of the accumulation period of time. And so that's to our benefit overall to have rates going up. Although it means in the short term that we've got to deal with some pain to get there. We talk about expected returns on a go forward basis and look at things like the market valuation and where yields are at. We don't like to see the tough periods of time that set us up for the good ones, but that is in fact how it works. I think that'll be true for bond investors too.

Casey Mullooly: So just kind of wanted to jump back to what you said, Brendan, about how market valuations and bond returns play into expectations that investors can have. I know we did a podcast, it was in early December, about the 4% rule for retirement and how that was going to have to be adjusted lower to, I think it was 3.3%, but the 4% rule is basically a rule of thumb for retirement investors that you can withdraw 4% of your account. That's considered a safe withdrawal rate. But it was going to have to be lowered because the stock market valuation was too high and bonds are expected to pay basically next to nothing for the next 20 or 30 years.

Casey Mullooly: Jump ahead four months to where we are now, and the S&P 500's forward expected price to earnings ratio, it was 23.88 in December and now it's down to 19.2. 19.2 is still above the five and 10 year average, but it's much lower than what it was just four months ago. So how is what's happened in the market and with interest rates over the last couple of months maybe changed that withdrawal rate discussion?

Tom: Well, a little bit of clarification, and feel free to jump in Brendan on this, but I think there's some misunderstanding when it comes to the 4% rule. The 4% rule is 4% on the initial balance when you start to make distributions, it's not 4% every year. So it's 4% based on where you start. I think that's the first mistake that a lot of people make, is that they're using the wrong math.

Brendan: It's 4% on the initial balance and then you inflation adjust each year after that, but this really came into its own in the eighties. And so to jump back to that math we were talking about earlier that Colin [inaudible 00:13:39] talked about with bonds being a diversifier during multiple regimes with interest rates and inflation and all of that, people have questioned whether a 4% distribution rate or the 4% rule, the way that it's laid out, will work moving forward considering that interest rates during this period of time where the environment was just vastly different than what we've been at for the last several years with the rates low, and everybody saying that they can't do anything except go up. Despite not actually happening until more recently, but-

Tom: For reference, when I was working at EF Hutton, so in 1983, we were writing into our financial plans that corporate bonds, AAA corporate bonds paid between 12 and 13% a year.

Brendan: Just a different environment. And so obviously I think it's what, the conversation that we had, I don't think that much has changed. Stock valuations are going to change depending on the P and the E meaning, the price and the earnings. So earnings have continued to be good thus far this year, which I think is a shining light in an otherwise rough first quarter for the market and the economy. You look at earnings from most companies, they've continued to be strong. It's a good thing. But prices have been lousy and especially lousy in some particular areas of the market. And so that's, I think, where you see the compression on the stock side.

Brendan: The bond side, yeah. I mean, I think you want to see higher yields, like we just said. While interest rates have jumped, I guess it really depends on whether we're entering a period of time where interest rates are going to be increasing 10, 20 years, like a retirement time span, or if it's going to be a period like 15 to 18, where we had the fed hiking rates for two or three years and then we're onward in the cycle to back to rates falling. You want to see those rates go up as somebody who's going to have 20, 30, 40, 50, whatever fits for your plan percent of your portfolio in fixed income. I think obviously all else equal you'd prefer to see higher returns on that side of the portfolio, but I still think it's wise maybe to temper expectations in terms of what a safe withdrawal rate really looks like past that 4% rule of thumb.

Tom: I want to just kind of branch off of that for a minute and just talk about what's going on with the fed and inflation, and maybe this is squishy economics, I don't know, but I think there's a fair amount of people out there who were not involved in the investment universe the last time we had these kind of inflationary numbers. And I wasn't either. I came in at the tail end of all of that. However, being a student, one of the things that I learned was that in the seventies when Paul Volcker was the chairman of the Federal Reserve, he saw this increasing inflation. I mean, inflation was just growing year after year after year. It wasn't like Powell turned it last year that it was transitory. So this was increasing inflation every year.

Casey Mullooly: Persistent inflation.

