How Crazy is a No-Stock Portfolio?

This was the headline for an article in *USA TODAY* Friday January 14, 2011, which I read while I was in New York in January for our daughter's graduation.

The thrust of the article is that many investors have been unnecessarily scared off the stock market by the last bear market (triggered by the global financial crisis). Therefore, they have now constructed investment portfolios with zero exposure to the stock market.

As the article points out, this is quite sound if the investor does not have enough experience and skill to invest in stocks. Stocks are one of the best performing mainstream asset class in the US and Australia. However, it is also very volatile (or appears to be because prices are published every weekday) and therefore demands an ability to time the market or a long term buy-and-hold approach, best implemented through true broad index funds or Exchange Traded Fund (ETF) securities.

However, it is also true that to take no risk, or low risk, can perversely be the most risky approach. This is because of two huge problems for any investor with a life expectancy of more than a handful of years:

1. **Inflation** – which will eat up the purchasing power of our capital and demands that we invest in growth asset classes, the best of them being the stock market, property and owning a good business.

2. **Longevity** – nobody really knows how long they will live. In our lifetime, the lifespan of both males and females has steadily increased with better nutrition and advances in medical science. The risk of outliving our financial assets is a very real one and may mean instead having to live off a government pension. The way out is again to invest in growth assets so that both our amount of capital and the income stream from it keep growing over time.

Using the figures in the article (which apply to the US market, but will be similar in Australia), the return over a rolling ten year period since 1926 for a portfolio of 90% stocks and 10% cash was 10%pa. For a balanced portfolio of 60% stocks, 30% bonds (fixed interest) and 10% cash, the return was 8.5%pa. For a conservative portfolio with 90% bonds and 10% cash, the return fell to 5.4%. These data are nominal returns, that is, before inflation. These return data were calculated by Morgan Stanley.

So, assuming that you have $500,000 of investment capital, this is what it will grow to assuming a 30% tax rate:

After years	Stocks	Balanced	Conservative
10	$983,576	$891,209	$724,614
20	$1,934,842	$1,588,507	$1,050,131
30	$3,806,128	$2,831,384	$1,521,879
40	$7,487,229	$5,046,711	$2,205,549
50	$14,728,513	$8,995,350	$3,196,343
60	$28,973,213	$16,033,475	$4,632,229

Take a moment to study this table. I took it to 60 years, which is the possible life expectancy for a person inheriting $500,000 at age 25.

You might think that if you retire at 60 with $500,000 in investment capital, it makes little difference by age 80 whether you have $1.935 million invested in stocks or $1.050 million invested in bonds. It sounds like a lot of money at today's prices. However, remember that at 4% inflation, prices double every 18 years, so the price of everything will have doubled twice in 20 years. If you needed an income stream of $50,000 to live off at age 60, you will need an income stream of $200,000 to keep that standard of living at age 80.

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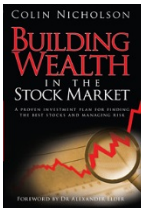

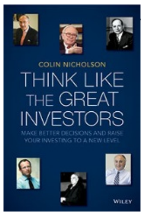

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