The following is in response to the ongoing exchange of letters regarding socially responsible investing:

Dear Editor,

In reading through the various letters to the editor responding to Adam Jared Apt’s article of May 21, Measuring the Cost of Socially Responsible Investing, an important issue has been overlooked. Apt referenced a generic methodology published by Adler and Kritzman in 2008 that purports to estimate the opportunity cost to active management of excluding stocks from an investable universe. Apt also referenced recent presentations by Krtizman at a meeting of analysts in Boston and at Middlebury College at which Kritzman explicitly stated that the cost of fossil-fuel divestment was hundreds of millions of dollars.

What Apt did not report is that Kritzman verbally confirmed that this seemingly outrageous cost amounted to a mere 0.3% of annualized incremental return over the period. This figure is “in the noise” — that is, statistically undetectable without the aid of thousands of data points from a mathematical simulation. What is more unfortunate, however, is that the data Kritzman provides for the cost of divestment is off by a factor of 2. His cost computation of $270 million (referenced by Apt and others) excludes 20% of the investable universe – but the entire energy sector in the world is half that number!

Kritzman (and by extension Apt) talk in general about socially responsible investments without clarifying that the estimated cost of divestment of fossil-fuel producers must max out at half the quoted $270 million figure. When the top 200 fossil fuel companies on Carbon Tracker’s divestment list (less than 5% of the universe) is considered, then the cost estimate drops to a quarter of the quoted figure. When other lists, such as Swarthmore College’s sordid 16, are considered, the potential cost of divestment becomes negligible and is essentially zero for practical purposes.

Regardless of what one believes about Adler and Kritzman’s approach, misrepresenting the cost of divestment creates confusion and does serious disservice for investors and their fiduciaries.

Sincerely,

Julie N.W. Goodridge, President and CEO
NorthStar Asset Management, Inc.
The following is in response to Joe Tomlinson’s article, Retirement Portfolios: Fears over Rising Rates are Overblown, which appeared last week:

Dear Editor:

Tomlinson makes the same mistake that many who defend bond fund investments make. He produces a textbook example showing that while a rise in rates may reduce the immediate value of a single bond that is sold the day after rates rise, the replacement bond will eventually catch up because it is earning a higher rate of interest.

This calculation would be correct in theory if bond funds owned only a single bond, no money was to be withdrawn from (or added to) the account, there were no transaction fees, and bond funds charged nothing for their services.

But these assumptions are not realistic when dealing with the circumstances facing personal investors. Bond funds own more than a single bond and they do charge fees. Even more importantly, investors, (especially retirees) do withdraw money on a regular basis and they may need this money before the bond funds have a chance to catch up.

Using the same example as the author used, assume an investor must withdraw $3,060 in five years to pay living expenses. He buys a 2% coupon bond at par today for $3,000 with a yield to maturity of 2%. Tomorrow, rates rise to 4%. He holds on until the end of year 5 and collects the $3,060 (plus the intervening coupon payments during the first four years, which he may spend or re-invest).

Assume, on the other hand, he invests $3,000 in a bond fund today that owns three bonds currently valued at $1,000 each, each with a 2% coupon and each with a current 2%. But assume one bond will mature in four years, one in five years and one in six years. Note that the average maturity is the same (we could even assume an average duration). This is closer to reality, because bond funds own many bonds of differing maturities within their own portfolios. Will the investor come out the same as he would if the bond fund owned only one bond? Will he have the same risk?
I think not, unless you assume 100% prescience regarding the yield curve and ignore the common risks associated with bonds that are not held to maturity. Assumptions regarding the yield curve become necessary because we now have differing maturities, as all bond funds do. Look at each bond separately.

The 4-year bond matures at the end of four years and the bond fund must replace it. We must assume some rate of return during the fifth year. Will it replaced by another five year bond at 4% coupon with a 4% YTM? We don’t know. The replacement bond will have to be sold at the end of the year 5 to provide the cash anyway, which needs to be factored in. This adds reinvestment and market risk.

For the five-year bond, the single bond analysis holds. It should be noted that the investor would need to reinvest the extra interest payments (i.e. the amount over $60 each year) to make sure sufficient cash would be there when needed from the 5-year bond proceeds. This adds a small element of reinvestment risk. This assumes, of course, that the investor will not need to sell it before it has the chance to catch up at the maturity date finish line. Interestingly, the author later suggests withdrawals are unpredictable, which weakens the assumption that the investor would not have to sell it.

For the six-year bond, we must assume it would have the same rate of return as a one-year bond at the end of five years, because it has only one year to go now. It must be sold to provide the cash for the withdrawal. It seems to me that this is where the analysis gets dicey. What would it be worth? That would depend on the YTM for one-year bonds at the end of 5 years. Who knows what it will be? This adds market risk and the possibility that the investor may be worse off. There is also the possibility of sequence risk if the investor must make these withdrawals annually, repeating this process, while rates continue to rise (a distinct possibility in today’s environment).

Of course, all of the above assumes the investor will not need this money for three years. What if he or she needed to withdraw it the day after rates rose? Investors are not compensated for any of these risks by holding the bond fund. But all these risks are avoided if the investor buys an individual bond. Even if one assumes the yield curve does not shift, there is no way to know what the one-year rate will be at the end of five years. The investor could well be worse off overall, even ignoring the first two risks. These reasons by themselves, I believe, defend the premise our July 2 article. Bond funds are dangerous for investors right now.

I also disagree with Tomlinson’s disparagement of bond ladders. Living expenses cannot be predicted with precision, but the heart of any serious financial plan is making projections of annual income needs during retirement over some span (typically 30 years) based on the most reasonable assumptions that can be made. A capital-needs analysis
rests on specific values for these variables, notwithstanding the fact that they must be estimated. Isn’t that what planning is all about?

Finally, Tomlinson stated that he prefers bond-index funds for diversification and low expenses. Diversification is a true advantage for bond funds but it comes at a cost, namely the fees charged by the fund managers. The index funds may have low annual expenses, but there are no expenses associated with buying individual bonds, other than the initial bid-ask spread and transaction costs. I fully agree, however, that actively managed bond funds are worse than index funds.

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