

Client's Corner

The Mythology of Bonds

THE ROUGHLY HUNDRED-YEAR RETURN OF LARGE- company common stocks in the United States—assuming dividends were left to compound—has been about 10% per year. The return of the most comparable corporate bond index—not exactly the same companies as in the S&P 500, but certainly the same *caliber* of companies—is about six percent.

Net of three percent inflation over this period, then, stocks have compounded at seven percent and bonds at three percent. Which is to say that equities have returned quite a bit more than twice what bonds did. These are facts.

Yet very large numbers of otherwise intelligent people are walking the streets of the republic even as you read this who are absolutely convinced that bonds are an importantly effective diversifier to equities. That is, they think it advisable to give up more than half the historical real return of equities to invest in bonds. The latter are seen as being somehow “safer.”

As surely they are, if one is calibrating the risk of America's largest companies going bankrupt. In that doomsday scenario, the bondholders have a lien on the assets, and must be made whole before the stockholders can recover anything. In the greatest extremity, the stockholders could conceivably end up with nothing. This is (however narrowly) true. But it isn't what people who regard bonds as “safer” are really thinking about. What, then, do such people believe?

In my experience, they're convinced of one or both of two theses that are manifestly not true. One is that bonds produce more income than do stocks. And the other is that bonds are appreciably more stable than are stocks, thus providing an effective defense against equities' frequent and not insignificant price declines—a phenomenon the folks call “volatility.”

These are illusions. Bonds certainly *yield* more than stocks do—if you just compare the current interest payments of bonds to the current cash dividends paid by stocks. Indeed, as I write in late August, Moody's Sea-

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soned Baa Corporate Bond Index—a good long-term bond proxy for the kinds of companies found in the S&P 500—yields just less than six percent, versus 1.4% for the S&P.

This narrow comparison sets aside (among other things) the fact that cash interest payments from the bonds will be flat for upwards of 20 years. While if history is any guide, cash dividend income will have grown over those two decades at something approaching six percent a year. Stated in the simplest terms, your dollar of income from the bonds will still be one dollar 20 years hence. Your dollar of dividend income may well be something close to \$3.20.

(You have my permission to start thinking about what this might mean over 20 years of retirement, in terms of your ability to fight off inflation in your living costs. An illustration based on the last five very eventful years follows momentarily.)

The other element of bonds' perceived safety is that they are believed to efficiently buffer your portfolio against equity “volatility.” The reality: sometimes they do. And at other times they very much don't.

To demonstrate the latter outcome, we need look no further back than the last really significant drawdown in stocks in 2022. The S&P 500 declined 25.4% that year. Moody's bond index declined 13%—its worst year since 1976. (The iconic 60/40 portfolio had its worst year since 1937.) That the bonds went down less than did equities was very cold

comfort to people who'd thought they couldn't go down at all. Am I cherry-picking here? Surely I am, but in a good cause: to make you keenly aware that whenever stocks get hit hard by rising interest rates, so will bonds, and for the same reason.

As a sort of real-world summing up, I invite you to consider the actual experience of the five years that are due to end this December 31. We begin therefore at year-end 2020. At that point the economy was stabilizing significantly post-COVID. The inflation resulting from a 40% increase in the money supply (to offset COVID hardship) had yet to explode. It was a moment of relative calm between storms.

- The S&P 500 ended 2020 at 3,756. As I write it is 6,300, **up 68%**.

- The cash dividend of the S&P 500 in 2020 was \$56.70. With eight of 12 months already in the barn, the consensus forecast for 2025's full-year cash dividend is around \$77.80, **up 37%**.

- Now the most important variable—the one by which all these other variables should be judged by a rational (which is to say: long-term) investor. At year-end 2020, the Consumer Price Index stood at 262.05. As of this June, it was 321.5. Let's assume it ends up three percent higher than it finished 2024; that would put it at 327, **up 25%**.

(Forgive me if I belabor what should be obvious: after these five quite volatile years, the purchasing power of your fixed dollar of bond interest will have fallen to 75 cents.

While the cash dividend income from mainstream equities will have risen considerably more than did the general

cost of living. The equity investor's dividend income actually ***gained*** purchasing power. This underappreciated juxtaposition should be of vital interest to the 10,000 Americans who will be retiring today and every day for the balance of the decade.)

- You could have bought a portfolio of high quality corporate bonds of 20+ years' maturity at year-end 2020; it would have yielded just over three percent. That same portfolio, priced at today's prevailing interest rate of very nearly six percent, would have declined significantly—though the original principal will (after two decades of inflation) ultimately be repaid. No more, no less.

Have I managed to choose the very worst five-year period for this comparison in the last 50 years? Dear reader, all I can say is: I certainly hope so. At any rate, I've surely ***tried*** to do so—again, in a good cause. Which is simply to illustrate that many people's intuitive sense of the benefits of bonds is an illusion, unsupported by fact—or, for that matter, by logic.

Sit down with your advisor, by all means, and perform this analysis over any meaningful time period you choose. The results may not be as extreme as the foregoing, but the same conclusions will surely present themselves. And the longer your investing time horizon—think in terms of your income needs over a three-decade two-person retirement—the less attractive bonds will look compared to equities. And the more equities will clearly emerge as the far superior inflation fighter.

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Sources: Long-term returns of stocks vs. bonds: Ibbotson *Stocks, Bonds Bills and Inflation*. S&P levels and dividends: Standard & Poor's; S&P 500 earnings history, NYU Stern School. Moody's Seasoned Baa Corporate Bond yield: Moody's; Federal Reserve Bank of St. Louis (FRED). Inflation: U.S. Bureau of Labor Statistics; FRED.