

William Bernstein – “Stocks for the Long Run”

By Michael Edesess
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William Bernstein is quite a polymath. A former neurologist, he became a writer of books on portfolio management that have become industry standards. He seems most of all however to be a historian *manqué*. In addition to his books on portfolio management, he has also written well-researched books on a range of other interesting topics, including the history of communication technology, economic history, and the history of world trade. His reading of history is that if you want to build a nest egg and protect against the “four horsemen” that threaten it over the long term, the best thing to do is invest in a globally diversified stock portfolio.

I have felt remiss for a long time in that I have not read a Bernstein book. I intended to, but having read so much about his work as well as snippets from his web site, I felt I probably knew what he said in his books.

This has done him an injustice, which I have now begun to correct.

I recently listened to an [interview](#) Bernstein had with Russ Roberts, the inimitable host of [EconTalk](#). It is worth listening to for interesting sparring on philosophy and the analysis of empirical data. Bernstein is an aficionado of expertly prepared empirical statistical studies – in the manner of epidemiological studies, which he would have been immersed in during his medical training and practice.

Bernstein’s historical orientation reveals itself in his latest book, *Deep Risk: How History Informs Portfolio Design*. He is skeptical of “black swans” — a phrase coined by Nassim Nicholas Taleb to describe hard-to-predict events with big effects. Bernstein argues that black swans “are sighted mainly by those who have not read enough history.”

In other words, nearly everything that will be known to humankind can also be found somewhere in history. (This would not have applied, however, to the actual discovery of black swans in Australia, which were unknown to Europeans at the time.) For example, the 2011 tsunami that devastated Japan’s shoreline and its nuclear power plants near Fukushima might be considered a black swan event, but a [similarly large tsunami](#) hit nearby in 1498. Bernstein is a careful reader of history and expects it to repeat itself.

Bernstein’s conclusions may not be much of a surprise — though, as we’ll see, they lead to a more surprising conclusion – but Bernstein is not out to provide any shocking news.





His analyses are within the range of conventional wisdom but are not bound by it. Nevertheless, he does subtly wink to the chinks in conventional wisdom.

Turbulence versus death

This is Bernstein's third in a series of short volumes he published recently with the theme "investing for adults," by which Bernstein means investors who already know basic investment theory. The first two were [*The Ages of the Investor: A Critical Look at Life-cycle Investing*](#) and [*Skating Where the Puck Was: The Correlation Game in a Flat World*](#).

In this volume, Bernstein distinguishes between "shallow risk" and "deep risk," or what we would ordinarily call short-term risk and long-term risk. It's an important distinction. Bernstein emphasizes that "the short-term volatility of financial assets, commonly measured as standard deviation, is a highly imperfect measure of the actual long-horizon perils faced by real-world investors." Retirement savings, he says, "are never destroyed by a too-high standard deviation: you need a real world event to do that."

Let's consider an airplane safety analogy. Short-term risk is like turbulence. It can make fearful flyers very nervous and wish they could just get off the plane. The real risk of flying, though, is different – like long-term risk. It is the risk that ultimately, you won't get where you're going because the plane will crash. This risk is measured differently from the risk of turbulence, which is only loosely related to the risk of a crash.

Bernstein defines shallow investment risk as risk that is observable over periods of fewer than 10 or 20 years. Deep risk, by contrast, is observable over 30 years or more. If you're a long-term investor, you can recover from shallow risk and usually will if you understand it and don't panic.

The four horsemen

Deep risk, however, is another matter. It represents a "permanent loss of capital" – which Bernstein defines as long-term negative real return over 30 years.

Bernstein sorts the deep risks into four categories, which he calls the four horsemen of financial disaster: inflation, deflation, confiscation and devastation.

The latter two, confiscation and devastation, are closely related. Confiscation means large-scale confiscation of assets by the investor's home government, as occurred in revolutionary Russia, Cuba and China. Devastation is usually due to geopolitical disaster, such as world war.



