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UCCESS

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Myths about Bonds

Bonds are a core part of many people's investment portfolios. But that doesn't mean they're widely understood. In fact, there are many common myths about bonds, and following those myths could lead to poor investment decisions. Below, we debunk a few of the most common myths about bonds.

Myth 1: Bonds Are Risk-Free Investments

It's true that investing in bonds is not as risky as some investments, like stocks or real estate. But less risk doesn't equate to no risk. A bond issuer may default on their obligations, which could leave investors without their principal. Also, some bonds are riskier than others. Treasury bonds, which are guaranteed by the U.S. government, carry relatively little risk — the U.S. has never defaulted on its debt obligations. Corporate bonds, which are issued by companies, are generally riskier than government bonds. You can get an idea of the relative risk of a certain bond by reviewing its bond rating, which is expressed as a letter grade. A triple-A bond means the issuer is extremely likely to meet its commitments. A bond with a C rating means the issuer is vulnerable.

Myth 2: Lower Returns Mean Investing in Bonds Isn't Worth It

Bonds may not be as glamorous as stocks and other investments, but that doesn't mean they don't have a

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Switzerland – Why Aren't We All Like the Swiss?

Diane and I recently returned from our annual international trip – this year to Switzerland. The country was incredibly beautiful, reminding me of our first trip to the Grand Canyon. You have to see it for yourself to grasp the enormity of the natural beauty. It was not only beyond words but even a picture doesn't quite do it, although I include a couple in our online version of this newsletter.

Like most countries, a visit will reveal a few surprises. For example, the famous Lake Geneva is not actually named as we know it. The real name is Lake Leman. Further, there are many kinds of cheese in Switzerland, not just the cheese with holes in it. We visited Gruyere, for example, and had Gruyere cheese. The Swiss make lots of cheese, and don't like it when tourists think they only make what we call Swiss cheese.

While we were there, they celebrated their version of Thanksgiving, but not as we expected – they fast.

While most of us know that the Swiss are famous for their neutrality, perhaps you will be surprised to learn that they are neither part of the Eurozone nor the European Union. They use the Swiss Franc and are completely independent and neutral from the rest of Europe, though situated right in the middle of it.

You will find plenty of cheese, chocolate and watches in Switzerland, but one thing you will find very little of is debt. The government of Switzerland runs a surplus. They spend less than they tax. As a result, the Swiss holdings of foreign currency reserves are worth more than their outstanding debt, and at about $40 billion, their gold reserves are amongst the largest in the world.

Government policies reflect the conservative financial practices of the Swiss people. For example, to take out a mortgage, banks require a 30% deposit. And very few Swiss have credit card balances. They have become wealthy without the debt. Their living standard is the third highest in the world, ignoring micro countries like Liechtenstein and Monaco. The two countries with a higher living standard, Norway and Qatar, are rich because of their natural resources. Switzerland has the Alps, which generates tourism income, but otherwise have no natural resources that contribute to wealth.

Perhaps they are so wealthy because they are so careful with debt.

There have been recent headlines about countries like Argentina and Turkey that are in trouble with debt. Their currencies have collapsed, leading to a lower standard of living for their citizens. But we don't have to look that far to find debt problems. In fact, we believe

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Myths about Bonds

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place in your investment portfolio. Bonds are a way to add diversification to your portfolio; a stock-heavy portfolio can earn great returns, but it can also lose a lot of money fast if the market drops. Your stocks may eventually regain their losses; but if you need the money in the interim, you'll need to find other resources. Bonds can also provide a steady source of income, which may be appealing if you're at a point when you would like to live off investment income. They are also a way to preserve your capital while still earning some returns. In addition, certain types of bonds offer tax advantages — income earned on municipal bonds is free of federal income tax and sometimes state and/or local income taxes, for example.

Myth 3: Bonds and Bond Funds Are Essentially the Same

Not exactly. In some ways, the difference between individual bonds and bond funds is similar to the difference between individual stocks and stock mutual funds. Like a stock mutual fund, with a bond fund, you give your money to a professional investment manager, who chooses a range of bond investments on your behalf. With an individual bond, you have an investment in a single bond, which you hold until the bond's maturity date. Individual bonds have fixed payments, often semiannually or quarterly; and if you hold the bond to maturity, you get your original investment back.

