EUREKA report

Bonds figure in rebalanced portfolios

By Doug Turek
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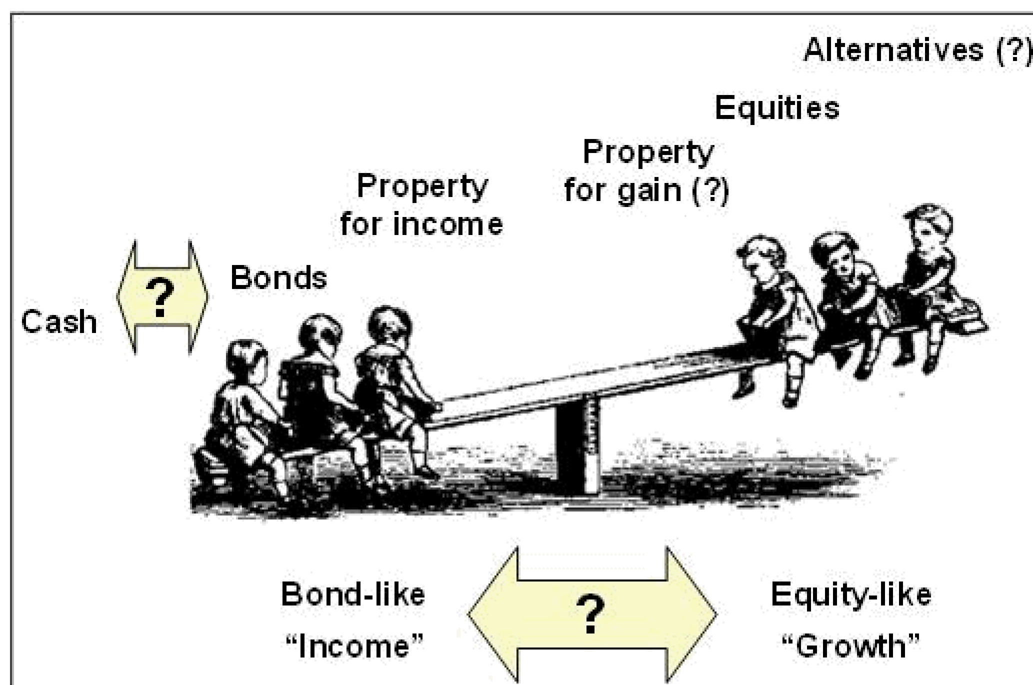
PORTFOLIO POINT: Discounted stock prices, very low cash rates and new bond offerings mean it's time for investors to rebalance their portfolios.

Today there are two big asset allocation questions on the minds of most investors (Figure 1): How to get the level of equity holdings right in the wake of the stockmarket crash; and how to get income from something other than cash.

nFigure 1: The big portfolio allocation decisions for mid-2009



How much of my portfolio should be in equities?

Taking the issue of how much shares first: The answer to this question may most immediately impact your income needs. This is because the dividend yield from shares (and listed property) can quite conceivably continue to exceed income from cash and bonds, even after adjusting for expected reductions in payout and neglecting tax benefits. At present the dividend yield for the ASX 200 is about 7%, making it one of the highest-yielding markets in the world.

What's more, the role of equities is not just to grow the real purchasing-power of the portfolio, but also to be available to be sold off from time to time (but not now!) to finance living expenses.

Designing a portfolio for income can make it difficult to fight inflation if this challenge arises in the future. However,

this doesn't mean you should rely solely on income from assets 100% invested in Australian and international shares.

Your appropriate mix of equities depends on your life stage and your pain threshold.

When you model the returns of retirement portfolios through periods longer than 100 years it suggests few should retire with more than 60% (or possibly 70%) of their assets in equities (see ***The trouble with wealth projections***).

Unless your spending needs are very modest relative to your capital, you run the risk of your money running out before you do. You need bonds to smooth returns and also to fund buying back into the market in down years.

This bear market, which has now been running since November 2007, has also reminded us that equity markets can be ferocious places at times. If you had a threshold for suffering only a 10% decline in equities, then the past 20 years of more detailed financial data told us you could tolerate 60% of equities. Recent experience suggests that should be 30%. If you can handle only a 20% decline then you maybe you need to limit your equity exposure to 50%. Again, bonds are needed to help you sleep at night.

