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WHAT IS THE SAFEST INVESTMENT ASSET?

In 2012, Eike Batista had an estimated worth of more than $35 billion.

The self-made Brazilian billionaire created an empire that stretched from mining to oil to public works. Many considered him the pride of Brazil.

Barely two years later, he had lost all $35 billion...and owed another $1.2 billion to creditors.

How does this happen? How does a $35 billion portfolio evaporate practically overnight?

You could point to several poor decisions, but perhaps the biggest of all was concentration risk (and Buffett's favorite destroyer, leverage). Batista's wealth was overwhelmingly tied to the global commodities boom. While that investment concentration was a huge tailwind in helping Batista become rich, it eventually proved his downfall as well.

This points to a critical takeaway every investor needs to be aware of...

The portfolio that helps you get rich isn't necessarily the portfolio that's going to help you stay rich.

"Let's say you're a conservative investor, and put all your money into safe US government short-term Treasury bills.

How big of a drawdown (peak to trough loss) after inflation did you experience in the 20th century?"

Research backs up the old saying "shirtsleeves to shirtsleeves in three generations." 70% of wealthy families lose their wealth by the 2nd generation, and a whopping 90% by the third generation. Granted, some of that is due to high spending, addiction, bad luck, leverage, or just poor decisions. But a lot of it is how people invest their money. Can you invest in a certain way to bombproof your portfolio to minimize losses?

In this piece, let's do what Batista should have done – spend a few minutes focusing on the "stay rich" part of the equation. If you're an investor who has already amassed great wealth what's the right market approach that will help you keep (and potentially even grow) your wealth?

What is the Safest Asset?

Let's say you've "won the game."

"Funded contentment". That's the description my friend Brian Portnoy uses to describe the purpose of wealth accumulation. Essentially, enough money to live the life you've dreamed about.

Now, what that amount is varies for all of us. For some it could be $100,000, for others $1 million or even $10 million wouldn't be enough. But let's say you hit your number.

What now? What if we no longer care about increasing our wealth, but rather, to simply protect it. As mentioned before, the portfolio that helps you get rich isn't necessarily the portfolio that's going to help you remain rich.

So what is the “safest” asset in the world? Is there such a thing?

When trying to engineer a “stay rich” portfolio, it makes sense to start with what the investing community refers to as the “risk-free” asset – US government Treasury bills.

Many investors believe T-bills to be the safest, most conservative investment available. In fact, if you look at T-bills back to 1926, they returned 3.4% per year with zero drawdown or losses. Pretty safe, right? Not a single down year, not even a down month!

Not exactly.

These are nominal returns, and nominal returns are an illusion because they don’t take inflation into account. All that matters to any investor is returns after inflation, or what we call real returns. And if you measure the returns of T-bills after inflation you see a different story – unfortunately, this is a story most investors haven’t seen.

I recently asked my Twitter followers the question below…

Meb Faber
@MebFaber

Let's say you're a conservative investor, and put all of your money into safe US government short-term Treasury bills.

How big of a drawdown (peak to trough loss) after inflation did you experience in the 20th Century?

Option	Votes
0 to -15%	22.7%
-15% to -30%	23.5%
-30% to -45%	16.3%
Worst than -45%	37.5%

846 votes · 1 hour left

3:14 PM · May 30, 2023 · **14K** Views

The actual real max drawdown was a whopping -49%!

But as you can see, about two-thirds of those who answered got this wrong. These are very intelligent people with far greater investing experience than most, yet they seriously underestimated the losses in short-term bonds.

So, the risk-free rate isn’t risk free at all. (And by the way, I’m ignoring other global sovereign bond markets including some that produced a -100% loss.)

The original version of this article ignored what a lot of people do with their money – leave it in the bank at 0% interest…the modern-day version of stuffing it under the mattress. A full third of investors responded to a poll that they earned 0% interest on their bank deposits or “didn’t know.” Over the past 100 years you eventually lose all your wealth (95%) at an inflation clip of about 3% per year. Ouch!

What about parking your hard-earned dough in other asset classes? Might real returns be safer elsewhere?

Unfortunately, no. The losses are even worse when we expand our analysis to other asset classes. Below are max real drawdowns back to 1926:

US Stocks:	Foreign Stocks:	10 Year US Bonds:	Gold:
-79%	-78%	-61%	-85%

Ouch.

The naysayer might look at this and say "These are max drawdowns that likely played out over several years. A smart investor would have gotten out after, say, one year of bad returns."

With that in mind, the below table highlights the worst 12-month, 3 year, 5, year, and 10 year period of real returns for each of the asset classes after annualized inflation of 2.94%. As you can see, nothing was truly "safe."