On the other hand, bond funds have fluctuating income based on how well the underlying bond investments perform. Bond funds are more liquid than individual bonds, however, which means it's easier to sell your investment if you need the cash. You'll also need to invest in a greater array of individual bonds to diversify the bond portion of your portfolio. Which one is right for you depends on your goals, comfort level with investing, and other factors.

Myth 4: All Bonds Are Safe Investments

First, it's important to understand there are no guarantees when it comes to investing — there's always risk. While bonds are generally considered less risky than stocks, that doesn't mean there's no risk, and some bonds are riskier than others. Bonds issued by the U.S. federal government carry minimal risk (for example, savings bonds or Treasury bonds). But similar bonds issued by a less-stable country or government could carry much more risk. State and local bonds (called munis) come with a greater risk of default than bonds issued by the U.S. federal government. Corporate bonds can be risky too, especially so-called junk bonds.

Want to get more of the facts on bonds? Please call to discuss bonds in more detail. ❍❍❍

Avoid These 5 Investing Mistakes

A great way to learn the ins and outs of investing is by examining the mistakes of others. This helps you determine steps that should be avoided. Make sure to avoid these five investing mistakes:

✔ **Putting all your investment eggs in one basket.** Diversification is a familiar term in investing. Investing in a variety of investment alternatives helps decrease risk. If you have all your money invested in one company and that company does not perform well, your portfolio is going to suffer. However, by diversifying your portfolio, your overall return will not be as drastically impacted by the poor performance of one company, because you'll have investments in many other companies.

✔ **Spreading your investments too thin.** While there is value in diversification, overdiversification can be problematic. With too many investments in your portfolio, each one has little impact on your total return. Thus, your return tends to mimic the market. Even if you selected one or two outstanding investments, they are not likely to have much impact on your portfolio.

✔ **Expecting instant gratification.** Investing takes patience. When investors jump into an investment seeking to get rich quick, they often find themselves giving up on an investment too quickly, missing out on returns that might have materialized over time. If you select an investment after careful research, you won't need to monitor its every movement. Most investments will fluctuate, but good investments tend to appreciate over time.

✔ **Neglecting risk level assessment.** Before investing money, you need to assess the investment's potential for both upside and downside gains and losses. When you understand the risk an investment faces, you are less likely to sell on emotion.

✔ **Skipping out on an investment education.** Many people invest without knowing anything about the markets or the field of investing. Whether the cause is time constraints or confusion, lack of education can be harmful to your portfolio. You need a solid understanding of investment basics. Once the education piece is in place and you have done your research, investing becomes much more interesting. ❍❍❍

When Can You Retire?

When can you retire? It depends — on how old you are; how much you have saved; the extent to which you'll rely on Social Security, a pension, or tax-advantaged retirement accounts; how your investments perform; the kind of lifestyle you want in retirement; and how long you'll live.

Factors to Consider When Setting a Target Retirement Age

1. What kind of lifestyle do you want in retirement? Given the same monthly savings rate, there is a tradeoff between when you can retire and the kind of lifestyle you can have once you do. For example, if you're currently 50 years old, earn $50,000 per year, and plan to live to age 90, for about the same monthly savings amount, you can retire at age 65 with 50% of your preretirement income or at age 70 with 100% of your preretirement income (Source: Kiplinger Retirement Savings Calculator). There's no right or wrong answer here, it's simply a tradeoff you'll have to make.

2. What does Social Security consider to be your full retirement age? The government will let you start receiving Social Security benefits at age 62, but those benefits will be less than what you'd receive if you waited until your full retirement age. For example, for an individual born in 1960 or later who retires at age 62 instead of age 67 (his full retirement age), his monthly benefits will be reduced by 30%. For individuals born before 1960, full retirement age ranges from 65 to 66 and 10 months, and the reduction in benefits for retiring at age 62 ranges from 20% to 29.17%.

Of course, if you're not counting on Social Security for retirement income, then you can retire whenever you want and wait until your full retirement age to start taking Social Security benefits.

3. What do your pension and other retirement plans consider to be full retirement age? Like Social Security, most pension plans have a certain minimum age at which they will begin paying benefits (at a reduced rate), and a certain age at which you become eligible to start receiving full benefits. Similarly, tax-advantaged retirement plans like 401(k) plans and IRAs penalize distributions (except in certain circumstances) before age 59½.