For those of you who had a balanced allocation to equities entering into this downturn and haven't retreated into cash, you deserve a "Financial Cross" for bravery exhibited to date. You should take comfort that you probably can live off your cash and bond holdings (assuming they can be separated within your portfolio) for more than a decade before you need to sell shares. I think the market will recover by then.

The same accolade should go to those continuing to make and invest regular superannuation contributions. **Dalbar** researchers in the US showed your accumulated contributions could be 50% higher after 10 years than if you follow the herd, investing more when the market is up and less or nil when it is down.

The balance of funds remaining after applying these two limiters logically should be invested in equities to earn a premium return. Figure 2 shows the distribution of the Australian equity premium each year since 1900. This is the difference between the total return from investing in Australian shares versus interest earned on 90-day bills. This shows you the extra reward you get (sometimes) for putting your money at risk rather than investing it into the "risk-free" alternative.

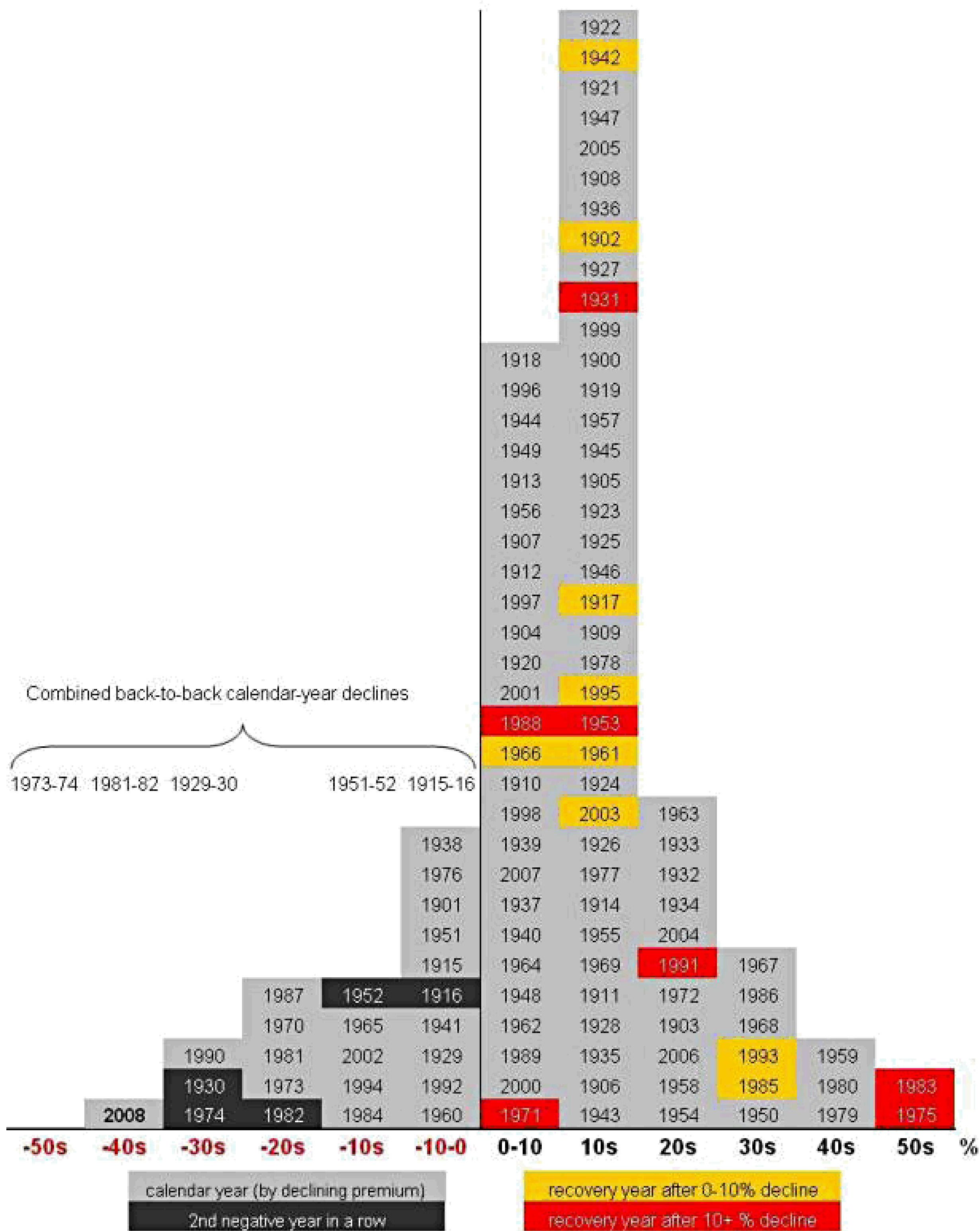
The chart shows that about 80% of the time annual returns from equities beat those from cash savings, and a little more than half the time it did so by more than 10%. The simple mathematical average outperformance was just over 11% per annum, though this figure may be lower over different periods of time.

