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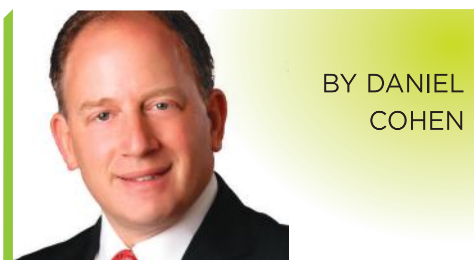
Rethinking balanced investing

Is it time to rethink the strategy of holding a certain percentage of a portfolio in stocks balanced with bonds?

With interest rates remaining at historic lows for an extraordinary length of time, maybe now is the time to rethink how much should be allocated to bonds in a portfolio.

Historically, it has made sense to hold a certain percentage of a typical portfolio in stocks balanced with bonds in order to reduce risk. Stocks have provided



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Personal Finance

the best protection against inflation as dividends generated by stocks have historically grown over time while the value of the portfolio has also grown. In the previous several decades of declining interest rates, bonds, like stocks, have provided steady, growth-enhanced income to investors because bond values have increased as rates have declined.

However, with rates having nowhere to go from here but up, the past strong returns on bonds are impossible to repeat. We have all heard the disclaimer, "past performance is no guarantee of future results." But few investors pay much attention to this warning.

With interest rates at historic lows, large amounts of money continue to flow into bond funds. In the last decade, there hasn't been a bigger demand for bonds relative to stocks than there is today. The expectation is that global growth and inflation will remain low and monetary conditions will not tighten so that gains in bonds will continue.

But if the global economy improves and monetary conditions tighten, bonds are likely to lose value. The meager interest rates paid on bonds today will not be able to offset losses. Moreover, a recent report by consulting firm McKinsey projects that total returns on bonds may be less than 1 percent over the next 20 years.

In the past, when investors wanted to reduce the risk in their portfolio they would add exposure to bonds and reduce their exposure to stocks. That conventional wisdom is under debate as many agree that the risk to bonds is much greater today that it was in the past.

Many investors, including Burton Malkiel, economist and author of the classic finance book, "A Random Walk Down Wall Street," recommends substituting high-yielding stocks for bonds in a portfolio.

In the most recent edition of his book, Malkiel suggests that, although stocks are usually riskier than bonds, favoring them over bonds makes sense, even for retired people, due to today's unusually low interest rates.

Many portfolio managers and investment strategists are reducing or eliminating their exposure to bonds and buying stocks that have a lower level of volatility than the overall market. These stocks tend to have above-average dividend yields, and this additional income is a great substitute for the lost income from bonds as rates have dropped so low.

Many retirees who traditionally rely on bank CDs or government bonds for income have also turned to stocks with above-average dividend yields to provide income during their retirement years.

The growing income and share price of stocks has been rewarding for many investors.

Examples of companies that are considered low volatility include U.S.-based firms like Procter & Gamble, AT&T, Johnson & Johnson, Verizon, McDonald's, ExxonMobil, Pfizer and Coca-Cola. Low-volatility companies internationally include Novartis, National Grid, GlaxoSmithKline, AstraZeneca and Diageo. Yields on these companies have ranged from 2.7 percent to 5 percent.

A better way to reduce risk in today's market environment may be to reduce rather than increase your bonds holdings. I believe it makes more sense to add a diversified mix of high-yielding, lower-volatility stocks. The average stock today returns more than government bonds and certainly a lot more than money held in the bank.

A balanced and diversified investment portfolio should probably look quite a bit different today than it did 10 years ago considering the current interest rate environment. It may finally be time for people who have relied on bonds for risk reduction to seriously consider reallocating their portfolio. NHBR

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