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How to Confront the End of the Bond Bull Market: A Review of Simon Lack's *Bonds Are Not Forever*

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What does the title of Simon Lack's latest book, *Bonds Are Not Forever*, mean? It's a question that Lack clarifies and then answers — by proposing a creative way to construct portfolios that have many of the beneficial characteristics of bonds but without much downside interest-rate exposure.

On his way to that recommendation, Lack's new book takes the reader through a tour of some of the most controversial aspects of the financial-services industry: Is a big financial-services industry a good idea? Do stock and bond buyers get fair prices when they trade? Are governments and households financially irresponsible? Should we worry about inflation? Are equities a better long-run investment than bonds?

In what amounts to a combined memoir and critique of the finance sector, Lack, a hedge-fund manager whose previous book, *The Hedge Fund Mirage*, critiqued the hedge-fund industry for delivering little value, ties all these issues together. *Bonds Are Not Forever* is quirky and wide-ranging. Despite having too many different focal points, it is an informative and lively read.

Most of today's readers regard bonds as a strategic and trading vehicle like any other security. Few readers would naively buy and hold bonds forever as their default strategy. What Lack seems to mean by his title is that "the bull market in bonds that started in 1981 will not last forever."

Most likely, he argues, it's already over.

Since one of Lack's goals is to warn investors about a new bond bear market, it's wise to recall the last one. It ran from 1940 to 1981 and was really a bear. The bear market in British Treasury bonds (gilts) caused £1.00 invested in a constant 30-year maturity, 2.5% coupon, portfolio to shrink to £0.17 in nominal, price-return-only terms, before adjustment for inflation. And there was plenty of inflation. In the U.S., bond prices fell only a little less.

Lack is also testy about the social function of finance. Having shown (not quite to my satisfaction) in his previous book, *The Hedge Fund Mirage,* that hedge-fund managers keep for themselves, through exorbitant fees, all of the economic profits they generate, he now wonders whether the whole financial-services industry is playing that game. Like many economic writers, he is too exercised about the economic progress of the top 1% versus everyone else. (In my opinion, the real problem is low-skilled workers, whom technology has forced over the line from positive to negative marginal productivity. The top 15% or 20% as ranked by income are doing fine.) He's too dismissive of activities such as high-frequency trading ("perfectly useless") and municipal-bond brokerages ("individuals…are receiving a terrible deal"). Middlemen such as these are considered bad guys until you need to buy or sell something and then you're banging on their door in the middle of the night.

Lack's personal story and the financial and social history that he weaves into it are the best part of the book. I already know quite a bit about bonds, but I benefited from his refresher on the British class system circa 1980. Highborn traders, he reminds us, belong to the champagne-and-polo circuit, while those from the working class constitute the gin-and-tonic-and-squash crowd – all along I thought it was beer! I also wonder how many Americans know the depth of depression reached by the British economy in the 1970s, the pernicious role played by the trade unions, or the vigor with which the depression ended in the Thatcher years. It's a cautionary tale that applies quite directly to us now, and Lack tells it well. The perspective of an Englishman who moved to the U.S. and became a patriotic American is enlightening, and Lack's depth of knowledge, combined with an easy writing style, make the book a pleasure to read.

Are We Too Reliant on Debt?

Lack has read his (Sidney) Homer[1] and has a strong historical background in the asset class in which he deals. However, there are elements to his history of borrowing that seems incorrect or at least incomplete. Lack says that the concept of borrowing for consumption is no more than 100 years old, while borrowing for production — say, agriculture or factory-building or war — has an ancient provenance.

But let's look at the real-estate market. People have always had to live somewhere, either in their own home or in a rented one. Because of the high inherent cost of a home, somebody — the occupant or the landlord — typically needs to borrow. The consumption is the same if a landlord borrows to build or buy and the occupant rents from the landlord as it would be if the occupant borrowed the money. All production is for eventual consumption, as is all borrowing.[2]

A Bad Deal in the Derivatives Market

Lack worked in the inter-dealer derivatives market in the 1980s and colorfully describes the characters who made it tick: Jacques Dejoux, an "imperious Frenchman," bet big on hunches and loved to see others fail, while the disciplined and mathematically minded Larry Hirshik regularly collected small arbitrage profits from Dejoux and others. As might be expected in a morality tale, the modest Hirshik gets his just reward: "Eventually the Frenchman's hand went cold and…he drifted quietly away. Larry meanwhile represented the future, and his career as a swaps trader continued for a great many more successful years."

