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Why bonds alone can no longer protect you

Dear Sir/Madam,

Investors are facing an extremely challenging period. Market uncertainty is high and returns are low. This is proving to be an uphill battle for even the most experienced financial professionals. In these difficult times, diversifying the financial assets in your portfolio can prove to be a shrewd investment strategy.

Before deciding on your asset allocation, consider your investment horizon, risk tolerance and any tax considerations. Also take into account the current market cycle. While a portfolio that was overweight on bonds may have performed well in the past, this may no longer be the case. A balanced portfolio that is spread equally between stocks and bonds might be more appropriate, especially if interest rates were to rise.

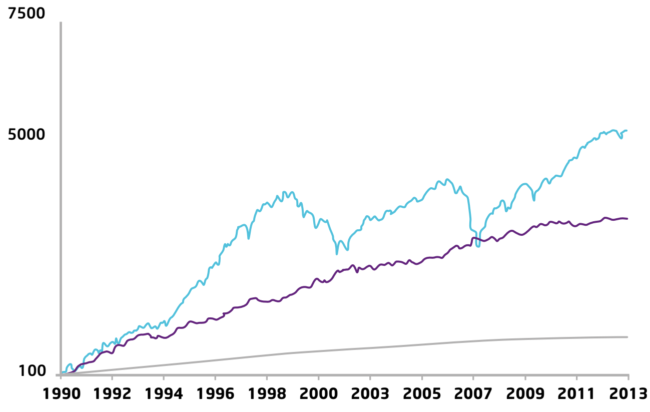
Yves Kuhn
Chief Investment Officer

In this edition of Focus we look at how a balanced portfolio can help you diversify risk and why in an environment of potentially rising interest rates we favour adding more equities to a stocks and bonds portfolio.

Investing in financial markets can often be a challenging and time-consuming exercise. Those who don't have time to analyse the markets typically end up picking big brand names like Apple and Google, or bonds issued by national governments. This approach can work well when markets are stable and prices are broadly rising, but it entails significant risks when things go wrong and volatility picks up.

One way to minimise the impact of these swings on your portfolio is to diversify your asset allocation. There are three main financial asset classes investors use to diversify their assets: equities, fixed income and cash.

US Performance by asset class (monthly, logarithmic scale)



Source: BIL, Bloomberg

> "When investing in financial markets, it is important to maintain a good sense of discipline"

As the chart illustrates in the previous page, equities tend to generate greater returns than bonds but are also prone to higher levels of volatility. Bonds are generally more stable than equities but returns can often be meagre - and even negative in some cases - when inflation is rising. By not putting all of your eggs into one basket and instead combining the two (we will exclude cash for now), investors can achieve a more balanced portfolio that can generate sizeable returns without taking on too much risk.

How to balance a portfolio

One method to balance your portfolio is to divide your assets equally between equities and bonds, i.e. 50% in stocks and 50% in bonds. Historically, these two asset classes have generally been negatively correlated to one another, meaning that if you made a loss in stocks you were at least likely to make some gain in bonds. However, in some extreme cases - the onset of the financial crisis in 2008 is one example - both bonds and stocks can simultaneously underperform.

Investors can also diversify the portfolio into other financial assets such as hedge funds, listed property, commodities and currencies. But be careful when considering alternative assets, as adding more asset classes to your portfolio doesn't necessarily diversify your risk. On the contrary, if the asset under consideration moves in tandem with either bonds or equities, it can actually increase the amount of risk you take on.

Once you settle on an asset allocation, the next step is to choose how often you want to rebalance your portfolio. This is done for you when you invest in a balanced fund managed by an investment professional. For those that manage their own portfolios, it can often depend on how much time you have free for managing your investments. Some investors rebalance their portfolio every day while others prefer to save themselves the effort and rebalance once a year.

What is the best portfolio mix?

There is no one-size-fits-all when selecting your portfolio mix. Much depends on your knowledge and experience in financial instruments, your investment objectives, investment time horizon and how much risk you are willing to accept. For example, investors nearing retirement may have a shorter investment horizon and, therefore, prefer less risky bonds over equities. An active investor looking to generate a return of over 5%, however, will struggle to meet their investment objectives with a 100% bond portfolio and may look to add stocks. A good balanced fund usually aims to generate an annual return of 2 to 3% over 10 years, with limited volatility.