Real Returns After Inflation 1926-2022	Cash Under Mattress	Cash T-bills	US Stocks	Foreign Stocks	10 Year Bonds	Gold
Annualized Returns	-2.94%	0.36%	6.85%	4.61%	1.82%	2.00%
Volatility	1.82%	1.82%	18.80%	16.04%	7.17%	14.99%
Max Drawdown	-94.22%	-48.91%	-79.18%	-78.01%	-60.63%	-84.39%
% Positive Months	36.34%	60.82%	59.97%	57.04%	53.61%	41.49%
Worst 1 Year Returns	-16.90%	-16.58%	-63.95%	-56.75%	-24.69%	-42.24%
Worst 3 Year Returns	-28.90%	-25.33%	-76.08%	-64.07%	-34.87%	-50.76%
Worst 5 Year Returns	-38.18%	-28.11%	-51.70%	-76.33%	-38.62%	-67.42%
Worst 10 Year Returns	-57.24%	-42.29%	-45.45%	-70.89%	-44.43%	-65.24%

SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

It could be reasonable to argue that people would prefer a slow erosion of wealth to a sharp loss, and in this case, T-bills do indeed look safest on these metrics. They had lower volatility, more positive months, and the lowest worst 12-month period.

However, the slower erosion of bonds might appear less painful at first glance but consider the analogy of the frog and the boiling water. As the analogy goes, if you throw a frog into a pot of boiling water, it will feel the pain and jump right out. But if you put a frog into a pot of cool water then turn on the burner, the frog will remain in the water until it boils.

The slow drawdowns with T-bills is a bit like the frog sitting in water that's simmering toward a boil.

So, let's pause and briefly recap. At this point, it's clear that there's no single asset that is guaranteed to preserve your wealth. The best we've done is a -49% decline. In the safest asset you still lost half your money at some point!

What now? Is there a way to combine assets and build a "minimum loss" portfolio?

Combing Asset Classes to Reduce Risk

Asset allocation strategies have long been known to reduce risk for a portfolio. So, what's the worst drawdown we've seen with the venerated 60/40 portfolio?

60/40:
-54%

Ok, that doesn't help really.

In addition to a global portfolio of stocks and bonds, how about adding real assets like real estate, commodities, and gold? This allocation looks like the "Global Market" (we'll refer to it as "GAA") portfolio we discussed in our Global Asset Allocation book (free download here).

Real Returns After Inflation 1926-2022	Cash T-bills	US 60 / 40	GAA
Annualized Returns	0.36%	5.28%	4.64%
Volatility	1.82%	11.92%	8.40%
Max Drawdown	-48.91%	-53.79%	-33.96%
% Positive Months	60.82%	58.93%	63.40%
Worst 1 Year Returns	-16.58%	-43.26%	-15.37%
Worst 3 Year Returns	-25.33%	-49.30%	-22.98%
Worst 5 Year Returns	-28.11%	-26.33%	-15.79%
Worst 10 Year Returns	-42.29%	-31.69%	-18.18%

SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

As you can see, we give up some real return, but we lower our max drawdown as well as the worst 1,3,5, and 10 year scenarios.

This all points to a takeaway which I think is vastly understated by almost every investor on the planet…
Nearly every allocation (or single asset class) will likely decline by at least 30% on a real basis – and probably more – in your lifetime.

That's a hard pill for many to swallow. But at least you have this knowledge ahead of time, which will hopefully help you anticipate it and better weather the storm.

So, What Does This Mean? Are T-Bills Still the Safest?

You might read this and think "Ok, you've been a real ray of sunshine and shown me that every asset class and portfolio is still susceptible to huge drawdowns. So, if it's all bad, then I might as well start back at the beginning – T-bills seem to offer safety, so that's where I'll park my wealth."

I'll propose an alternative suggestion.

Our studies have shown that historically, an investor can combine a diversified global market portfolio with some cash to produce an outcome with similar or better loss levels as T-bills, yet greater returns.

Real Returns After Inflation 1926-2022	Cash T-bills	25% GAA 75% T-bills	50% GAA 50% T-bills	75% GAA 25% T-bills	GAA
Annualized Returns	0.36%	1.48%	2.57%	3.62%	4.64%
Volatility	1.82%	2.74%	4.49%	6.42%	8.40%
Max Drawdown	-48.91%	-36.87%	-31.18%	-29.22%	-33.96%
% Positive Months	60.82%	59.97%	61.25%	61.51%	63.40%
Worst 1 Year Returns	-16.58%	-16.18%	-17.55%	-23.86%	-15.37%
Worst 3 Year Returns	-25.33%	-26.10%	-26.95%	-28.12%	-22.98%
Worst 5 Year Returns	-28.11%	-25.87%	-24.86%	-25.41%	-15.79%
Worst 10 Year Returns	-42.29%	-35.64%	-28.68%	-21.13%	-18.18%