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[1] The late Sidney Homer, who spent most of his career at Salomon Brothers, was the "dean" of bond research. See Homer, Sidney, and Richard Sylla. *A History of Interest Rates.*

[2] Even a government borrowing to wage a war is borrowing so that the people it pays — soldiers, munitions manufacturers, etc. — can consume.

A market full of Damon Runyonesque characters, many of whom become very rich, isn't likely to be efficient in providing the best possible price to customers. But competitive forces and the increased speed of communication should force such a market to become more efficient over time.

Surprise — it hasn't. End-user customers (corporations, pension plans, and others facing risks they'd like to hedge) are two parties removed from the inter-dealer broker (IDB), which clears the market for derivatives, or hedging instruments. Customers deal with their banks, which transact with other banks through an IDB. Nobody but the IDB gets any price transparency with respect to the overall market. Derivatives markets are dominated by the swaps market, in which virtually all transactions are customized and transparency doesn't have much meaning. Lack continues:

> The result is an insider's market where [a large] profit margin [is] built in. … Why is this model stable? …Why don't new participants enter the market and drive pricing down, as economic theory would predict? The answer is that additional entrants require the cooperation of the banks, and the status quo suits their purposes.

Lack then describes an atmosphere in which regulators, entrenched traders, and inattentive customers conspire, half unwittingly, to keep derivatives prices and, to some extent, bond prices inefficient. The picture Lack paints is damning. "Stocks," he says, "are fairer." Who knew?

Lack concludes that bond-based retail products are mostly ripoffs. For example, structured notes, such as equity-linked notes sold to affluent private-banking customers, are priced at 1-2% markups over the bank's cost of constructing the payoffs in the derivatives market. When banks sell these notes, they typically book profits right away (not gradually over time). Customers, Lack argues, would be better off building the product themselves using riskless certificates of deposit or Treasury bills and futures contracts on stock indices.

A banker might respond that the 1% or 2%, amortized over the life of the note, is a reasonable "assembly charge" for a strategy that would otherwise require quite a bit of trading and monitoring by the customer. But a retail customer could get fairly close to the same payoff just by buying a mix of stock index funds and low-risk bond or cash funds, calibrating the amounts held so that the overall downside risk were acceptable.

Inflation and the Bond Market Are Political

Lack explains in clear language the relation between the government's expenditures, revenues, deficit, and public debt. He also addresses the multi-level nature of government and government debt in the United States (states and localities go into debt, as does the federal government) and shows how private and public debt combine to create problems that are not immediately apparent.

I've been less concerned about private debt than about government debt because the private decision of whether to borrow to acquire an asset is subject to the discipline of the marketplace. However, private debt still has to be paid back with funds left over after taxes have been paid and can be problematic for households from a cash-flow perspective.

Lack believes that the mountain of debt we've accumulated shows that the U.S. political system is in need of reform. He is encouraged by the top-two voting system now being used in California and Washington and suggests it may be effective in reducing political polarization. In such a system, the two candidates who receive the most primary votes run against each other in the general election. If the two general-election candidates are from the same party, the more centrist of the two is likely to win, the thinking goes. Over time, this causes candidates to be more centrist in general.

I agree that centrist solutions are often good ones, but I am not sure that a top-two voting system will produce them, at least in the short run. Consider who runs for office in today's polarized atmosphere. A Democrat is likely to see even the more moderate of two Republicans as being pretty far to the right, and a Republican is likely to be dismayed at having to choose between two Democrats perceived as pretty far to the left. Thus, about half the voters will feel disenfranchised at election time. I'd like to be allowed to vote for someone of my own party in a general election, thank you. Over the very long run, a top-two voting system might bring the parties closer to the center, but there is absolutely no guarantee of it.

We've often wondered why "financial repression" (administered interest rates well below inflation – that is, negative real rates) has persisted as long as it has. Lack has a political explanation. Homeowners with fixed-rate mortgages are much more numerous than affluent savers and outvote them. House prices benefit from inflation, and house payments benefit from low rates. Leveraged homeowners usually also have substantial non-mortgage debt that is less burdensome at low interest rates.

