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Why Bother with Bonds?

By Ian A. Post, CFA

A refrain I frequently hear from clients and others is if we believe stocks earn more than bonds over time and equity volatility is just short-term pain, then why not just invest solely in stocks? Why bother with bonds?

A February 12, 2016 *New York Times* article, titled *"How Much of Your Nest Egg to Put Into Stocks? All of It."* buys into this idea by making the unusual recommendation that investors should invest all or nearly all of their retirement assets in stocks. The flawed reasoning by author David Levine presents an opportunity to review why well-constructed global asset class portfolios should include an allocation to high-quality bonds, even when bond yields are at historically low levels.

Following are three key issues that drive home the need for high-quality fixed income in portfolios: 1) Equity Markets *Don't* Always Come Back, 2) *When* Returns Happen is Important and 3) Downside Risk Matters (to Most of Us).

1. Equity Markets *Don't* Always Come Back – The Cherry Picking Error

Levine bases his argument on the past performance of U.S. stocks. The possibility exists, however, that the previous ninety years of U.S. stock market performance was an anomaly that should not be counted on to repeat itself.

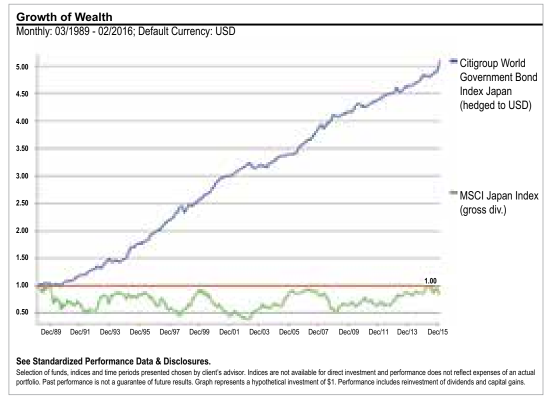
As an example, we can look at the recent experience of another modern economy. Take a Japanese investor making a portfolio allocation decision in March 1989. Had the investor taken Levine's advice and allocated 100% of their portfolio to Japanese stocks[1], through February 2016, they would have experienced a cumulative loss of over 16%. Over that same twenty-seven-year period, Japanese bonds[2] recorded a cumulative gain of over 400%.

2. *When* Returns Happen is Important - Sequence of Returns Risk

A recent retiree whose unlucky enough to begin portfolio distributions at the beginning of a bear market will have a much lower safe withdrawal rate for their retirement *even if long-run returns end up matching expectations.*

According to Wade Pfau, Professor of Retirement Income at The American College, in a paper titled *"The Lifetime Sequence of Returns: A Retirement Planning Conundrum,"* the return sequence during the first ten years of retirement explains 77% of the final retirement outcome compared to only 5% based on the returns generated over the final twenty years of a thirty-year retirement distribution period.

Growth of Wealth



The research shows that *when* returns happen is critically important not just the returns themselves.

3. Downside Risk Matters (to Most of Us)

The *NY Times* article notes that "No less an authority than Warren E. Buffett has stated that 90 percent (equity allocation) is the right answer." Unfortunately, Levine misses a major point here. If Mr. Buffet losses fifty percent of his net worth due to market losses, he would still have billions of dollars to support his retirement. Most investors don't have that luxury. To them, downside risk matters. An allocation to high quality bonds mitigates the downside risk of an equity portfolio.

The basis for asset allocation is that asset class returns are unknowable beforehand and for those who wish to reduce the range of potential investment outcomes, global asset allocation portfolios with sufficient exposure to high quality bonds to match the risk tolerance of investors is the best long-term strategy.

If you have any questions you would like answered, email Ian at ipost@fifthsetinvestment.com.

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[1] MSCI Japan Index (gross div.)
[2] Citigroup Government Bond Index Japan (hedged to USD)