Bernstein discusses these risks and how to protect against them – such as preparing to flee the country, situating assets offshore and perhaps buying a home in another safe country. He ends up dismissing these protective “insurance” measures as, for the most part, too costly and burdensome. If you were thinking of buying a home in another country anyway it may be advisable. Otherwise, the hassle and cost of protecting your assets – and yourself – against confiscation and devastation are too great, unless you’re in a country where the risk is especially high.

Bernstein regards deflation as a low-probability scenario, and one with less than disastrous consequences. He says that “in the fiat money era, the probability, and so the deep risk, of significant deflation is at least an order of magnitude less than the risk of inflation.” In the only modern example of “deflation-associated long-lasting capital markets disaster,” Japan’s CPI fell a grand total of 2.06% from 1995 to 2013. That leaves inflation – particularly hyperinflation – as the biggest long-term risk. What is the best protection against that risk?

Remember, this is deep risk – the risk of permanently losing a large portion of one’s assets. Bernstein examines that risk for various investments, but particularly investments in stocks and bonds.

Bernstein remarks that “the historical databases we’re most familiar with— in the United States and England in particular— were those of the ‘winners.’” Still, he confines his analysis to the historical data on stocks and bonds in those developed economies, because that is where his targeted readers live and he believes those histories will be most relevant to them.

A permanent loss of assets after 30 years has been very rare for stock investors in the developed countries Bernstein examines. He notes that mathematical derivations have argued that the risk of investing in stocks increases over time (for example, in [a 1995 paper by Zvi Bodie](#)), but Bernstein is a student of the historical empirical evidence, not of mathematics. “Stocks, when looked at through a mathematical lens, become riskier with time,” he notes, “but swap out the math lens for a historical one and you get an entirely different picture.”

Deep losses over long periods of time have not been as rare for investments in bonds. Bernstein concludes that bonds are an inferior investment for averting deep risk. He points to several pieces of historical anecdotal evidence. For example, “in the forty years between 1940 and 1979, French investors saw the real value of their bills decrease by 96% (-7.8% annualized) and of their bonds by 84% (-4.5% annualized). French stocks, while hardly tearing up the track, saw, with dividends reinvested, their real wealth actually increase by 124% (2.0% annualized).”



The upshot

Bernstein neatly summarizes the deep risks posed by the four horsemen and the appropriate responses in a table:

Table 3. Probabilities, consequence severities, and insurance costs of the four horsemen

	Probability	Consequence Severity	Method of Insuring	Cost of Insuring
Inflation	+++	++	Global Equities Commodities Producers Gold TIPS	+
Deflation	+	++	Global Equities Long Treasuries T-bills Gold	+++
Confiscation	++	++	Foreign-held assets and real estate	++
Devastation	+	+++	Foreign-held assets (for local devastation only)	++ to +++*

*Depends on country of residence

The most important box is the method of insuring against inflation. Bernstein argues that inflation has the highest combination of probability and severity and is the least expensive deep risk to insure against.

Although Bernstein lists several measures in that box, he emphasizes investment in globally diversified equities and gives relatively short shrift to the other investments listed. (Gold, he points out, has been shown to be a poor hedge against inflation. The reasons are cited in a recent Advisor Perspectives [article](#).) The history of international stock returns argues for the superiority of the globally diversified equity portfolio as a hedge against inflation. As Bernstein notes, “a long-term negative global stock return requires not merely universal inflation, but universal Armageddon.”

A few quibbles and a congratulatory note

I wonder why Bernstein does not give more weight to Treasury Inflation-protected securities (TIPS) as a hedge against deep risk. I presume that the reason is because, as one of Bernstein’s exhibits shows, real returns on equities for 19 developed nations from 1900-2011 ranged from a little below 2% annually to a little above 7%, averaging about 4%



or 4.5%. By comparison, 30-year TIPS maturing in 2043 offer about a 1.5% real return. So TIPS offer, on average, about 3% less than the average equity portfolio.

