October 20, 2020

Banyan's equity composite rose 9.8% in the third quarter of 2020 compared to the S&P 500's total return of 8.9%. Year-to-date, our equity composite declined 1.7% compared to the S&P 500's total return of 5.6%. We have traded little this year despite intense research activity. High prices and weak economic conditions have made actionable ideas rare. While we hope to find a promising investment soon, we will not allow impatience to threaten our discipline.

* * * * *

Myths are prevalent in the investment arena, and we would like to use this letter to dispel one. The myth in question is almost universal, and dispelling it can drastically improve your quality of life. The myth is that your investments should change upon retirement to reflect the change in your life. As the thinking goes, cash and bonds, not stocks, are more suitable because (1) your assets must generate an income stream and (2) preserving rather than building wealth is the new objective.

We have long dissented from this orthodoxy. Retirement is a big life event; it need not be a big financial event. Retirement is a transition from living off your *labor* to living off your *savings*. If properly prepared for, this transition necessitates no change to an already well-constructed portfolio. At Banyan, in fact, it is business as usual. The nature of our job, ***<u>building permanent wealth</u>***, is the same whether our client is 20 or 80 years old. Our clients' portfolios reflect this.

Our approach is to compound *through* retirement, and this philosophical difference has real world impacts. Below is an example from a portfolio Banyan has managed for over 30 years on behalf of a couple now in their eighties. The portfolio's make-up did not change when they retired and is currently constructed like your portfolio. They tell us their income needs, and we satisfy their need with a monthly distribution on the 5th of every month. The liquidity usually arises naturally, but, if not, we sell a small block of the least promising stock. As you can see, the results are powerful.

November 30, 1998, through September 30, 2020

Securities & Cash Deposited	Distributions	Portfolio Value 09/30/2020
$3,282,184	$3,528,415	$5,556,295

Over the 22-year period, distributions exceeded contributions by over $240,000. Yet, the portfolio is worth $5.56 million today. This flies in the face of the orthodoxy. Stocks are risky, the financial clergy argue, and retirees do not have a long enough time horizon to ride out volatility. Yet, the above portfolio was largely comprised of stocks and modest amounts of cash throughout the period and is similarly situated today. The portfolio flourished *in spite of* the dotcom bubble, the financial crisis, and now a pandemic, among numerous other setbacks along the way.

Is this portfolio an exception or does it serve to disprove the orthodoxy? It is not an exception at Banyan. Many of our clients have enjoyed a similar experience in retirement. Many more will enjoy the same when they retire. We do not think Banyan is exceptional, either. A well-selected group of great businesses that are sensibly priced will do the trick. In our opinion, the orthodoxy is simply wrong, and retirees adhering to the flawed orthodoxy pay the price with poor returns.

The orthodoxy's flaw is rooted in an unwarranted short-term mentality. At age 62, the average American couple has a 71% chance of at least one partner living to age 85. There is a 44% chance one will live to age 90. In 18% of the cases, one will live to age 95. A 20-to-30-year retirement is thus the norm, which is plenty of time to smooth out volatility. As a result, retirees have the luxury of adopting a long-term mentality to investing. It is not a luxury available only to the young.

This is especially true for the wealthy. Many wealthy individuals consume a fraction of their net worth each year – frugality, after all, is usually a big factor in their becoming wealthy. As a result, their wealth will outlive them unless their lifestyle changes drastically in retirement. The individual's life expectancy is therefore irrelevant. The objective is to compound on behalf of the beneficiaries, whether decedents or institutions. Near-term volatility is of minor importance.

The long-term mentality this allows is key to our approach of compounding *through* retirement. It allows you to think about risk the right way. Academia's definition of risk as price volatility, or how much a security's price gyrates over a given period, is too myopic. We define risk instead as the likelihood of suffering a *permanent* loss of *purchasing power*. Under our definition, the meaning of risk changes along with the time horizon applied, as it should.

Stocks are awfully risky, for instance, if the funds in question are needed soon. Stock prices are too unpredictable over a short period. Should prices fall, the investor may suffer a *permanent* loss upon liquidation. The opposite is true of high-quality bonds nearing maturity. Their prices don't gyrate much, and, thus, the investor is unlikely to suffer a *permanent* loss upon liquidation. In the short-term, therefore, price volatility is risk under our definition.

As the time horizon lengthens, however, the meaning of risk begins to change under our definition. Business fundamentals, not price volatility, matter more and more. Eventually, it is bonds, not stocks, that are riskier if the objective is to avoid a *permanent* loss of *purchasing power*.[1] Between

[1] *See* Estrada, Javier, *Stocks, Bonds, Risk, and the Holding Period: An International Perspective*, The Journal of Wealth Management (Fall 2013), 34 (finding, "[T]he evidence shows that in the short term stocks have higher volatility, higher spreads, and higher downside potential and deliver more painful losses than do bonds. However, for holding periods longer than 10 years, the opposite is largely the case; that is, stocks gradually become less risky than bonds.").

1926 and 2002, in fact, U.S. Government Bonds earned negative real returns in almost 60% of the possible 20-year holding periods.[2] This has *never* occurred with U.S. stocks going back to 1870.[3]

The situation is even worse today. The 20-Year Treasury Bond offers a measly 1.3% yield *before tax*. Owners are virtually certain to lose purchasing power if they hold the bond to maturity, and the pain is immediate if rates rise. The bond's price will fall almost 40% if yields rise to a mere 4%. That is a poor risk-reward proposition at any age. There is nothing "safe" about it.

Hence our reluctance to alter a portfolio at retirement. Regardless of age, most investors are best served by a reasonably diversified portfolio of great businesses trading at sensible prices. Such a portfolio should compound faster *and* reduce risk *if* the objective is to avoid a *permanent* loss of *purchasing power*. The long-term mindset needed for this approach is a luxury available to retirees and the young alike, and a long-term mindset is key to ***building permanent wealth***.

Sincerely,

Drew Estes, CFA
Partner & Portfolio Manager

Alek Nabulsi
Partner

---

[2] *See* Shen, Pu, *How Long Is a Long-Term Investment?* Federal Reserve Bank of Kansas City, Economic Review (First Quarter 2005) 12 (finding, "[I]n this exercise the frequency of stocks returning less than inflation decreased as the holding period lengthened – and eventually reached zero for periods of at least 19 years. . . . The chart also shows that the frequency of bonds returning less than inflation initially *increased* as the holding period lengthened. . . . When the holding period rose to 20 years [from two years], returns on bonds failed to keep pace with inflation almost 60 percent of the time [compared to 35% of the time for a two year holding period]." (emphasis in original)).

[3] See *U.S. Stock Market Returns – 1870s to Present*, The Measure of A Plan (March 25, 2018), *available at* https://themeasureofaplan.com/us-stock-market-returns-1870s-to-present/