Tom: Persistent. And so Volcker actually went to Jimmy Carter in '78 or '79, and he's like, "Look, the only way, the only way that we're going to be able to whip inflation now," they had those buttons, the only way to get ahead of inflation is to get the short term interest rates above the rate of inflation. Short term interest rates at the time, in 1978 and '79, 5%, we had inflation at like 11. And so we're talking about just an unerupted string of interest rate hikes, and that really killed things for a while, but it wrung a lot of inflation out of the system. And then that allowed rates to go down for such a long period of time. And so it kind of depends if you're in the belief that we're going to be in the persistent inflation camp, I think you can build your investment approach one way, if you believe it's transitory or temporary or whatever you want to call it, I think it's going to be a different set of circumstances.

Tom: One of the differences at least from the stock side of things is that in the seventies and into the eighties, these big corporations, they did not have pricing power. They didn't have the ability to change prices on the fly to keep up with inflation. This time around, a lot of businesses have the ability to raise prices. Yeah, it costs us more, but this is why, as Brendan alluded to, the shining light in the first quarter is these good earnings that we saw and they are not forecasted to be slowing down at any point in the near term. And so we're going to continue to have good earnings, or at least we think we are. And I really think that six, nine, 12 months from now, people are going to say, "Wow, the fed's doing something about inflation. Inflation's coming down. Earnings are still good. This is probably a good time to be putting money to work."

Casey Mullooly: How long was inflation rising before Volcker made that decision?

Tom: 13 years. I mean, we started seeing inflation in 1965, but it really started picking up speed in 1969. And then we had the first oil crisis [crosstalk 00:19:26]. The Mid East, the Six-Day War in 1973 and '74, and then we had a second oil shock in '78 and '79. Yeah, things kind of took off from there.

Brendan: Yeah. I mean, so two things coming to mind, I think that obviously history can be a good guide for us, but I think that there's definitely, and maybe it's me just being young and resentful of people telling me that I don't understand because I wasn't there, but I think that sometimes people learn too specifically from history too. And I think that some people are just jumping straight into this analog of this is the seventies all over again. [crosstalk 00:20:05] and it doesn't have to be, we can have some aspects of that while having our own set of circumstances here that make things turn out differently. So I would be hesitant to apply the playbook from last time. It's like fighting the last war. I don't think that's helpful for anybody. I think that the context can be helpful in terms of expectations, but you should also acknowledge that we can't predict the future.

Brendan: And another thing I think that comes from the commodity markets specifically, but comes to mind when we're talking about inflation and commodities are part of inflation in the first place, is that the cure for higher prices is just higher prices. Meaning at some point with these prices like gas or food costs going up, at some point you do reach a point where the consumer of those goods pulls back because they're not willing to bear those higher prices. I think it's been good for things like the stock market that we haven't reached that point yet with consumers, bodes well for the economy at least in short term, but I also don't think that we would just be able to do the sort of price increases that the consumer has borne now for the last year let's call it to infinity. I don't see that happening. At some point, people are going to say, "Enough, I'm not purchasing this anymore. I'm going to purchase less of it, or I'm going to purchase an alternative that's cheaper." And that's just how things work with the economy.

Casey Mullooly: Well, that's kind of what I was getting at when I asked how long had the inflation data been increasing, because it feels like it's been going on forever, but were we talking about this last April?

Tom: I don't think so.

Brendan: We were like just beginning to. As a result of all the stimulus, obviously this sort of a thing was on the table, the fed was starting to talk about inflation and how we were going to continue to have some weird economic data points as a result of basically the other end of the spectrum from the ones that we saw in 2020, we saw insanely weird negative economic readings in '20 because of what happened. And then we started to see the opposite side of that in the back half of '21 and now into '22. And yeah, they used the word transitory and everybody likes to dunk on them now because it looks stupid. But I think in the moment, things feel like forever more than they actually are, to your point. It hasn't been forever. It's been like a year, maybe a year and a half tops.

Casey Mullooly: Yeah. I think the reading started to get really hot in the fall. That was when we started to see six, seven, and now we got eight and a half percent this week, but that was nine months ago. So we're nowhere near where we were in the seventies where we had 13 years of increasing inflation readings. So I think it's important to keep that context in mind.

Casey Mullooly: All right. I think that's going to wrap up episode 390 of the Mullooly Asset podcast. We want to thank you guys as always for listening, and we'll be back with you for episode 391 next week.