But the real return on TIPS is assured – at least insofar as we can rely on the U.S. government to pay its debts. And like stocks, government inflation-protected securities can be diversified internationally if there is concern about sovereign risk. TIPS also protect against deflation, because their principal payment at maturity is guaranteed not to fall below their original face value. Nevertheless, the only qualms Bernstein raises about them are that they can pose a tax headache if held in a taxable account and that they can be risky if not held to maturity, because of price fluctuation and a relatively thin secondary market. He also overstates the tax burden posed by TIPS, which merely require the accounting for “phantom income” – the accretion of the bond’s purchase price – on an annual basis, something easily done in a spreadsheet. But he rightly points out that TIPS should be held in a ladder until maturity and that there is no reason to hold them in a mutual fund.

A second quibble is with his recommendation to “spend your nest egg down on living expenses until age 70 so as to obtain the world’s cheapest and best inflation-adjusted annuity: the 8% per year increase in Social Security payments from delaying their start.”

An 8% per year increase in Social Security payments sounds good, but there’s no good reason to delay the start of Social Security payments. Each year of payments delayed is a year of payments you don’t receive, so of course the payments need to be increased to make up for the lost year. Unless a Social Security recipient has reason to believe her actuarial prospects are significantly different from the average person’s, she should be essentially indifferent as to whether she starts collecting early or late. The Social Security actuaries undoubtedly designed the level of increase that way on purpose.

A third quibble has to do with Bernstein’s very brief mention that the place where “deep and shallow risk meet occurs at the point where it’s not certain which you’re dealing with. Most deep risk, of course, starts out as shallow risk.”

That’s a risk he doesn’t really cover, at least not in any depth. When people are uncertain which risk they’re dealing with, they bail out when they shouldn’t – at least shouldn’t have in hindsight.

Bernstein illustrates how much fortitude is required to weather shallow risk that looks like deep risk by invoking a scenario of the 1929-1932 bear market. In this scenario, the fortitudinous investor resolves to rebalance his portfolio to its original 75%/25% stocks/Treasuries allocation every year on June 30. The result is that after rebalancing on June 30, 1932, the investor has hardly any of his Treasury-bond cushion left, because that cushion has dwindled with each rebalancing.



Why doesn't Bernstein use that scenario to question the bromides about rebalancing? If that hypothetical investor held his portfolio instead of rebalancing, the stocks' value would have come back eventually and he would have had the original Treasury-bond cushion all along. But the conventional wisdom says "rebalance," so rebalance he must.

Lastly, I want to draw attention to an important parenthetical Bernstein aside: "(Being softer in the head, I tend to view taxes more as the dues I pay for membership in a club with a billion-person waiting list.)"

Why doesn't anyone ever say this? It's supposed to be the duty of the investor to avoid all the taxes she possibly can – and the duty of the advisor to help her do that. Yet at the same time, that investor and even that advisor may rail against too-big-to-fail banks for using regulatory dodges to make heaps more money. If these two are to criticize others for doing everything they can to get around regulations instead of trying to abide by the spirit of the law, they should at least realize that they are also living in glass houses.

A surprising conclusion

If you buy into Bernstein's argument that bonds have more deep risk than stocks, then those target-date funds designed to manage assets to one's retirement date make no sense. Their premise is that younger investors face only deep risk because they have longer time horizons (more than 30 years), while they become more exposed to shallow risk as they near retirement, because their horizons are shorter (20 or less years).

But this is false. If an investor saves a regular annual amount from a young age until retirement and then spends down the accumulation, the average dollar resides in the investor's account 30 years.

Imagine a person who starts saving at age 35 and saves the same amount each year, then retires at 65 and dies at 94. What she invests at age 35 grows in her investment account to become her retirement income at age 65, what she invests at age 36 grows to become her retirement income at age 66, and so on.

If each dollar resides in the account 30 years, then each dollar is subject to deep risk, not shallow risk. It should be invested in stocks, not bonds. Hence, the only target-date glide path that makes sense is one that holds a constant 100% stock allocation.



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