Shares bonds or Cash?

By Michael Kemp

A perpetual dilemma for investors is the optimal allocation of their investment capital between shares, bonds and cash. For those who base their investment philosophy on market timing the decision is heavily influenced by their view on the future direction of the stock market (for shares) and interest rates (for bonds). But for those who don't take such a view the capital allocation decision is more likely to be influenced by their perceptions of risk and return. This article discusses the risks, returns and considerations in deciding how to choose between these asset classes.

Bond risk

Unlike shares, which are commonly described as a risky asset, government issued bonds are often given the status of a near risk free investment. But such a claim can only be made in relation to default risk. This is because the risk of a substandard return, another form of risk, is high.

The failure of many to appreciate this has much to do with differences in how shares and bonds are quoted in the market. Shares are quoted in terms of a market price. Bonds are quoted on the basis of yield. And changes in bond yields don't capture public attention in the manner that movements in share prices and indices do. Consequently the holder of a 30-year US Treasury might be unaware that the yield on his bond has changed from 3.5% to 4.66% since last August. His focus is likely to be on the unchanging semi-annual coupons and the guaranteed redemption at maturity. But these give a false sense of stability and fail to deliver the news about how the market is currently valuing those future cash flows. If instead the bondholder was informed that within 6 short months the bond's price had dropped by 20% then the information might elicit a different reaction. That is exactly what has been happening in the US bond market recently.

I hear someone say that if the bond is held to maturity then the capital loss due to the drop in market price is not realized. That's true but since the coupon is fixed the offsetting penalty would be a substandard return between now and maturity. Your fate is cast whether you sell or hold.

Volatility and risk

Now that we have established that bond prices are indeed volatile the statement needs to be further refined. Firstly are bond prices as volatile as share prices? Historically: no. But the degree of volatility can be significant and it increases with longer dated maturities. The take home message here is that bond prices are volatile hence this fact needs to be taken into consideration when constructing a portfolio to suit your particular needs. Consider the information in the table below. Between 1980 and 2010 the annual returns achieved from holding a portfolio of Australian bonds varied from a low of negative 5.1% to a high of positive 25.6%. This includes reinvestment of returns. In comparison the All Ordinaries Accumulation Index, over the same period, demonstrated a larger variation of returns – from negative 29% to positive 54%. It must be stated however that the bond index used in this comparison was calculated using a composite of short and long dated bonds. This lowers the variation in returns over that which would be seen from a portfolio comprising long dated bonds only.

ANNUAL ASSET RETURNS 1980 – 2010			
	SHARES	**BONDS**	**CASH**
BEST YEAR	54%	25.6%	18.5%
WORST YEAR	-29%	-5.1%	3.9%
AVERAGE	**11.1%**	**10.2%**	**9.3%**

In an earlier newsletter I discussed the relevance of using price volatility as a proxy for investment risk ("Volatility and Risk are not Synonymous" – Newsletter 106). Whilst I won't repeat what I wrote in that article it is relevant to discuss the potential financial impact of price volatility depending upon whether you are in the accumulation or drawdown phase of the investment process.

The accumulation phase

For those investors who have accumulated sufficient capital that they can simply live on the income derived from that capital the vagaries of variations in market prices are usually of little concern. But more typically the investment process can be divided into two phases; that when capital is being accumulated and that when it is consumed. The asset classes selected during the course of these different phases can have a profound effect on the amount of money ultimately available for consumption.

During the accumulation phase shares should form the core asset of any portfolio. Why? Because it has been shown that when extended investment periods are being considered the return achieved by holding a diversified portfolio of shares outperforms that achieved from holding bonds or cash. Wharton professor, Jeremy Siegel demonstrated this point in his book "Stocks for the Long Run". Based on two centuries of US share data Siegel showed that a single dollar invested in 1802 had grown to $597,485 of purchasing power by the end of 2003. This was far ahead of the $1,072 derived from investing in bonds and the $301 derived from investing in short-dated Treasury bills. Whilst one can find specific time periods when shares have underperformed bonds, bills or cash the overwhelming bias is for them to outperform. And whilst this doesn't guarantee that shares will outperform other assets in the future I'll run with data such as this in preference to a crystal ball any day.

Secondly, whilst the market prices of shares are the most volatile of the asset classes under consideration, this provides greater opportunity for purchase at depressed prices. And since the process is one of accumulation, low prices should be met with enthusiasm not concern.

