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Ignore bonds at your peril

Bonds stabilize, diversify

There has always been a contingent that has preached a 100% stock strategy. Justification goes something like this: stocks outperform bonds and cash in the long-term so why hold anything else that will just drag down your return? This argument has intuitive appeal but it ignores key fundamentals of investor behaviour and portfolio construction.

The long-term

The mutual fund industry is notorious for watering down what I consider to be a proper definition of 'long-term'. It's not unusual to hear "five years" as the definition of a long-term holding period. While a five-year holding period for stocks will usually result in a positive return, substantial losses can be (and have been) experienced over five-year holding periods.

For example, the MSCI EAFE C$ index saw a loss of 28% from March 1998 through March 2003. Canadian stocks lost more than 9% over this same period. From August 2000 through August 2005, the S&P 500 C$ lost 30% of its value. Going back further in time would reveal more substantial losses but you get the point. On the other hand, I could not find a period where bonds suffered losses over a five-year period. That doesn't mean it has never happened (or never will) but there is clearly less downside risk with bonds.

The role of bonds and cash

This brings us to the role of bonds in a portfolio. Once upon a time, when bond yields were relatively high (in nominal terms); people used them to produce income. Today, with gross yields of 4% to 4.5%, it is difficult to get a sufficient level of income from such low yields. This challenge is exponentially tougher when you consider the average bond fund sports an annual management expense ratio of 1.5% per year.

Bonds, however, should be viewed as a portfolio stabilizer. It's true that rate hikes put pressure on both stocks and bonds. But when you need the diversifying power of bonds most – i.e. in recessionary times – they tend to deliver. In slow economic times, economic activity slows. This prompts central banks to, at best, lower interest rates (great for bonds) or, at worst, leave rates alone (which means bonds will post positive returns).

So, even though their future return potential is nothing to brag about, bonds serve an important role in most investment portfolios – a role that is more important after four years of strongly recovering stock markets.

For a refresher on bond risks, see this April 2003 article:
http://thewealthsteward.com/wp-content/uploads/2010/12/WS_Archive_BondRisks_20030425.pdf

Behavioural implications

Even if you like the 'all-stocks all the time' portfolio strategy, there is the little fact that most investors cannot handle the ups and downs that come with 100% stock portfolios. This is the case even for investors who say or think that they can. This is not meant in a patronizing tone but the person who can truly predict how he will feel in a stressful situation not previously experienced is rare, if he exists at all.

In my many years in counselling individual investors, I have found the most challenging aspect to be fully capturing the client's true tolerance for the ups and downs of the market. This phenomenon, which is admittedly anecdotal, is consistent across occupations and income levels. But it tends to be more prominent among investors with larger portfolios (i.e. over $500k).

My general rule is to assume an investor's stated risk tolerance is higher than its true level, unless they have knowingly experienced a bear market with a sum of money that resembles their current portfolio size. (I say 'knowingly' because some clients may not have had enough interest to look at their statements during past bears, which means they never saw the falling monthly or quarterly values.)

Portfolio guidelines

Benjamin Graham wrote that investors should keep a minimum of 25% in each of bonds and stocks. This means that the maximum allocation to either is 75 percent. These are guidelines that make a great deal of sense, despite that fact that Graham articulated these rules many decades ago. Proper diversification within the stock component remains important, but these are guidelines I continue to use today when constructing portfolios.

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