EXPLORING DIVERSIFICATION – BONDS VS. STOCKS

2007 Returns

Many investors experienced negative returns in their portfolios in 2007 for the first time since 2000-2002. An equally weighted Canadian/US/International passive equity portfolio lost about 2% in 2007. The same mix of actively managed funds returned on average negative 2.4%. Bonds experienced capital losses for most of the year but were saved by the interest coupon to average a 3.7% total return for 2007.

Diversification

One of the most basic strategies of successful investing is diversification – don't put all your eggs in one basket. The simplistic rationale behind diversification is that investors should protect themselves from all their investments declining simultaneously. In positive markets investors would be pleased to have all their investments appreciate concurrently, and that is why many investors tend to forget diversification in bull markets. Portfolio diversification is primarily a form of "insurance" undertaken by investors in order to reduce the risk in their portfolio while at the same time often reducing the upside and thus underperforming in bull markets.

For a Canadian investor, diversification typically translates to not investing ones entire portfolio in Canadian equities, but also investing in Global Equities (US and International Equities), and investing in fixed income instruments. Certainly from a diversification standpoint fixed income has consistently had the lowest correlation with equity markets. Therefore, if equity markets experience a sharp decline, the fixed income portion of an investment portfolio should serve as the "insurance-like" portion of an investor's portfolio but the insurance comes with a cost - taxes and inflation.

Bonds

Indeed "bonds are fundamentally different" then stocks. Let's revisit why, using the example of a 10 year Government of Canada Bond at January 11, 2008 rates:

1. Bonds represent a promise to repay capital (Government bonds have "NO" credit risk)
2. Bonds go up and down in price with less volatility (prices were actually negative for most of 2007)
3. Bonds pay a coupon interest rate in cash (currently 4%), but today you must buy at a premium hence the yield is less (currently 3.8%)

Long Term Investment Plan

So why not allocate all your capital to bonds when stock prices are falling? Our firm never has, and never will, engage in market timing. Quite simply, we don't know for certain if stock prices will rise or fall at any point in time looking forward. We only know looking back. We do know that stock prices constantly go up and down but generally go up more often than down (about 2/3 up and 1/3 down) and almost always beat bonds and inflation.

Equity markets have been extremely strong over the last few years and investors may have reduced their fixed income exposure and increased their equity exposure in the quest for higher returns. If the recent market volatility and its potential impact on your investment portfolio is causing you significant concern then you should consider reducing your equity exposure and increasing bonds.

However, it would be imprudent to change your long term asset mix strategy every time there is some market adversity. In the long term, a portfolio entirely invested in bonds almost guarantees you will shrink your capital (inflation - adjusted) as the following calculation shows using that same 10 year Canada bond:

Canada Bond @ Jan 11/08	**10 yr**
Current return/ yield	3.8%
Less tax on 4% coupon @ 46%	(1.8)
Less inflation estimate over 10 years	(3.0)
Net of tax real loss	(1.0) %

Remember also that stocks usually return 3-5% more than bonds at one-half the tax rate resulting in a net of tax real return of about 2.5 % to 4.9% on stocks. Bonds do make good sense in tax deferred structures such as your Company Pension Plan, RRSP or Exempt Insurance Plan (whole life) so use those structures to their maximum advantage. However a dramatic rebalancing from stocks to bonds will significantly reduce long term real growth in a taxable portfolio.

Conclusion

Based on numerous conversations with money managers we believe that returns in 2008 may not be as high as they have been in the last few years, but for most managers it should still be possible to invest in quality companies with upside potential that exceed bond returns. As we still do not have a crystal ball to tell us when the stock market may rebound we continue to believe that the best long term investment strategy is to remain invested in equities, but sufficiently diversified in bonds in line with your risk tolerance.

- BWMG Team
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