Fortunately (yes, fortunately) these rewards are highly uncertain over the short term.

I meant fortunately because if equity returns were more certain, then the future premium (read also discount) that you as an investor could command from buying shares from other investors or from companies raising capital, would be less. If you have a long enough horizon and you can stomach volatility, you will be rewarded. If not, your loss will be someone else's premium.

US adviser Nick Murray puts it neatly: "Take care in moments of great stress, such as the current environment, to wish away the volatility of equities, because you are – whether you realise it or not – wishing away the [premium] returns."

nFigure 2: Australian equity premium (total return vs 90-day bill) annually since 1900



It follows then that at distressing times like now you should expect as an investor to attain an unusually higher risk premium when investing new money. In several years time, or perhaps this or next year, you should be duly rewarded. The yellow, red and black coloured years in Figure 2 point to what premium, investors earned the following year after investing following an Australian stockmarket decline. Three out of four times the premium was positive. Noted in yellow are those recovery years where the prior year decline was less than 10%. Those years

where the prior year decline was more severe are marked in red.

At the extreme, those who invested in Australian shares at the end of 1974 and 1982, when conditions were bleak, earned an excess return of better than 50% the following year. Even those who invested during the Great Depression after two years of Australian stockmarket declines in 1929 and 1930 earned premium returns over cash rates of 17%, 26%, 27%, 26% and 11% for each year between 1931 and 1936 (actual stockmarket returns were 20%, 28%, 29%, 28%, 27% and 13%, with cash rates pushed down to 2%). Perhaps that was a legitimate premium for investing in uncertain times and distressed companies then.

Be careful if you are a trader because one-quarter of the years the market declined, it did so for two years in a row – like after 1915, 1929, 1951, 1973 and 1981, as noted in black in Figure 2. It is possible that our decline has been serious enough, as compared with the combined losses from past two-year declines shown, and concentrated neatly into the 2008 calendar year, such that a second negative calendar year does not have to follow. Who knows?

Rather than try to get clever timing a recovery, consider instead the discipline of realigning your out-of-balance portfolio back to its target allocation. For instance, if you still target having 60% of equities in your portfolio and did so in late 2007, your portfolio through severe equity devaluation and possible bond appreciation may now only be 45% invested in equities.

Consider redeeming some of your bonds and investing excess cash to buy back some or all of the necessary equities. As I outlined in a previous article (see ***Rebalance and realign your portfolio***) doing this over the next few months can be an ideal time including, setting aside next year's pension payments where applicable. Rebalancing is not just about reducing the risk of having too much in equities, but also too little.

How can I get more income in my portfolio including from bonds?

