

Notes

To: PMs

RE: *The Merit of Conventional Wisdom*

Investment advice at the retail level (sub-\$1M) has evolved quite a bit through the years. Back in the day, firms like ours were relatively common. Today, there are many financial planners on the scene. Rather than specialize and develop expertise in a particular niche, as we do with U.S. equities, financial planners are generalists whose primary mission is to blend various asset classes to achieve an “optimal” risk/return balance. The preceding is a gross oversimplifying of what a financial planner does, but on the other hand, seeing something like a 60% Stock/40% Bond mix is incredibly common. I can’t tell you how many clients and prospective clients have gone through an extensive, seemingly thorough financial planning process, answering pages of questions to determine their unique investment objectives and constraints, and out pops this particular mix. Obviously, long-term return potential is compromised, as compared to a 100% stock allocation, so the diversification/risk reduction benefits must be appreciable, right?

The table to the right is the data customarily used to justify mixing stocks and bonds.¹ As the table shows, over one-year investment time horizons, a Stock/Bond mix dramatically improves “Worst” returns, defined as the absolute

1 Year Returns - 1950 to 2010						
Stock/Bond Ratio	Worst	Bad	Average	Good	Best	StDev
100/0	-43.3%	-4.9%	12.3%	29.5%	61.0%	17.2%
75/25	-34.8%	-2.8%	10.8%	24.5%	56.4%	13.7%
50/50	-26.3%	-1.5%	9.5%	20.4%	51.7%	10.9%
25/75	-20.5%	-1.4%	8.1%	17.6%	47.0%	9.5%
0/100	-18.2%	-3.0%	6.9%	16.7%	46.7%	9.9%

worst return over this 61-year period. Using the academic definition of risk, i.e., standard deviation (StDev), a 25% stock/75% bond mix is actually less risky than 100% bonds, though “Worst” returns are slightly lower. Viewing asset allocation via this one-year investment time horizon prism strongly argues for mixing Stocks and Bonds.

There’s a critical assumption made in this analysis, however, and that’s that one-year investment time horizons are the appropriate interval to consider. In point of fact, it’s not the appropriate horizon for any of our clients, who all have much longer investment time horizons. So for them (and us), a different examination of the data is called for. For instance, investors with five-year horizons should consider the evidence presented in the second table.² Please note several things. First, the differences in “Worst” returns shrink dramatically. Second, StDev differences also compress. Finally, note that “Bad” returns, defined as Average returns minus one StDev, favor heavier equity allocations. Clearly, the case for mixing in Bonds weakens at the five-year investment time horizon mark.

5 Year Returns - 1950 to 2010						
Stock/Bond Ratio	Worst	Bad	Average	Good	Best	StDev
100/0	-6.6%	3.7%	11.2%	18.7%	29.7%	7.5%
75/25	-4.2%	4.2%	10.2%	16.2%	27.2%	6.0%
50/50	-1.9%	4.2%	9.1%	14.0%	24.5%	4.9%
25/75	-1.5%	3.4%	7.9%	12.4%	23.7%	4.5%
0/100	-2.3%	1.7%	6.6%	11.6%	23.9%	4.9%

¹ Ibbotson data definitions: Large Company Stocks = S&P500 Composite with dividends (Total Return), Long-Term Corporate Bonds = Salomon Brothers Long-Term High Grade Corporate Bond Index (Total Return).

² Returns greater than one-year are annualized.

Not to belabor the point, but these trends regarding “Worst” returns, “Bad” returns and StDev continue as investment time horizons lengthen, as the ten-year table reflects. At this point, risk differences measured by the academic definition (StDev) are further narrowed and “Worst” returns approach and move into positive territory. Differences in expected return favoring equities are of course always present, but note that “Average” 100% Stock returns at this point surpass “Good” 100% Bond returns.

10 Year Returns - 1950 to 2010						
Stock/Bond Ratio	Worst	Bad	Average	Good	Best	StDev
100/0	-3.4%	5.8%	11.0%	16.2%	19.5%	5.2%
75/25	-0.9%	5.7%	10.2%	14.6%	18.6%	4.4%
50/50	1.1%	5.3%	9.2%	13.1%	17.8%	3.9%
25/75	1.3%	4.4%	8.1%	11.8%	17.3%	3.7%
0/100	1.0%	3.0%	6.9%	10.8%	16.9%	3.9%

Now *to* belabor the point (just for fun), at twenty-year horizons there is no risk/return argument in favor of owning Bonds. The return sacrifice remains, but risk as defined by typical investors (“Worst” returns) is now *increased* with bond exposure, while academic-defined risk (StDev) is equivalent.

20 Year Returns - 1950 to 2010						
Stock/Bond Ratio	Worst	Bad	Average	Good	Best	StDev
100/0	6.4%	8.1%	11.1%	14.1%	18.3%	3.0%
75/25	5.8%	7.4%	10.3%	13.2%	16.8%	2.9%
50/50	4.7%	6.5%	9.4%	12.4%	15.2%	2.9%
25/75	3.4%	5.4%	8.4%	11.4%	13.6%	3.0%
0/100	1.3%	4.0%	7.3%	10.5%	12.8%	3.2%

Despite the arguments above, 100% Stock exposure is clearly not appropriate for all investors, as one can’t dismiss with data the day-to-day volatility and trials and tribulations of stock market investing. However, particularly in the present low interest rate environment, automatically loading up on Bonds simply because one hits a certain age or a certain stage of life (retirement for instance) isn’t all it’s cracked up to be either. All of the preceding charts contain an unrealistic Bond return assumption in their calculations when the interest rates of today are factored in. Over the past 61-years, the average Bond return was almost 7%. With today’s MUCH lower interest rates, Bond returns ahead will be a fraction of that and will in fact almost certainly be negative on an inflation adjusted basis (possibly on an absolute basis too). This is an enormously important factor that increases dramatically the attractiveness of Stocks over Bonds today. Optimal asset allocation decisions are best reached when investors consider both the short- and long-term ramifications and the current environment.

The importance of investment experience cannot be overstated either. There are 70- and 80-year old, “grizzled” investors who care less what the market does in the short run. They’re investing for the balance of their retirements and then for their grown children’s future retirements, and due to their long experience as investors, are psychologically prepared to ride out any market storm. Meanwhile, there are 30- and 40-year old investors just gearing up as investors who will find the next big market knock an enormous challenge. Arguably, inverting conventional wisdom to accommodate this experiential difference is the more appropriate course.

In the end, as fond as we are of fancy computer programs and sophisticated algorithms, the business of finding the optimal asset allocation is too personal for such devices. Awareness of the facts and finding a mix that allows one to sleep comfortably at night is the key to discovering the personally right answer.

Enjoy!

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