

HEADWATER INVESTMENT CONSULTING, INC.

Registered Investment Advisor

Part 2 of 3 in a Special Article Series: Managing Risk

In the 2nd Quarter Newsletter, we looked at the Art of Risk – defining your personal risk tolerance. The next step in portfolio management is determining what investments are right for you. At Headwater Investment Consulting, we formulate an Investment Policy Statement (IPS) unique to each client. The IPS is a written plan to outline your risk tolerance, investment goals, and timelines for your investments. A key component of the IPS is asset allocation, or the decision of what proportion of stocks, bonds, and other assets should be used to create your portfolio. The following article delves into the Stock-Bond decision.

THE STOCK-BOND DECISION

Choosing a basic stock-bond mix is an important first step in portfolio design. Although the decision may appear simple, it can have a profound impact on your wealth.

Portfolio theory explains the value of making a deliberate, strategic decision about the proportion of stocks versus bonds to hold in a portfolio. This decision has roots in the “separation theorem,” which was proposed by Nobel laureate James Tobin in the late 1950s.¹ The separation theorem proposes that all investors face two important decisions: (1) deciding how much risk to take, and then (2) forming a portfolio of “risky” assets (equities) and “less risky” assets (fixed income) to achieve this risk exposure.

Your stock-bond decision sets the asset allocation, or risk exposure, for your portfolio.

The Rationale

The theorem proposes that all investors who are willing to take stock risk should begin with a diversified market portfolio. Each investor then can dial down total risk in the portfolio by adding fixed income to the mix. The greater the bond allocation relative to stocks, the less risky the portfolio and the lower the total expected return; the greater the stock allocation relative to bonds, the higher the portfolio’s risk and expected return.

So, how does one confidently allocate between stocks and bonds? A common method is to evaluate model portfolios along the risk-return spectrum. A riskier portfolio holds 100% stocks, and the least volatile portfolio holds 100% bonds. Between these extremes lie standard stock-bond allocations, such as 80%-20%, 60%-40%, 40%-60%, and 20%-80%.² Then you compare the average annualized return and volatility (standard deviation) of each model portfolio for different periods, such as one, three, five, ten, and twenty years. Volatility is one of several risk measures investors may want to consider. With this in mind, the analysis should feature average returns, as well as best- and worst-case returns for the various periods.

While this technique relies on historical performance that may not repeat in the future, and does not consider various investment costs, it may help you think about the risk-return tradeoff and visualize the range of potential outcomes based on the aggressiveness of your strategy.

Refining Your Stock Allocation

After establishing the basic stock-bond mix, investors turn their attention to refining the stock allocation. Investors who are comfortable with higher doses of equity risk can overweight or “tilt” their allocation toward riskier asset classes that have a history of offering average returns above the market. Research published by Eugene Fama and Kenneth French found that small cap stocks have had higher average returns than large cap stocks, and value stocks have had higher average returns than growth stocks. By holding a larger portion of small cap and value stocks in a portfolio, an investor increases the potential to earn higher returns for the additional risk taken.

The final step in refining the stock component is to diversify globally. By holding an array of equity asset classes across domestic and international markets, investors can reduce the impact of underperformance in a single market or region of the world.

Fixed Income Strategies

Research shows that two risk factors—maturity and credit quality—account for most of the average return differences in diversified bond portfolios. In other words, long-term bonds and lower-quality corporate bonds typically offer higher average yields to compensate investors for taking more risk. Just like selecting specific stock funds, selecting the mix of bond funds is based on the client’s investment goals.

Investors generally hold fixed income to either (1) reduce overall portfolio volatility, or (2) generate a reliable income stream. These objectives typically lead to different investment decisions. The first approach, volatility reduction, is an application of separation theorem (i.e., hold equities for higher return and use

fixed income to temper portfolio volatility). Certain fixed income asset groups are better suited for this strategy. With an eye to minimize maturity and credit risk, they hold short-term, high-quality debt instruments that have historically offered lower yields with much lower volatility.

The second purpose for holding bonds is to generate reliable cash flow. Income-oriented investors, including retirees, pension plans, and endowments, may not worry as much about short-term volatility in their bond portfolio. Their priority is to meet a specific funding obligation in the future. Consequently, they design a portfolio around bonds and accept more volatility in hope of earning higher yields, which they pursue by holding bonds with longer maturities and/or lower credit quality.

Whether investing for total long-term return or for income, a portfolio should be diversified across issues and global markets to avoid uncompensated risk from specific issuers and to capture differences in yield curves around the world.

Summary

The stock-bond decision drives a large part of your portfolio’s long-term performance. During asset allocation, evaluating different stock-bond combinations can help you visualize the risk-return tradeoff as you consider the range of potential outcomes over time. Once you determine a mix, it can guide more detailed choices of asset classes to hold in the portfolio. And as your risk tolerance shifts over time, you can revisit the allocation targets to estimate how adjusting your portfolio mix may better meet your shifting investing goals.

The information presented above was prepared by Dimensional Fund Advisors, a non-affiliated third party.

Endnotes

¹ James Tobin, “Liquidity Preference as Behavior Towards Risk,” *The Review of Economic Studies* 25, no. 2 (February 1958): 65-86.

² The basic stock component may be reflected by the S&P 500 Index, or preferably, by a broader market proxy, such as the CRSP 1-10 Index. The CRSP 1-10 Index is a market capitalization weighted index of all stocks listed on the NYSE, Amex, NASDAQ, and NYSE Arca exchanges. The S&P 500 Index offers a proxy of the large cap US equities market. The fixed income component may be represented by an index of short-term US government securities or government and corporate bonds.

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