

The Muhlenkamp Memorandum

Mom ☞ The Squeeze on your "income", (Continued)

For the past five years, you have heard and read our arguments that "Houses Don't Make Money". You have seen our chart depicting the costs of home mortgages versus house price inflation, which we've been foisting on friend and family alike. What has changed in the past year is that much of the public now realizes house prices don't always go up. As long as people believed that a big house was a good investment (regardless of interest rates) they were willing pay 10-11% rates on a mortgage. With the help of the recession, that conviction died in the past year. As recently as November 1990 mortgage rates were still 10 1/2% and CD's were 8%. So this realization and the current incentive to refinance is only a few months old. The incentive to refinance is still "news" and receives extensive coverage in your local newspaper. Yet any mortgage written in the past ten years is now susceptible to being refinanced at lower rates. Conversations with banks and savings and loans indicate to us that only about 20 - 30% have been refinanced to date. Of these, roughly 20% have opted for 15-20 year mortgages (as Sis has done). If this is truly a trend, it has a long way to go; and it will continue to drive rates even lower. You can monitor the progress of this trend(?) by simply talking to your children and to your friends about their children. For as long as mortgages are being refinanced for shorter periods the increased monthly principle payments will keep downward pressure on rates. As long as mortgages are being refinanced at lower rates these new lower rates will be reinforced. Fixed rate mortgages are refinanced down, not up. Which is why many homeowners are now replacing their adjustable rate mortgages with fixed rate mortgages.

When you remember that in the 50's and 60's, mortgage rates were 4 1/2%, and passbook savings were 2%, you get a good idea of where rates may be headed. As recently as 1972, the treasurer of the insurance company where I worked adamantly maintained that normal mortgage rates were 4 1/2%. Each of us who has a mortgage will do our best to drive rates back to those levels.

Meanwhile....on the other side of the ledger, you and your friends have seen CD rates drop from 8% to 4%. (I almost said "seen CD rates drop through the floor" but the floor is likely to be on the order of 2%.) This has been a shock to those who had come to believe that "normal" CD rates were 8% (and who relied on such rates for their income). But such high rates were an anomaly of the 80's. They resulted from the high inflation rates of the 70's and the baby boomer belief that such inflation rates were normal. I have argued above that inflation and inflationary expectations (in housing at least) have just died. If so, "normal" CD rates may be 2% and other short-term "riskless" instruments may reach similar levels.

You said last week that you wouldn't change your lifestyle in response to lower interest rates on CD's. You needn't.... provided you change your MIND.... about the acceptability of various kinds of investments. For background, please reread our essays from 1989 titled, "Inflation Time Bomb", "Defusing the Time Bomb" and "Risk". Be aware that earning good

returns on your assets normally requires significant amounts of thought and effort. This is true in farming, and it's true in investing (and in every other endeavor that I can think of). Only in the past ten years have short-term rates (on no-effort investments) been significantly above inflation -- and those days are over.

For over a decade financial planners, advisors, and other experts have maintained that long-term investments like stocks and long-term bonds are risky and CD's and other short-term debt are risk free. But their definition of risk looks only at short-term price changes. They have ignored the long-term loss of the purchasing power of your assets; and they've simply assumed, contrary to history, that the high interest rates of the 80's would continue.

The simple truth is all investments have risks. There is no "free lunch". If you focus too narrowly on short-term risks, you will be vulnerable long-term. If you focus on the long-term (as we do), you will suffer setbacks short-term. My complaint is many advisors have encouraged you to finance your long-term retirement (for 20+ years) using only short-term instruments, which were clearly at unsustainably high rates.

These same advisors are now helping your friends buy "longer term" investments which they will be called out of as interest rates continue to drop. The most popular has been mortgage backed securities which still promise rates of 7.5%. But these rates will hold only until the mortgages are refinanced, at which time people will have to reinvest at lower rates, just as you did a year ago. Others are buying Corporate Bonds, which are also callable, leading to the same problem.

The only investments which allow you to benefit in a climate of falling inflation and interest rates are common stocks and long-term treasury bonds. By law, treasuries are non-callable. (Unless, of course, Congress changes the law.) Most other fixed-income investments are subject to call or redemption. Remember, there is someone on the other side of the piece of paper whose job or incentive is to lower his borrowing costs.

Finally, look carefully at your own investing experience. In 17 years of investing in common stocks, you've had one down year. Your annual returns have averaged 15% (9% over the average inflation rate of 6%). So your assets multiplied 10 times, while the cost of living nearly tripled. Has this been so "risky" you'd rather not have participated?

During this same 17 years, your short-term investments (CD's, etc.) have averaged about 8% (2% over inflation). With inflation, each year your income bought less. In the last year, this income has been cut in half. Has this been riskless investing?

Mom, the recent period of high interest rates on CD's is over. It is over because your children are no longer willing to pay an 11% interest rate on their mortgage. So your choices in sustaining yourself through the rest of your retirement has become more difficult. You can still do well, but it will require more thought and effort on your part. You must think for yourself and be skeptical of the conventional wisdom. Let me know if I can be of help.