The elephant in the room - fighting the last war

Wow - I lost a lot of money on my bonds

Wow. Interest rates have been on one serious tear. Rising from just 0.499% on the 10-year U.S. Treasury (back on March 9, 2020) to a new high of 4.25% as of October 24th. That's a 752% proportionate increase. This is a pretty big deal. In fact, it's the biggest interest rate move since 1850.

But when I say "Wow" . . . I'm **NOT** referring to this historic interest rate move. Instead, there's a far bigger elephant in the room. And that elephant is all about how investors are responding . . . and doing so with potentially quite self-destructive behavioral bias. Let me flesh out this observation.

Many investors are reacting to the recent 752% proportionate interest rate rise (i.e., out-sized losses on their bond portfolios) in the worst possible way. That's a pretty bold statement. So, how could it be true? Or to put it differently, what's the problem, what's the danger?

Behavioral Bias

You and I are human and as such we suffer from potent behavioral bias. This bias gains the greatest traction and does the most damage when investment markets torque and threaten us . . . such as right now.

Four behavioral biases, in particular . . . are gaining traction today, are biting:

- **Loss aversion** - Irrational risk avoidance. *Expecting to find high returns with low risk.*
- **Media response** - Listening to the news. *Tendency to react to news without reasonable examination.*
- **Regret** - Would of, could of, should of. *Treating errors of commission more seriously than errors of omission.*
- **Herding** - Following the crowd. *Copying the behavior of others even in the face of unfavorable outcomes.*

How are these biases being expressed today? You and I have lost big money on our bonds. We thought bonds were safe and secure. Instead . . . we lost money, more than we expected, more than we understood, more than we ever dreamed.

I'm scared and frightened - Maybe I should change what I'm doing

Here's the danger, here's the risk . . . we embrace our humanity and conclude ***"It didn't work as expected, therefore it's broken, therefore I can only progress on a better future path, if I make changes, and the sooner I make those changes, the better off I am!"*** This response is just so human. And also, just so wrong and self-destructive. Yay, that's blunt, but it's also so true.

So, what's going on here? We're attempting to fight the last war. We jump to the wrong conclusion. We take action that would be the perfect solution for the past . . . for what was . . . for what could have been, if we had just made this decision in the past. We're taking the prefect action as if we were living back on March 9 of 2020 . . . but, unfortunately, we don't live back then. Mr. Peabody's Wayback Machine only existed in our easier-times imagination.

Fighting the last war

What can I say, this is nothing more than sloppy, weak thinking. And to be equally honest, both you and I suffer from such backward-looking behaviors. Hopefully, we can keep these self-destructive tendencies bounded and in check. What are these "wrong" and "backward-looking" behaviors? We change our portfolios so that they adopt:

- Radically shorter average maturities
- Pure U.S. Treasury compositions, i.e., adopting ultra-high credit quality and near-flawless liquidity

Unfortunately, the investment industry is not being helpful, instead, they're making it harder. How so? This is the story of the one-trick-pony. Yep, they got it right over the 32 months ending Oct 2022, but never before . . . and never again. Too many in the investment industry (far far too many) are promoting products that just happened to be in the right place at the right time during this "once in a 150-year event." This is so seriously embarrassing.

Don't fall for such misleading story-telling. Wherein the story-tellers suggest that their respective success over the last (rare and unique) 32 months speaks to their talents for the future . . . they don't and won't, not ever! Which is why the government requires (as a matter of law and regulation) advisors and investment managers to remind you that ***"Past performance is not indicative of future performance."***

Sure, are there incredibly talented and beneficial bond managers? Of course, there are. But that has nothing to do with "*did they get it right over the most recent once in a 150-year exception!*" Please don't fall for this false story-telling. And certainly a 100% pure U.S. Treasury bond ladder best exemplifies such self-destructive thinking. Whatever you do, don't fall for the false and misleading U.S. Treasury bond ladder being currently promoted by so many false charlatans.

The solution

So, what's the solution? Coming up with "the solution," might be a bar too high. But here's what I do with my own very small set of clients. When I onboard a new client, we spend a single standalone meeting on one and only one topic, i.e., behavioral bias (no other topic is allowed to invade the discussion). We end this meeting by observing that eventually, seriously scary events will unfold, and their arrival will drive us to hold a follow-on meeting to discuss the specific behavioral bias (or biases) that have taken root and are threatening to disrupt our prudent/balanced decision-making.

Yep, it' all about how emotion driven fear (or greed) might be encouraging us to make the absolute worst decision . . . at the worst possible time.

I guess this is a long-winded way of saying . . . don't drive down the proverbial Los Angeles freeway (I used to live in and raised my dear-family in Los Angeles) looking in the rearview mirror . . . it just doesn't end well. Instead, stay intensely focused on the future. Where is the puck going, not where's it been.

So, in another sense, don't react to the recent 752% proportionate interest rate rise by changing your already existing bond portfolio. That is just so wrong. But are there qualifications? Yep, there sure are.

Look, we're in the very beginnings of a bond bear market. These are not unusual or rare events. But if you lack a serious historical perspective, you might not have an appreciation for just how troublesome bond bear markets can be and are! As a placeholder, (nothing more) interest rates might continue to rise from now through say "2040." This would set the foundation for a bond bear market. And when you combine that interest rate rise with high and/or accelerating inflation, one ends up with a classic and seriously troublesome bond bear.

Bottom line

Are there solutions to the arrival of a "20-year" bond bear? Absolutely. Your financial advisor has a menu of possible investment solutions that are directly relevant to the issues discussed above. But the solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

Trying to be helpful, here's one last thought . . . ask your advisor "***How do I help you, help me?***" After all, isn't this the right question you and I should be asking of every professional that we interact with? A doctor, a dentist, a carpenter, a lawyer, a financial advisor. . . how do I help you help me?

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All data was provided by Global Financial Data, Inc. on November 4, 2022.

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