There are so many independent, experienced, sober and successful investors who believe that we are in the midst of a low-return world that it is next to impossible to find equally serious and clear-thinking investors who believe the opposite. Why is that?

The common answer is because a low-return scenario is compellingly obvious. The evidence is plentiful, and the arguments are convincing: In almost any outcome, long-term annual returns for conservative bond investors are unlikely to exceed 2%. U.S. common stocks — depending upon what form of valuation you use — are somewhere between moderately to excessively valued; perhaps they are not in bubble territory, but they are not so far removed from it either. The consensus of investors whose opinions I respect conclude that five- to 10-year returns from common stocks are likely to be on the low side of historical averages — and that represents their bullish scenario.

This sets up a challenge for 76 million baby boomers that cannot be understated. When it comes to investing their life savings, they are looking primarily for guarantees. The return from the safest guaranteed investments (10-year Treasury notes) has declined nearly 70% over the last 10 years: from 4.6% to 1.5%.

In dollar terms, the amount of money needed to generate an income of just $25,000 per year has tripled, from $540,000 to $1,660,000. The other option (risking their nest egg in potentially overvalued common stocks) hardly feels like a compelling alternative.

Wall Street has put its best minds to work, searching for creative solutions. Their sensible conclusion is: Don’t chase yield, at least not on traditional sources of income. Instead, they offer up a menu of non-traditional sources of income, and suggest hedging one’s bet by diversifying among them.

It all sounds so well thought out and logical — and in fact, it is. Alternative investments are more sensitive to different types of risk than are traditional investments. What Wall Street neglects to mention is that different risk doesn’t necessarily mean less risk. More likely, it means less-understood risk. Yet what other options do investors have? Surely if there were other sensible choices, we would have heard about them by now.

The narrative of a low-return future is persuasive — built on solid historical evidence, simple mathematics, logic and common sense. It is hard to imagine an alternative narrative as convincing (which explains the lack of commentaries about a high-return world). The strength of a good narrative is that it is likely to be correct. But the weakness of a good narrative is its
pull on our attention, which impairs our perceptual flexibility, keeping alternative solutions hidden and increasing our risk.

The Enemy Is Us
The obstacle to identifying alternative solutions to this challenge appears, once again, to be us. We are born with valuable instinctual and biological filters, without which (given the amount of actual input the world throws at us) we would not be able to remain sane. To order and prioritize what we perceive in the course of a typical day, we use various mental models of the world — artificial constructs that tell us what’s important and what’s irrelevant, processing the input through our emotions, memory and value systems.

All of this happens instantaneously and subconsciously. Without these critical filters our experience of everyday life would be (in the words of William James) “A blooming buzzing confusion.” Stories and narratives are important tools we use to communicate our understanding of things. Author Abby Smith Rumsey has a wonderful insight about them. She writes, “We create narratives that make sense of our passage through time just as our maps make sense of our passage through space.”

Filters, mental models, narratives and stories are enormously valuable tools we exploit to make sense of things. But their use also means that our daily perception of the world is, by necessity, a heavily redacted version of the real thing. Cognitive psychologist Chris Firth calls it, “A fantasy that coincides with reality.” And Nobel Laureate Daniel Hahmemann, in “Thinking Fast and Slow,” demonstrates in one example after another how simple it is to manipulate our perception of reality by slightly reframing the same narrative.

Thus, we need to be very careful: The same tool that helps us gain clarity in one scenario can be an obstacle to it in another. Maintaining a healthy skepticism of even the most compelling narrative may be our only intelligent option.

That said, we can still learn a great deal by seriously considering the narrative of a low-return world. At this point, it is the best working explanation about the investment implications of abnormally low interest rates and an elevated stock market. And it raises the question: What are the most sensible options for individuals who need to live on their investments?

Investors who rely on their savings are legitimately concerned about generating a sustainable return. When earned income stops, it’s a logical step to want to replace it with investment income and to evaluate the investment universe through the lens of that mind-set. But unless an investor’s nest egg is exceptionally large, or their need so small that the annual income needed as a percent of investments is less than 2% — in today’s interest rate environment there are few if any investment options that don’t require taking on more risk than retirees normally want to take.

A challenge like this demands that investors do whatever they can to make good investment choices, ones that will withstand the tests of time. Not knowing the future, making good choices seems like a long-odds gamble. Charlie Munger’s advice (borrowed from mathematician Carl Jacobi): “Invert. Always invert” reframes our goal to “Don’t make avoidable mistakes.”

How Not to Make Stupid Mistakes
The first step is to eliminate the truly stupid mistakes and then the not-so-stupid but still obviously bad mistakes. Last are the not-so-obvious mistakes. What remains when we’re done is a universe of choices that even if we threw a dart, the odds of it landing on a good choice would be excellent.

The idea of achieving success by systematically avoiding bad choices is less exciting than when realized as a result of a brilliant strategic insight. But as bad choices out-number brilliant strategic insights by a wide margin, they are easier to identify and easier to avoid. Investors who fear bad markets would be far better off fearing bad choices. And the easiest bad choice an investor can make in a low-return world is to live above his or her means while taking inappropriate risk to try to make up the difference.

Life, as we know, serves up challenges we were not expecting: A spouse dies, a natural disaster occurs, we suffer a business reversal or investment loss, medical costs for a family member exceed insurance coverage. In each of these situations our response is the same: We tighten our belt, recalibrate and reprioritize. If the circumstances are temporary, we can regain some or all of what we sacrificed. If not, as when facing any challenge, we make the best of what we can to play the cards we are dealt.

Investors need to consider the possibility that in a world in which guaranteed returns are historically low and traditional sources of future returns appear to offer, at best, well-below-average prospects — there may not be an investment solution. Like a business, the financial part of life is all about revenues vs. expenses. Investors hold all the cards on the issue of expenses.

And in today’s environment, many individuals are facing a reality that they did not anticipate: Their investments may not provide enough of a return, and the single most-valuable investment strategy at their disposal, the one that will make the difference between living within or above their means — is their ability and/or willingness to reduce their expenses.

Our perception of the world may be heavily edited by our limitations. But we really don’t need to worry about the risks of a world we can’t see. We should, however, be very worried about ignoring the risks of a world we can see. We have the tools to make good choices, we just need to be willing to actualize them.

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