Siegel also found that the inflation adjusted returns on shares demonstrated mean reversion. Whilst varying from year to year real returns have tended to mean revert around a long-term average of 7%. This was also consistent for the three 60 to 70 year sub periods he assessed. Thus US share returns have hugged a long-term average trend line. However neither bond nor cash returns have demonstrated this tendency. Long-term returns for Australian shares have been similar.

The characteristics of short-term volatility, long-term reversion of inflation adjusted returns and historically superior returns indicate that shares should be held as a core asset in any portfolio during the accumulation phase. Cash should be treated as a “parking spot” pending further investment opportunities. Market timers increase or decrease their weighting in cash depending upon their view on the index. Stock pickers should have cash on hand pending their next share purchase.

However, the game changes during the drawdown phase.

The drawdown phase

The ultimate purpose underpinning the investment process is consumption. Thus, there comes a time for most investors when financial securities are progressively sold to meet this aim. Traditional advice has been to decrease portfolio exposure to shares and to increase holdings in cash and bonds during this phase. The main thinking behind this advice is:

1. Since securities need to be sold to fund living expenses an investor does not want to be forced to sell during times of depressed market prices. Cash holdings are used not only to pay for daily living expenses but also to provide a buffer allowing some discretion as to when shares are sold. The level of this discretion depends upon the amount of cash that is held at any time and the duration of any market down turn.

2. Dividends vary; coupons are fixed. The reliable stream of payments that bonds deliver is often very attractive even though they can be associated with suboptimal returns.

Inflation and asset selection

Predicting inflation levels is as difficult as making forecasts about interest rates. Everyone has a view. But it is a phenomenon to be observed and measured, rather than reliably predicted. But since inflation is the enemy of the bondholder it is relevant to any discussion on asset allocation.

When inflation hits, the bondholder has nowhere to hide. In order to combat inflation central banks typically tighten monetary policy which usually has ramifications right along the yield curve. Bond yields increase and bond prices fall. Fixed coupons mean a fixed income, which starts to look inadequate as general prices rise. And whilst bonds guarantee a fixed return of principal at maturity, this is little consolation if its purchasing power has been decimated. Double-digit inflation can see purchasing power halved within 7 short years.

Shares have traditionally been perceived as a better hedge against inflation than investments in bonds or cash deposits. It is argued that inflation results in a commensurate increase in the value of a company’s real assets and this, coupled with an increase in the prices of the goods and services it sells, will flow through to an increase in earnings and dividends paid. Whilst intuitively appealing, the relationship is not quite that straightforward. Warren Buffett wrote extensively about this issue in the Berkshire Hathaway annual reports during the late 1970's and early 80's. It is no coincidence that the US inflation rate was approaching 14% at this time.

Buffett reminded us that part, and in some cases a substantial proportion, of the apparent ability of shares to keep pace with inflation can be attributed to the retention, by companies, of a proportion of their earnings. Put another way unless managements are destroying capital as quickly as they are retaining it, increases in share prices must be expected – inflation or no inflation. It is also worth considering that those companies best suited to an inflationary environment are those that possess the ability to increase the prices that they charge for their goods and services without materially affecting their sales volumes. Not all companies are capable of doing this.

Summary

So where does that leave us? Like most decisions associated with financial markets there are no precise answers. But there are some principles which, if followed, should achieve a good result in an otherwise uncertain world.

During the accumulation phase

1. Think of risk as both the risk of default (company failure or non-repayment of debt securities) and the risk of a substandard return. Don't think of risk as market volatility.

2. Use shares as the core asset in your portfolio. Bonds are held to a lesser degree and cash is held pending further investment opportunities.

During the drawdown phase

1. Change your perception of risk. The risk of capital loss due to market volatility is now greater. Restructure your portfolio to contain a smaller proportion of shares.

2. The percentage of your portfolio devoted to shares depends on how long you expect the drawdown phase to last. If you anticipate it to be substantial then continue to retain shares as a core holding, albeit a reduced one and reduce it further through time.

Finally - no apology is made for the absence of specific recipes in this article. Everyone presents with their own needs, fears and circumstances. My aim has been to raise awareness of the issues. I wish you happy investing.

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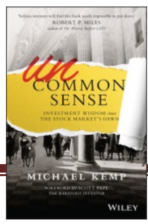

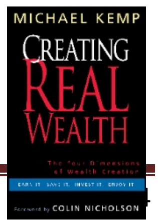

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.