Bonds vs. Stocks for the Long-Term

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A recent article in The Wall Street Journal posed the question: "Will Stocks Trail Bonds Over the Next Decade?" For long-term investors, i.e. those with at least a ten-year time horizon, the answer to this question could be significant. Saving is critical to have a sufficient nest egg for retirement and, if that nest egg is too small, then retirees will have to make some hard choices about quality of living in retirement. Professor Edward McQuarrie forecast that there is only a 4 in 10 chance of stocks outperforming bonds. His research shows that bonds outperformed stocks by 38.7% in all 10-year periods since 1793. On the other hand, another well regarded economist, Jeremy Siegel, expects stocks to easily outperform bonds. We must be careful about interpreting statistics; a big part of the bonds outperforming stocks story occurred during the 19th century!

Traditional methods of forecasting interest rates are centered on the belief that the current interest rate is the future interest rate. One reason is that a bond purchased at 100 today yielding 2% that matures in 10 years will provide a current return of 2% even though the bond price may fluctuate between now and then. If you are invested in that 2% bond, you cannot take advantage of changes in interest rates. For example, if interest rates go up to 3%, your 2% bond would have to compete with that 3% issue if you wanted to sell your holdings to buy the 3% bond. The principal loss would lower the money you would have to buy the 3% bond, just about equaling the yield of 2%.

As such, in today's world of low interest rates, i.e. 0.7% on a 10-year treasury bond, getting a higher yield is next to impossible. To participate in an expected rise in interest rates you would have to be invested in a portfolio of short-term fixed income securities to benefit from the turnover in that portfolio as interest rates rose. On the other hand, if interest rates fell, you could benefit from a rise in an individual bond's price if you sold it to buy another security.

The greatest period of bond performance occurred from about 1980 to 1990 when the return on long-term bonds went from a trailing 3% to a 16% rate of return. However, this return was mostly due to record high interest rates, where 10-year treasury bonds started the period in the 15% return range. As rates entered a 40-year decline, bonds temporarily benefited from the short-term capital appreciation of that 15% yielding bond adding to total return. Given the current low interest rates that exist it is impossible to duplicate historic bond returns over the past forty years. At current low rates, expectations of a long-term return above 5% would take a major rise in interest rates starting now. Such a feat would be even more difficult as the Federal Reserve announced a commitment to no interest rate increases until 2022 at the earliest and that increase will depend on economic circumstances. Such a commitment will further reduce the chances that bond investments will produce any meaningful return for the foreseeable future.

On the other hand, a few market observers forecast that there is a minimal chance that stocks outperform bonds because stocks are currently high priced based on a few measures of valuation.

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However, the yields on stocks are about 1.9%, not too far from Barclay’s investment grade corporate bond yield of 2.3%. An important difference is that dividends tend to increase over time whereas bond interest payments are fixed. One standout opportunity is the high yield bond market as measured by the Bloomberg Barclay’s High Yield Index return of nearly 7%. The reason for such a yield difference is that the high yield bond market is made up of companies with lower credit ratings that have the potential to default on their interest payments -- especially during difficult economic times -- whereas investment grade bonds are less likely to default. This feature of high yield bonds produces short-term price volatility that approximates the volatility of the stock market. If the stock market is overvalued and not likely to go up at an historical rate of 10%, then the yield on high yield bond portfolios could produce a favorable long-term return.