Porter, White & Company

Guaranteed Return Now More Expensive

Investment Commentary, July 2012, Number IMC 10

I. Introduction

In our investment commentary entitled, "Can Investors Have Their Cake and Eat It Too?," written two years ago, we examined whether the following promise was too good to be true: "GUARANTEED return of your investment PLUS a return linked to the stock market!!!" We concluded that this promise was not too good to be true, if the investor ignored taxes, inflation, and the financial implications of "locking up" the investment for a period of time.

Since July 2010, the equity markets have gone up and down, but are generally higher. Interest rates have gone up and then down, and are now significantly lower. We focus on interest rates because they have broad ramifications on reducing risk in our client portfolios. Given the historically low interest rates, we thought it would be informative to revisit the "GUARANTEED return" scenario. We find that guaranteed return is now more expensive.

II. Step 1: Guaranteed Return OF Your Investment

While the budgetary drama in Washington and threats to not raise the debt ceiling have raised the specter of insecurity of US government debt, Uncle Sam (a.k.a. the United States Treasury) is still the best place to go to guarantee a return of your money. In implementing a "have your cake and eat it too strategy," we used a zero coupon bond. Two years ago, to guarantee the return of our hypothetical investment of, say, $1,000 in 10 years, we needed to pay Uncle Sam approximately $725.[1] Today, because interest rates have declined, we would need to pay Uncle Sam approximately $860 for the same guaranteed result. That is almost a 19% increase!

III. Step 2: Plus a Return Linked to the Stock Market

Since buying the treasury strip to guarantee the return of $1,000 in 10 years now costs $860, we only have half as much to invest in the stock market. This amount is invested in an S&P 500 index fund. In this way, our "portfolio" of one bond and one S&P 500 index fund is "guaranteed" to give us our money back in ten years plus some additional return linked to the stock market.

[1] Pricing is approximate based on market rates current as of June 30, 2010 and June 6, 2012. These rates change over time.

IV. The Results

Then and now, the value of our portfolio in 10 years can never be less than $1,000. If the stock market doesn't generate any return (as was the case for the 10 years ending December 2010), our portfolio will still be worth $1,000 plus our initial investment of $140 in stocks which is equal to a portfolio return of 1.3% per year on average over 10 years. The result is lower than the result from two years ago because interest income is lower.

If the stock market does well and generates a return more consistent with historical averages (i.e., 9.6%), then our portfolio will end at $1,350 with a return of 3% per year. This result is lower than the result from two years ago because the amount available to take risk decreased. The ending portfolio is over $300 lower with a little more than half the return of the same strategy implemented two years ago.

The results from the scenario using market interest rates in July 2010 from our previous commentary are copied for convenience below.

Table 1: Guaranteed Portfolios as of July 2010

		Value in 10 years under different stock market return					
S&P (10 Year Total Return)		-100%	-50%	0	50%	100%	150%
Annualized		*-100%*	*-6.7%*	*0.0%*	*4.1%*	*7.2%*	*9.6%*
Portfolio							
S&P Investment	275	-	138	275	413	550	688
Treasury Strip	725	1,000	1,000	1,000	1,000	1,000	1,000
	1,000	1,000	1,138	1,275	1,413	1,550	1,688
Portfolio (10 Year Total Return)		0%	14%	28%	41%	55%	69%
Annualized		*0.0%*	*1.3%*	*2.5%*	*3.5%*	*4.5%*	*5.4%*

Using current market rates as of June 2012, the results are not as attractive:

Table 2: Guaranteed Portfolios as of June 2012

		Value in 10 years under different stock market return					
S&P (10 Year Total Return)		-100%	-50%	0	50%	100%	150%
Annualized		*-100%*	*-6.7%*	*0.0%*	*4.1%*	*7.2%*	*9.6%*
Portfolio							
S&P Investment	140	-	70	140	210	280	350
Treasury Strip	860	1,000	1,000	1,000	1,000	1,000	1,000
	1,000	1,000	1,070	1,140	1,210	1,280	1,350
Portfolio (10 Year Total Return)		0%	7%	14%	21%	28%	35%
Annualized		*0.0%*	*0.7%*	*1.3%*	*1.9%*	*2.5%*	*3.0%*

V. So Now What?

Guaranteed return has gotten more expensive, so, unfortunately, achieving the same result requires more risk. We never want to recommend a portfolio that has more risk than a client is willing to take, but all clients need to balance their need for return against the risks of investing.

The current economy may have recovered from the recession of 2007-2009, but the uncertainties seem far greater than they were even two or five years ago. We are left to continually assess our investment goals and adjust our expectations and portfolios to meet our needs as time goes by. The future is always uncertain and change is inevitable.

Goodloe H. White, CFA
July 3, 2012

Important Notes:

(a) Annualized returns are geometric (compound) averages.
(b) The S&P 500 is not "investible" and does not reflect the deduction of any fees or expenses.
(c) Historical performance results for investment indexes, or categories, generally do not reflect the deduction of transaction or custodial charges or the deduction of an investment-management fee, the incurrence of which would have the effect of decreasing historical performance results.
(d) Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that a portfolio will match or outperform any particular index or benchmark.
(e) Past performance is not a guarantee of future results.

Porter White and Company
15 Richard Arrington, Jr. Blvd., N. • Birmingham, AL 35203-4103 • P.O. Box 12367 • Birmingham, AL 35202-2367
205/252-3681 • FAX 205/252-8803 • www.pwco.com