Important to note: While most people focus on the earliest age at which they can retire, it's also important to understand when you may be required to start taking retirement benefits or distributions from retirement accounts. 401(k)s and 403(b)s require minimum distributions beginning at age 70½ (unless you're still working in most cases), as do traditional IRAs.

If you would like to retire at age 62 but the math just isn't working out, you might consider partial retirement. By continuing to generate income even after you've left the workplace, you can retire earlier than if you're not generating any income at all.

Ways to Partially Retire

✔ **Work part-time —** Working part-time, either at your current job or another one, is one way to continue generating income while still having more time to pursue the retirement activities you've been looking forward to. Some people enjoy working a few hours every day, a couple of days a week, or even just a couple months out of the year, depending on the job.

✔ **Consult —** You've likely spent many decades honing your skills in a particular job or industry. And while some employers might be wary of hiring older workers full-time, they're often eager to tap the expertise of older workers on a contract basis. So consulting can be a good way to continue earning income while also freeing up time to golf, play with the grandkids, and whatever else you've been putting off for retirement.

✔ **Sell your wares —** If you had planned to do craft-related activities in retirement anyway, why not consider selling your wares? Online craft sites make selling homemade items relatively easy. If you join a local craft-making group, you could find the activity both financially and socially rewarding.

Please call if you'd like to discuss this in more detail. ❍❍❍

Switzerland

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that one of the biggest financial issues that we face here in the United States is debt.

The U.S. government is running up debt like never before. New debt issued by the U.S. government may be part of the reason that interest rates are rising. The 10-year Treasury rate has recently risen to 3.25%, from 1.36% in July of 2016. At least the U.S. government can print money to pay off the debt, though that may cause inflation.

We are more concerned about the affairs of the states. Though the official debt levels of the states have generally been flat for a long time, at about 4% of U.S. GDP, include the total obligations of the states and the numbers start to look almost hopeless. Obligations of the states include the cost of healthcare and pension payments to state retirees. Many states, including New Jersey, have woefully underfunded health and pension obligations.

To find out what can happen, consider the history of Bethlehem Steel. Bethlehem was ranked 8th in the Fortune 500 in 1955. This company built 1,127 ships during World War II, and also supplied the steel for San Francisco's Golden Gate bridge. At its peak in 1975, Bethlehem Steel employed 115,000 people.

But from its Fortune 500 peak in 1955, Bethlehem Steel waned. Some blamed the union and contracts that didn't allow for headcount reductions. Some blamed foreign steel imports made by lower wage earners in low income countries. Some blamed bad management. CEO Eugene Grace once remarked, "I have no doubt that the story will be one of increasing per capita use of steel in spite of the development of competing materials. I have no qualms about excess capacity. The United States will never catch up to its material needs and aspirations."

These confident, and in hindsight, overconfident remarks were reflected in company spending. In 1973, well after profits had started to fall, the company built a 21-story new headquarters which cost significantly more than was typical because it was designed to have as many corner offices as possible.

In 1986, Pulitzer Prize winning author John Strohmeyer wrote a book titled *Crisis in Bethlehem, Big Steel's Struggle to Survive.* Strohmeyer blamed the union (pp 164), management (pp 142) and the decline in demand for steel (pp 180). But Strohmeyer, whose book was written 16 years before Bethlehem's demise, did not even mention the biggest risk for Bethlehem Steel.

Unfunded pension plans, and not bad management, foreign steel or union contracts, sunk Bethlehem Steel. Over the years, Bethlehem Steel chose to fund their pensions on a "pay as you go" basis, rather than funding pensions as they were earned. Shortly after the company closed in bankruptcy in 2003, Fortune Magazine ran a story called "The Sinking of Bethlehem Steel…a FORTUNE autopsy." Fortune concluded that "the ultimate error was the steel industry's pension and health benefits. The history here is revealing. From World War II on, wage and price controls intermittently slowed wage increases. Written into the contracts as offsets, though, were a long string of benefit improvements. These took up their role as company killers."

As further evidence that it was not bad management, union demands or foreign steel that did Bethlehem Steel in, consider US Steel. US Steel faced all of the problems that Bethlehem Steel faced, but is still around today because unlike Bethlehem Steel, US Steel funded its pension obligations.

The state of New Jersey is looking a lot like Bethlehem Steel. The issues for Bethlehem that made the headlines were union negotiations and decrease in demand. Governor Christie's union negotiations were constantly in the news, but the decrease in demand - not so much. But consider that demand is shrinking. Demand can be measured by population growth, and New Jersey is almost the lowest in the country. Further, New Jersey suffers from a loss of high wage earners who are moving out. For wage growth, therefore, New Jersey ranks 49th in the country. From wages come tax revenues.