Portfolios allocations typically fall into one of the three categories, depending on your investment objective and personal situation:

Income: 30% stocks/70% bonds

An investor looking to generate income with minimal risk to principal. They are comfortable with only modest long-term growth in principal and have a short- to medium-range investment time horizon.

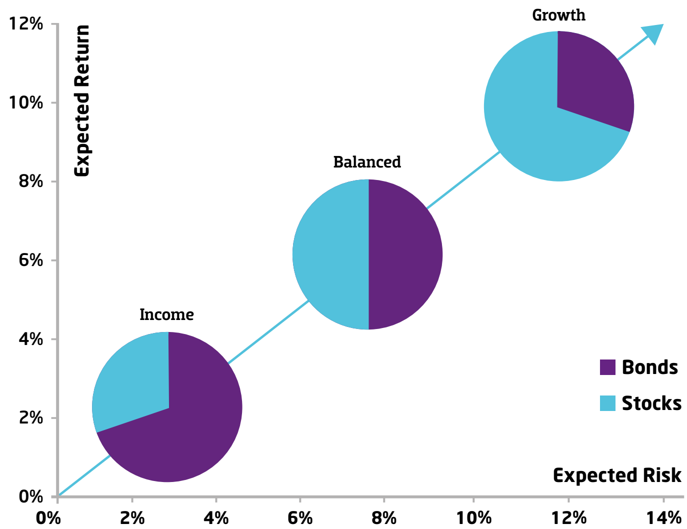
Balanced: 50% stocks/50% bonds

An investor seeking to reduce potential volatility by including income-generating investments in their portfolio while accepting moderate growth of principal. They will often have a medium- to long-range investment time horizon. This investor must be willing to tolerate short-term price fluctuations.

Growth: 70% stocks/30% bonds

An investor seeking growth will tend to have a long-term investment time horizon and attempt to maximise their long-term potential through growth of principal. A growth-oriented investor must be willing to tolerate potentially large short-term price fluctuations.

Three main allocation profiles (based on risk/return)



Source: BIL

“Investors have been increasing the bond component of their portfolio”

Disproving investment myths

When investing in financial markets, it is important to maintain a good sense of discipline and not to get side-tracked by investment myths. For example, investors will often hear that in order to make money, you need to hold stocks when they are hot, or that in order to be successful in markets you need to time your entry well. A balanced portfolio does a good job of disproving these myths. Your entry point matters little when you employ a long-term investment strategy. Meanwhile, by investing in over 15 stocks you can diversify your risk far more easily than when you are investing in just one or two “hot stocks”.

Another positive aspect of a balanced portfolio strategy is that it acts as a reference point for investors. Some may feel tempted to increase their holdings in equities when stock markets are rallying. But in doing so they must be willing to withstand a relatively higher degree of volatility, which can result in lower overall returns. Likewise, going too overweight on bonds in a bull market can mean missing out on potential returns on equities. Forcing investors to stick to predetermined weightings and rebalancing accordingly can instil good discipline in an investment strategy.

Searching for the ideal portfolio

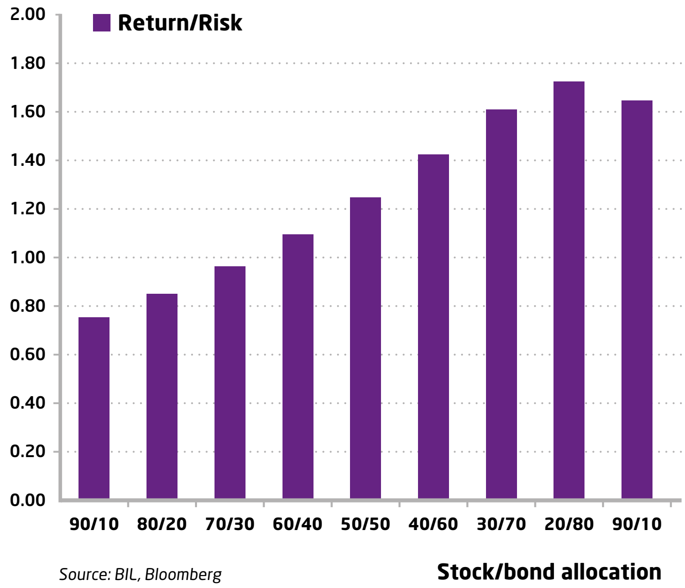
During the great bull market of the 90s, a 60% stock and 40% bond portfolio was widely considered the industry standard for portfolio allocation. The late Peter Bernstein, a former investment manager at Bernstein-Macaulay Inc. and an ardent proponent of this investment strategy, argued that a portfolio with more stocks than bonds made sense given that the dynamic process involved in pricing stocks relative to less risky assets meant stocks offered a greater return than bonds.

