Beginning to Think About 2013

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The Big Picture

I hope your 2012 has been a good one because it's almost over. Although we have three weeks left in the year it's probably wise to begin thinking ahead to the new year. This business is all about thinking like a chess player and the player who thinks the most moves ahead generally has a sizable advantage. But we also have to be careful about trying to look *too far* ahead….After all, the problems that trip us up are often right in front of us.

Unfortunately, the people we can't look to are Wall Street's analysts. As is usually the case their 2013 estimates are very optimistic. In fact, if we look at the 2013 year-end targets for 2013 there is only one firm currently expecting a negative return. Luckily, that firm releases multiple calls (their bank unit is actually calling for a 10%+ return).

	Year-End S&P Target	% Change (Current)
Wells Fargo	1390	-1.98%
UBS	1425	0.49%
Morgan Stanley	1434	1.13%
Deutsche Bank	1500	5.78%
Barclays	1525	7.55%
HSBC	1560	10.01%
Goldman Sachs	1575	11.07%
BMO Capital	1575	11.07%
Oppenheimer	1585	11.78%
Bank of America	1600	12.83%
CitiBank	1615	13.89%

Source: Orcam Financial Group, LLC

"Failure to prepare is preparing to fail."
-Coach John Wooden

The Inter-temporal Conundrum

Forecasting the future is often a lost cause. Not because the future is unpredictable, but because forecasters don't properly develop an understanding for thinking about the future in a multi-temporal manner. Yes, we can make huge long-term macro calls with some degree of higher certainty. Some things - like we expect output to grow at a trend rate of about 2% or we expect the S&P 500 to generate a return in the historical trend range 6-7% range. But these are calls that span multiple investment lifetimes in most cases. As wonderful as the old Jeremy Siegel mantra of "stocks for the long run" might sound, the reality is that life gets in the way of this "long run" plan.

I call this the "inter-temporal conundrum" for savers. The theory behind buy and hold is that you can always depend on these huge macro trends to remain in force over the long-term. You just have to be able to stick to the plan long enough to benefit from this huge macro trend. And yes, I certainly do believe in this huge macro trend. Although I might sound pessimistic at times I am a firm believer in the idea that human beings are constantly making progress and pushing themselves to the limits. This insatiable desire to improve is inherent in us and it results in a powerful long-term economic trend. Fighting that trend over a 50, 100 or 200 year period is almost certainly a losing bet.

But this doesn't translate to all of our investment lifetimes. Most of us do not amass a substantial savings portfolio until we are in our 40's or even our 50's. We've spent our 20's & 30's building a stable career, perhaps paying off student loans, perhaps starting families or focusing on the largest purchase of our lives—our homes. And we're all hoping to retire and live off this savings when we're 65 or so. So if you think about this timeline realistically most of us have an investment lifetime of about 20-25 years. Those years between 40 & 65 are the most crucial because they are the years when we are in peak earnings mode and making our money "work for us".

But the problem is that all asset classes don't always translate to this timeframe terribly well. For instance, while it's unusual for equity markets to go 20-25 years without gains it's certainly not unheard of. So there's no guarantee that this mantra of "stock for the long-run" will actually pan out for the average saver.

This creates a real conundrum because a savings portfolio requires a certain degree of certainty. After all, we need to be able to plan around this "nest egg" so we can be prepared for life's surprises or even the not-so-surprises (like retirement—which, come to think of it, might actually be a surprise for some given the current economic environment).

The Beauty of the Laddered Bond Portfolio

So the question is, can you create portfolios that reduce this element of time or at least reduce the risk of duration? One idea I often discuss is the laddered bond portfolio. If you're not familiar with the structure of a laddered bond portfolio—it's actually rather simple. The idea is to invest in a series of maturities across the curve so that you create a portfolio with consistent maturity dates. So, if I had $10 I might invest $1 in each duration out to 10 years (starting from 1 year to 10). As the bonds mature you roll them over. It's a simple idea, but remarkably beautiful.

Not only does it reduce your interest rate risk, market price risk and reinvestment risk, but if you continually implement the portfolio over an investment lifetime you can virtually eliminate duration risk. That is, you can construct a portfolio that spans the duration of outstanding bonds in a specific class in such a manner that eliminates the problem of time. In other words, your portfolio has no expiration date. It has no inter-temporal conundrum.

"Get to the Point, Cullen!"

The point here is to emphasize the importance of developing a framework and thought process for portfolio construction. A portfolio that reduces the risk of the inter-temporal conundrum has a substantial advantage in that it reduces the uncertainty involved in timing. We spend so much of our investment lifetimes obsessing over the concept of time, timing, time horizons, etc. The reality is that we should be developing portfolios that make time irrelevant. Of course, that's easier said than done, but it's an important lesson to keep in mind at all times.

So, as we begin to think about 2013 let's not obsess too much over the specifics of what 2013 will look like on December 31st 2013. The analysts on the prior page do not know and yours truly certainly doesn't know. So let's be sure not to fall victim to these types of forecasts. But more importantly, let's remember that proper portfolio construction involves the understanding of many timeframes with the goal of reducing risk in the overall portfolio.

More thoughts on 2013 to come this week….Stay tuned.

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