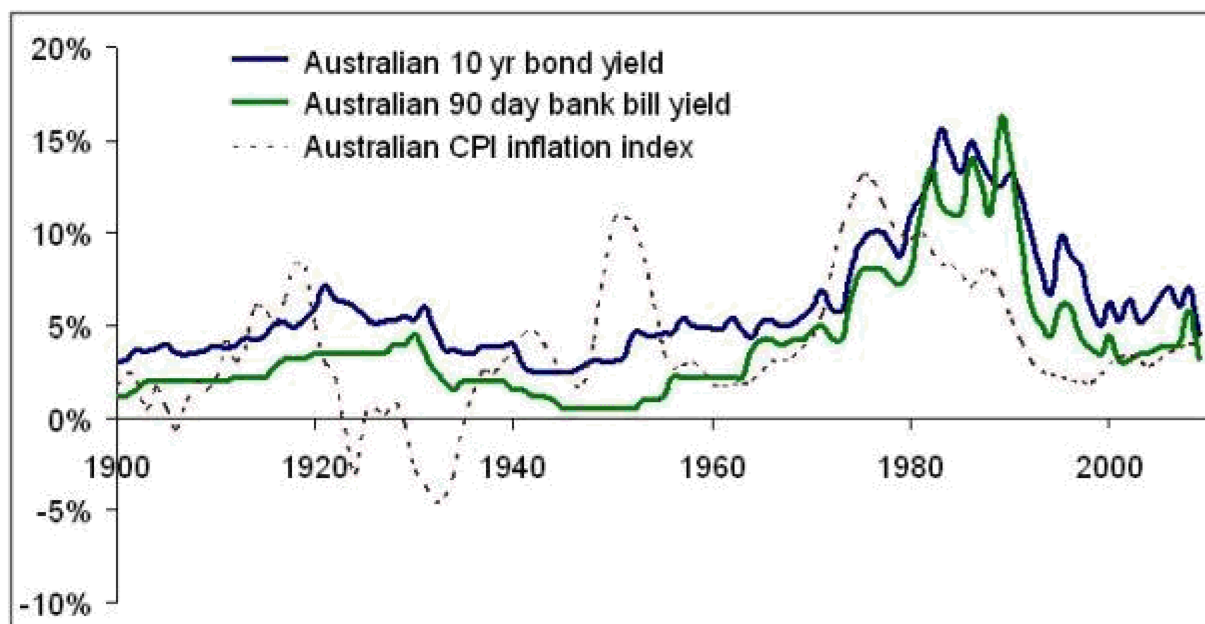
Many in the past used high-yielding cash and term deposits with ING Direct, BankWest and others as a proxy for bonds. That worked while their yield matched that of longer duration bonds. However, when interest rates fell, those not holding quality bonds missed out on the capital appreciation associated with bonds locked in for longer to receive higher yields. Online cash rates are now only yielding 3.5% at most.

While chasing bonds now is perhaps doing so a year late, like the Chinese proverb about planting a tree, it's never too late to make this a part of your portfolio.

It is important to tread carefully in the current environment. Recall the mess we are in now is partly due to yield hungry US and European investors being duped by too-accommodating product suppliers and credit agencies. The recent experience of Australian investors in ASX-listed variable rate bonds/hybrid securities has been mixed at best. In addition to managing credit risk, locking into long-duration fixed-interest bonds exposes your bonds to devaluation once interest rates rise. Figure 3 shows the 100 year record for Australian 10-year bonds and cash (90-day bank bills) and highlights a few key points:

- The premium return from riskier bonds over cash, which is perhaps only 2% over the long term, is modest compared to equities.
- While not shown here, the incremental yield taking on lower credit quality bonds pales in comparison with the expected returns from marginally increasing your equity allocation (while at the same time balancing with sovereign or other ultra-high credit quality bonds). Recall our bond industry invented the term "high-yield bond" to use in place of "not investment-grade".
- Be careful investing into bonds when inflation and interest rates rise. In the 1970s and 1980s the premium for bonds over bills sometimes disappeared or reversed.
- Traditional bonds and cash don't always beat inflation and certainly don't get in front of it. Many bonds perform best after interest rates have risen, not before. You'll need to get your inflation defence somewhere else – equities, commodities or maybe through inflation-linked bonds.

nFigure 3: Annual yield from Australian bonds and bills vs inflation (5 year smoothed) since 1900



An article I wrote in February, which that laid out a bonds wishlist (see ***A retail bond wishlist***) attracted some reader interest and was also acknowledged by the Federal Treasurer's office. I think in the coming months Australian investors will be swamped with an increasingly diverse and attractive smorgasbord of bond products competing for scarce funds. (Scarce relative to the enormous combined [re]financing needs of federal and state governments, utilities, companies, property trusts, mortgage funds and perhaps banks, if you take too much of "their" cash away.)

Get ready, including on budget night (Tuesday, May 12) to hear about "Infrastructure Bonds", "Australian Savings Bonds" and, hopefully, "Inflation-linked bonds". The latter I have been especially championing, alongside life insurers and others in the business of securing long-term retirements. These may even impact on the amount of equities you need to have in your portfolio. Over the past decade, the bond market in Australia has been modest and poorly accessible to retail investors. This will not be the case for the next decade.

Accordingly, I suggest you postpone taking on any new bond offers until the full range of options becomes clear. A risk of investing now in offers such as those recently from AMP and Tabcorp is that they may be later priced down when more attractive competing issues are offered. Indeed, the race is on by bond issuers (including the government) to get your money! Your first offer might not be your best offer.

Expect going forward a changed investment landscape where equities may suffer a long malaise, which means new investor money could earn greater premium returns as well as healthy dividends (much like in the 1950s). Bonds are back and inflation may not be far behind, so tread carefully. Your portfolio will need to evolve.

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