Like Bethlehem Steel, labor negotiations and shrinkage in revenue are not the real problem. The real problem is that New Jersey is not funding its pension obligations.

In the 1950's, New Jersey centralized government worker pensions. Teachers, prison guards, local police, firefighters, general government workers, judges and state police workers all had their pensions consolidated and taken over by the state. The state government, however, skimped on contributions. Between the Whitman, McGreevey, and Corzine administrations, covering from 1994 through 2001, contributions were only $3.2 billion, far below what was needed.

Things reached a crisis level in the 2000 to 2002 recession. New Jersey's pension fund portfolio registered investment declines of 10.4% in 2000 and 9% in 2001, followed by a gain of just 3% in 2002. The combined shortfall of those years robbed the pension system of $21 billion in assets (NJ pension report pp 7). At the same time, state revenues declined because of wage declines. Required contributions rose to $1.5 billion by 2006 and such contributions were well beyond the state's ability to pay – so it didn't.

To its credit, the Christie administration did substantially increase contributions, but not by enough. According to the state's own 2018 budget report, "the rising costs of defined benefit pensions and health benefits continue to burden the State government and constrain the ability to be responsive to other priorities. As of June 30, 2015, the State's combined net pension liability was over $160 billion." According to the 2016 State Pension Funding Gap report prepared by the Pew Charitable Trust, New Jersey has only funded 31% of its pension obligation, which with Kentucky represents the lowest funding level in the country. The debt rating agencies have responded by cutting the ratings of New Jersey debt time and time again, from just below AAA to current ratings of A-, which are under review for further downgrades. According to Standard & Poor's, New Jersey has the worst pension crisis in the nation.

The current administration has responded by raising taxes on corporations and the wealthiest members. This won't work. In a quote in the Star Ledger, Assemblyman Jon Bramnick responded, "From small business owners to New Jersey's 22 Fortune 500 companies, nobody will like being treated like the Garden State piggy bank. The people who are most upset, you're never going to hear from, they don't do press conferences. They don't call and say 'Hey I'm leaving,' they just leave."

Famously, in 2016, David Tepper, the wealthiest resident of the state, left, costing the state hundreds of millions of dollars in lost tax payments. Several New Jersey lawmakers, who had to redo the budget, cited his relocation as proof that the state's tax rates are chasing away the rich. (New York Times, April 20, 2016 Robert Frank Inside Wealth).

The government watchdog Manhattan Institute put out a report in January of this year titled "Garden State Crowd — Out." The 13-page report chronicles the crisis and concludes with this:

"Faced with the Garden State's ballooning pension costs, the New Jersey Pension and Health Benefit Study Commission ultimately recommended wide-spread changes to the state's pension system as well as additional cost-savings to employee benefits."

None of the changes were implemented by new Governor Phil Murphy, despite the fact that he headed the Commission while at Goldman Sachs.

The Manhattan Institute went on to say that "the Rockefeller Institute of Government defines a government pension system that's below 40% funded as in crisis. New Jersey's pension system is well below that line. Yet even when the costs were considerably less, the state's political leaders balked at fixing the system. We've now reached the point where neglecting to construct an adequate and lasting fix pushes the pension system on a path toward failure, a catastrophic scenario for New Jersey's public employees and taxpayers."

In an October 27, 2018 *Wall Street Journal* article, titled "Spelling Doom for Muni Bonds," author Spencer Jakab wrote, "If that sounds worrisome…The American Legislative Exchange Council determined that using more realistic assumptions, New Jersey is at 19.7% (funding)."

The 2008 recession was very painful and caused by too much mortgage debt. We believe that the next painful recession may well be caused by issues with a different kind of debt, government debt, and New Jersey is, unfortunately, at the forefront.

New Jersey has ignored the example that Switzerland set, and is following the path the Bethlehem Steel took to its demise. New Jersey won't go away but the state, unless it changes course, will be faced with raising taxes to pay for the pensions when they come due and there won't be enough taxpayers to tax. The state may well become only the second state in history to default on debt payments.

We will be vigilant, considering how this will affect our clients, but if you would like to discuss this risk, please bring it up with us.

Sincerely,

John B. Burke

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President, BFS