In recent years, however, investors have been increasing the bond component of their portfolio, at the expense of stocks, in order to smooth returns. Rick Ferri, an investment manager at Portfolio Solutions and author on portfolio theory, said that a 30% stock and 70% bond allocation offers just enough equity to grow, but at the same time sufficient fixed income to keep portfolio volatility at bay.

So what is the optimal asset allocation mix? We have used data on US equity and bond indices* over the last 26 years to find out which portfolio mix offered the best risk-adjusted returns. Falling rates amplified the return on bonds in the long run, so it is no surprise that our findings show that a 20% stock and 80% bond portfolio generated the highest risk-adjusted return over the last 26-year-period. In contrast, the more equities you held in your portfolio the lower your risk-adjusted returns.

The term risk-adjusted return is important to understand here. It measures how much money a portfolio made relative to the amount of risk it took on over a specific time period. In other words, if two portfolios generate an 8% return, the less risky portfolio would have a better risk-adjusted return. In the same way, while absolute returns on stocks may be higher than bonds, when adjusted for risk, bonds can be seen as outperforming stocks.

20% stocks/80% bonds beats the rest (1990-2015)



Source: BIL, Bloomberg

*MSCI USA and JP Morgan US Government Bond Index (measured in local currency)

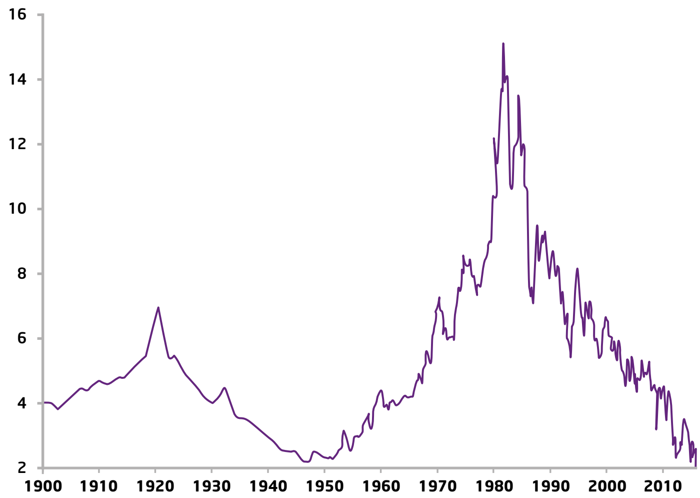
> The last time long-term rates were in an upward cycle, Ronald Reagan was in the White House

Bonds are no longer enough

Given the relative stability of bonds over the last 30 years, it might be tempting to be overweight bonds. One reason not to is the change in interest rate cycle. Long-term US interest rates have been on a long downward trend since the 1980s, from a peak of 14% to just over 2% today. This secular trend, however, could come to an end sooner than expected. In an environment of rising rates, the return on bonds is likely to be lower than in the past.

This would be unchartered territory for many investors. The last time long-term rates were in an upward cycle, Ronald Reagan was in the White House. In uncertain times it is not uncommon for investors to move into less risky assets like bonds. While this might be fine in the short term, there is a significant danger of understating the risks associated with bonds and overstating the potential returns given the past performance of this asset class.

US Treasury Yields (20-year)



Source: BIL, Bloomberg

Bring in more equities

2016 looks set to be a challenging year for investors. Major risks lie ahead with China, oil and interest rates all being sources of potential market instability. Moreover, opportunities to generate a return will be few and far between: bonds are expensive and earnings growth for US companies is not very promising either.

As we might enter a new rate cycle, investors with a strong overweight allocation in bonds can benefit from a more equally weighted portfolio that includes some equities. While your exact allocation should depend on your individual needs, a 50% stock and 50% bond portfolio is a good starting point that both generates sizeable returns and limits your exposure to excessive volatility.

Faced with significant market uncertainty, a balanced fund offers a number of benefits. Investors can choose an investment approach that fits their specific risk profile and investment horizon. While a balanced fund cannot guarantee returns, it provides discipline and control over your investment strategy.

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