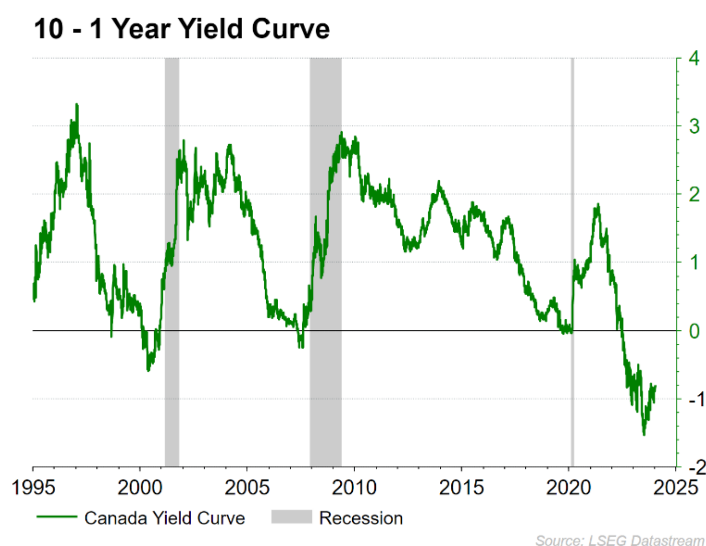
<u>Case Study</u>: Why Avenue doesn't invest in T-Bills and GICs as a long-term investment strategy.

To continue our tribute to the late investing pioneer Charlie Munger, we would like to comment on how Avenue incorporates Charlie Munger's investment strategy of inversion. In the next few Case Studies, we will address Avenue's investment strategy from the perspective of what Avenue doesn't do and the reason behind these decisions. Here we will discuss why there is always a potential opportunity cost when investing in Government of Canada Treasury bills (T-bills) or bank sponsored Guaranteed Investment Certificates (GICs).

There is often a need to have cash on hand to live your everyday life. Businesses also need cash in a bank account to operate day-to-day. Investing in short-term instruments like T-bills and GICs is an ideal way to make some interest income on money that is needed in the short-term. What we are talking about in this case study is rather money that is characterized as long-term savings for an individual, family or business. At Avenue, we believe that over time, our savings will get a higher return when invested in bonds or stocks. The mix of each portfolio of investments between bonds and stocks is determined by the risk tolerance of each investor.



Why this is a timely topic is because investors are currently presented with the choice where short-term interest rates are higher than long-term interest rates.

This has occurred because the interest rate yield curve has inverted, where short-term interest rates are higher than long term rates because of the central bank interest rate hikes over the past two years.

The chart to the left shows 10-year interest rates minus 1-year interest rates in Canada. The negative number shows that short-term rates are higher than longer-term interest rates.

We can observe that short term interest rates are higher than longer term interest rates by the most in almost 30 years.

The rational course of action is to always capture the highest rate of return for the least amount of risk. The temptation today is to not own bonds and stocks at all and simply buy a T-bill or GIC for the next year. This seems like a decent return for taking little risk. At Avenue we believe the real risk is the longer-term opportunity cost from missing out on higher rates of return in the bond market and the stock market. This is where we can use Charlie Munger's way of thinking to guide us in our investment decision making.

Charlie Munger's theory of inversion asks the investor to always turn a situation inversely and look at it backwards. "Instead of trying to achieve success, make a list of how to avoid failure."

Using this process, we will analyze a 1-year investment in a T-bill or GIC by thinking about what we will then do with our money in one years' time. Let's say we buy a GIC and accomplish our short-term

investment goal and with todays 1-year interest rate our money will compound at about 5% for 1-year. This does not sound like a failure, but what Charlie Munger is getting us to think about is what do we do next? Here is where we forecast that there is a risk that when we go to reinvest our money in one year's time, the interest rate could be much lower. This is called reinvestment risk. The real risk is the lost opportunity to have a higher rate of return for longer.

While nothing about the future is certain, short-term interest rates being higher than long-term interest rates should be considered an anomaly. Rational expectations require that lending longer term will desire a higher interest rate to compensate for the risk taken.

Given the risk of having to reinvest at a lower interest rate a year from now, Avenue has two strategies depending on how much risk the client chooses and how long is the investment time horizon.

For clients where lower risk is important and we are investing for 3 to 5 years, Avenue's bond portfolio is invested in a handful of Canadian corporate bonds that mature in 3 to 4 years. So instead, while a 1-year T-bill return is around 5%, Avenue has locked in on average a 6% return for the next few years. We are taking on a bit more risk, but we expect to get a much better return.

For long-term investors where stock market risk is appropriate, timing the stock market by going in and out as proven very difficult over time. We refer you back to the Charlie Munger quote from our above letter - "The number one rule of compounding is to never interrupt it unnecessarily."

That said, Avenue's equity portfolios will have cash on occasion as individual investments are reduced and we will invest this cash in T-bills when appropriate. It is important to remember that this is a temporary situation as we look for our next stock market investment opportunity.

Bill Harris
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