Where do we hear an outcry over financial repression? In the *Wall Street Journal*, *Forbes*, *Barron's,* and *Advisor Perspectives*. The readers of these fine publications, while powerful in other ways — at the very least, in purchasing power — don't have enough votes to influence policy very much.

The prognosis is not good. "A society," writes Lack, "that has borrowed excessively has an incentive to allow inflation and low rates until the point at which they're clearly negative for overall economic growth. Such a condition may persist for many more years."

The Social Function of the Trader

I'd add that the doctrinaire neo-Keynesians who are running things seem to think that low rates are always good for economic growth, as long as they don't cause inflation. So why don't bonds last forever, or almost forever? Lack's answer comes toward the end of his book. Before that, he takes us on a detour through his own experience as a fixed-income and derivatives market maker at a succession of banks in the 1990s. Here, too, he finds a lesson in politics to teach, but not before a much-needed reminder of the social function of the trader:

> Because market making requires some appetite for risk, it blurs the line between providing a service of liquidity to clients and taking proprietary positions. … [There is no] discrete difference [between the latter two functions.] A risk-averse market maker will do no business because his prices will never be competitive if he has to ensure that every trade can be profitably offset. A proprietary trader indifferent to meeting the liquidity needs of clients will [also] do little … business, since he'll only trade with clients when it suits him.

Why didn't our business school professors explain things to us with such clarity? Because they were teaching us complicated math that they had developed to impress other academics, that's why.

Yet Lack stumbles when, later in the same chapter, he can't enunciate with comparable clarity the social function of the financial-services industry more generally. After noting that doctors and teachers don't have to explain their social value because it is so obvious, he says that "an increasing share of [GDP] from financial services does not … appear to create substantial benefits beyond the industry itself."

Lack holds this view despite his general belief that capitalism allocates resources efficiently. Perhaps he ought to listen to one of *my* lectures, in which I ask an anti-capitalist student how he got to the lecture. "I rode the bus," he says. "Who paid for the bus?" I ask. "I paid for my share of it, by paying the bus fare." "You did, but who can afford to spend $250,000 right now on a bus that will be paid for with two-dollar tickets that will be sold over the next 30 years? Surely not the city government, which merely arranges the transaction and guarantees the payments. Wall Street bought the bus."

Our lives are enriched, as few in history have been, by magnificent edifices — buildings, roads, bridges, parks, schools, hospitals, airplanes and airports, information technology — all bought with the savings of investors big and small from around the world, directed into these uses by the financial system for a fee. We tend to take these benefits for granted, or we credit great engineers and colorful entrepreneurs such as Steve Jobs and Richard Branson. But very little of today's startling technological environment and standard of living would have been built without finance, a field that includes derivatives traders and others whose contributions are not obvious.

The Specter of Inflation

As a would-be expert on asset allocation and long-term investing, I spend a lot of time worrying about inflation. While I've read quite a bit about creeping inflation (what we have in the U.S.) and about hyperinflation, I didn't appreciate the prevalence of near-hyperinflation in both distant and more recent history. Lack notes that the United Kingdom, a model of stability, had inflation in excess of 20% per year in 5% of the years from 1500 to 1799.[3] The French franc lost 99% of its value relative to the dollar from 1900 to 1958.[4] The good news, we suppose, is that:

> By contrast, in Latin America, commonly perceived as perennially vulnerable to hyperinflation, prices during the last half of the eighteenth century were [more stable] in Argentina or Chile than in Denmark or Portugal.

Denmark?

Lack repeats some misinformation about the current economic malaise that bears correction. For example: "The typical household lost almost 30 years of progress through the 2007-2008 collapse, and as a result is back to where they were in 1983." As evidence, he shows a Federal Reserve-generated chart of median household net worth.

There are so many problems with this "statistic" that I don't have enough space to list them. First, the typical household with assets in 2008 didn't exist in 1983. The residents of those households were in high school or college or were just starting out in adult life.

Second, medians are tricky statistics to work with. The median household has essentially no assets. It's a sad fact that portfolios of financial investments mostly belong to the top 20% of the population by income. So the tremendous decline in median assets around 2007-08 is mostly a decline in highly leveraged home equity. It's hard to suffer from a stock market decline when you don't have any stocks.

Finally, human capital is most people's largest asset. While it's admittedly hard to estimate the value of human capital (the present value of future earnings), the household-assets analysis counts it as worthless, and clearly it's not.