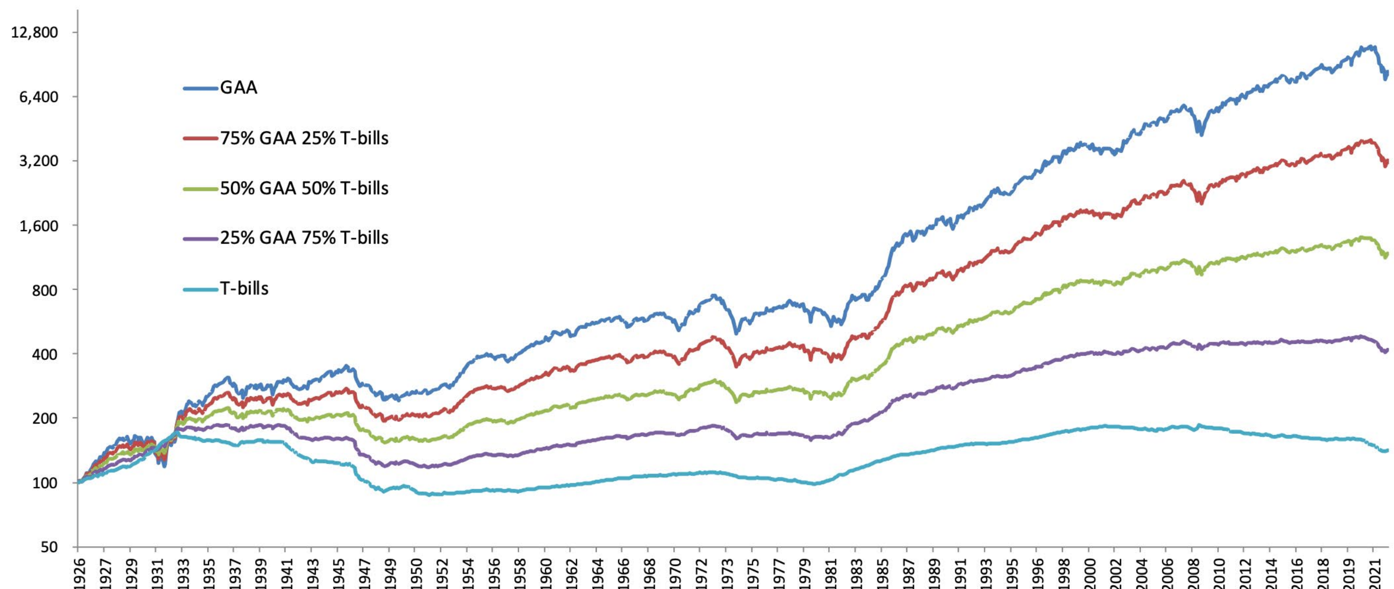
SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

This approach enables an investor to engineer a strategy that offers comparable loss levels of T-bills, yet while generating an additional two plus percentage points of return per year.

Or, perhaps framing the return as "yield" would make more sense as a comparison?

At a minimum, the "GAA" part of the equation offers some protection from the catastrophic losses Batista's incurred when concentrating all his wealth in just one asset class.

Below we chart the T-bills vs. various GAA and T-bills combos. As you can see, there is a little more volatility with the GAA/T-bills, but well worth it for much higher returns over time.



SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

Of course, this is a philosophical departure for many. Many conservative investors keep their safe money in a savings account that earns T-bill like returns. But is that really the safest place for it? History would suggest that investing across a broad global portfolio with some cash has been a safer allocation than T-bills alone.

For those looking to be even more different, which is nearly impossible, you could consider active approaches like adding trend following to the mix. Below is a table including a hypothetical trend system modeled after our old paper, perhaps the best performing portfolio of them all! (Note: no transaction costs included.)

Real Returns After Inflation 1926-2022	Cash T-bills	US 60 / 40	GAA	IVY
Annualized Returns	0.36%	5.28%	4.64%	5.51%
Volatility	1.82%	11.92%	8.40%	6.76%
Max Drawdown	-48.91%	-53.79%	-33.96%	-18.82%
% Positive Months	60.82%	58.93%	63.40%	62.97%
Worst 1 Year Returns	-16.58%	-43.26%	-15.37%	-12.38%
Worst 3 Year Returns	-25.33%	-49.30%	-22.98%	-16.77%
Worst 5 Year Returns	-28.11%	-26.33%	-15.79%	-14.11%
Worst 10 Year Returns	-42.29%	-31.69%	-18.18%	-4.85%

SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

Most of us prefer the safety of “not looking too different”. Or in the corporate world, we’re dominated by “career risk”. After all, how many corporate treasury departments park all of their spare cash in a diversified portfolio of ETFs? Likely zero. (Well, our company Cambria does, but we’re guessing we’re just about the only one.)

So, as you sit down to dinner to discuss moving your “safe” money out of your savings account into a diversified portfolio of ETFs, how do you think your spouse will respond? Our guess is three words: “that sounds risky”.

But historically, it wasn’t.

Now, as to the threat to your wealth posed by that high-spending child and your derelict spouse, well, that’s another problem…

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