

# Porter, White & Company

## Can Investors Have Their Cake and Eat It Too?

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### I. Introduction

In these volatile economic times, some investors find the following promise alluring:

**GUARANTEED return of your investment  
PLUS a return linked to the stock market!!!**

Is this promise too good to be true? Can investors have their cake and eat it too? In this investment commentary, we examine this promise, the ways that an investor might be able to achieve such a goal, and the implications of the concept for our client's investment strategy.

### II. Step 1: Guaranteed Return OF Your Investment

There is only one person that we know of who can be relied on to guarantee the return of one's money: Uncle Sam (a.k.a. the United States Treasury). While there are many people that are worried that Uncle Sam is spending way too much money, he is still the most credit worthy entity we know, and the only one that can guarantee the return of our money. He does this in the form of various forms of IOUs called bills, notes and bonds.

In implementing a "have your cake and eat it too strategy," we are particularly interested in a US Treasury Strip – also known as a "zero coupon bond" – that will pay us the amount of our investment at maturity. To guarantee the return of our hypothetical investment of, say, \$1,000 in 10 years, we must pay Uncle Sam approximately \$725<sup>1</sup> today.

### 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 only costs \$725, we are free to invest the remaining \$275 in the stock market. To keep things simple, 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.

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<sup>1</sup> Pricing is approximate based on market rates current as of June 30, 2010. These rates change over time.

#### IV. The Results

The value of our portfolio in 10 years can never be less than \$1,000, or the initial investment, but can be more depending on the return of the stock market (S&P 500). Even 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 in stocks (totaling \$1,275) which is equal to a portfolio return of 2.5% per year on average over 10 years. 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 \$1,688 – pretty good for a “no risk” portfolio?

S&P (10 Year Total Return)	Value in 10 years under different stock market return						
	-100%	-50%	0	50%	100%	150%	
<i>Annualized</i>	-100%	-6.7%	0.0%	4.1%	7.2%	9.6%	
<b>Portfolio</b>							
S&P Investment	275	-	138	275	413	550	688
Treasury Strip	<u>725</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
	1,000	1,000	1,138	1,275	1,413	1,550	1,688
<b>Portfolio (10 Year Total Return)</b>	<b>100%</b>	<b>114%</b>	<b>128%</b>	<b>141%</b>	<b>155%</b>	<b>169%</b>	
<i>Annualized</i>	<i>0.0%</i>	<i>1.3%</i>	<i>2.5%</i>	<i>3.5%</i>	<i>4.5%</i>	<i>5.4%</i>	

#### V. The FINE PRINT

So, what's wrong with this strategy? In summary, the strategy is based on a number of simplifying assumptions that may or may not be true.

##### A. Taxes

Completely ignored is the fact that many investors pay taxes. US Treasury Strips are very tax inefficient. The taxable investor must pay taxes each year for the “accrued interest income” on the bond even though the bond does not pay a cash coupon. For the non-profit or individual retirement plan account, taxes do not impact this analysis.

##### B. Inflation

Unfortunately, if an investor just gets their initial investment back, the investor will have lost money because it is highly likely goods and services will be more expensive 10 years from now. Price inflation is an issue for most investors. The only returns that are “real” are those in excess of inflation. We could re-run this analysis using “Treasury Inflation Protected Securities” and that would reduce the amount of the investment in the stock market.

### C. Bonds Can Lose Money

If interest rates rise at any point over the 10 year investment horizon, then the Treasury Strip purchased for the portfolio could go down in value. Since the stock market investment is even more un-predictable, the total portfolio could have a value of less than \$1,000 during many points in time prior to the end of the 10 year period. This is sometimes called “mark-to-market” risk and might cause an investor to abandon their portfolio and lose money.

### D. Risk-Free Alternative

The investor could have decided to invest all of the money in a US Treasury security, thus ensuring some level of positive return. We believe that risk and return are related, and this promise of “GUARANTEED return” of the investment does not violate this relationship because the investor is actually taking some risk – however well disguised.

## VI. So Now What?

For an investor who is willing to take investment risk on the “income” portion of a portfolio, but would like to protect the original amount of the portfolio, combining equity market exposure (i.e. investment in the stock market) with the purchase of zero coupon bonds issued by the U.S. Treasury can achieve this objective.

In fact, helping investors figure out how much of their money to allocate to stocks and bonds is one of the most important decisions that we help our clients make. We call this the asset allocation decision. Understanding a client’s risk tolerances and selecting an asset allocation policy that the client can stick with is critically important. The type of analysis illustrated here is helpful when an investor decides how much money to allocate towards bonds and stocks in an investment portfolio.

We try to help our clients understand the various risks that they face, and “getting your money back” (i.e. return of capital) is only one part of the investment decision. So to answer the question, investors cannot have their cake and eat it too, but there are many things that can be done to keep the cake from burning up while it is being baked.

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*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.