Lack's point is that many voters would benefit from a higher inflation rate, so investors should worry about inflationary government policies. But he shouldn't cite misleading data to support a sound premise.

The lesson is that governments that are net debtors always have an incentive to create unanticipated inflation—they can pay off their debts with cheapened currency. And at least in a democracy, governments usually have an incentive to go into debt, because voters typically wish for more government services than they are willing to pay for with current taxes. The few bouts of government budget surplus in history are the result of either unusually rapid economic growth, during which tax receipts have risen sharply, or windfalls from natural-resource discoveries.

Very low inflation rates are not forever. We should not get used to them.

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[3] Reinhart and Rogoff [2009].

[4] Homer and Sylla [2005].

Measuring Inflation

Lack also engages in a well-crafted — and very detailed — explanation of the reason that nearly everyone feels inflation is higher than reported in the Consumer Price Index (CPI). The answer is basically that the CPI intentionally measures the cost of a fixed standard of living, while people gauge their own progress relative to an evolving, and usually improving, living standard. Thus, if one's salary or retirement spending only keeps even with inflation, one will feel poorer over time.[5]

This is why the Social Security Administration is right to calculate initial benefit levels by inflating past wages earned over a worker's career at the rate of wage inflation, which runs about 1% higher than CPI inflation.[6] A person who earned the U.S. per-capita GDP in every year of her 40-year working life would have earned only $29,623 (inflated to today's dollars using the CPI) in 1974, but $52,800 in 2013. The same work history inflated to today's money using wage inflation would amount to earnings of $52,800 every year. If her benefit were calculated based on the first formula, no wonder she would feel poor! Retirees are competing to buy the same goods and services as working people, so wage inflation needs to be taken into account in setting retirement goals and policies.

The Bond Bull Market is Most Certainly not Forever

So you need to invest at a real rate of 1% or so, just to break even. How might one do so when current real interest rates are below that level? Lack's final chapter suggests an answer.

The chapter begins by revisiting the idea that bonds are an unattractive investment. Even if yields do not rise, Lack says, returns after taxes, transaction costs, and true inflation — which is faster than CPI inflation — will be negative. If yields rise, as they almost surely will, then capital losses will exacerbate the damage. So what should you do?

"The answer is equities," writes Lack. "Make your own bond" out of the part of the equity dividend stream that is stable and growing. Since there are really only two large asset classes, stocks and bonds, this is a natural answer and one consistent with finance theory. But stocks, which appear fully priced, can fall sharply even though their expected return is higher than that of bonds. So, what conservative asset should one hold? "Cash, even yielding close to zero percent, can be used as a risk enabler," Lack writes.

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[5] We'd note, by the way, that Lack introduces an error into this valuable discussion. He says that the U.S. politician Ron Paul thinks the CPI overstates inflation. As Lack acknowledges in an earlier passage, Paul thinks the opposite.

[6] While wage inflation is used to adjust past earnings to calculate the initial Social Security benefit, cost of living adjustments after retirement are made using the CPI-W, which is a consumer price inflation index, not a wage inflation index. Former Senator Rick Santorum famously said that Social Security cost-of-living adjustments reflect wage inflation, but he was confused. Only the formula used to determine the initial benefit reflects wage inflation, while later cost-of-living adjustments reflect CPI inflation.

Lack proposes a model portfolio with about the same risk as a 10-year bond, consisting of about 25% in equities and 75% in cash. He also suggests a dividend and low-beta tilt to the equity portfolio. (Full disclosure: My own portfolio looks a lot like Lack's, but without the tilts. I mostly use index funds.)

Finally, Lack describes a hedged dividend-capture strategy and a master limited partnership (MLP) strategy, used in the fund he manages. I am a little concerned about MLPs because they have gone up and up, achieving a stunning 15% compounded annual return over 2004-13, when the S&P 500 earned only 7.4% annually. But MLPs still offer a good yield, around 5%. It is interesting that Lack leaves out real estate and real-estate investment trusts, despite the appeal of those asset classes as income sources and inflation hedges.

Lack's investment strategy is consistent with much that has been written, by me and others, about the dangers of bond investing in the face of massive government debt, ongoing deficits and a historically low going-in rate. It's a simple and sensible strategy. While you don't have to read his whole book to get to the investment-strategy part, you will be better informed and entertained for having done so.

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