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Income, safety or growth?

Investors in recent years have been looking at financial markets that are largely without precedent. Short-term interest rates have been at rock bottom for an extended period of time, and longer-term rates are not much higher. Bond investors have the twin worries of low current yield and the possibility of principal loss on paper should interest rates begin moving higher. Stock markets have been buffeted by a variety of international forces. Although market performance has been exceptional, the lingering cloud of unsatisfactory employment numbers hangs over the U.S. economy.

Stocks and bonds have been on a roller-coaster ride during this volatile economy. After suffering a 37% collapse in 2008, the large company stocks represented by the S&P 500 grew by 26% in 2009 and 32% in 2013 (including dividends). Bonds delivered almost a mirror image, gaining nearly 26% in 2008, then losing nearly 15% the following year, as stocks returned to favor.

Balancing act

To avoid the extremes of one asset class or another, one needs to employ an asset allocation strategy for smoothing portfolio performance. Much of the riskiness of an investment portfolio can be mitigated by the mix chosen. Here are the returns for various mixes of stocks and bonds in the five-year period 2010-2014.

Smoothing the volatility

Year	100% large-cap stocks	70% stocks, 30% bonds	30% stocks, 70% bonds	100% long-term government bonds
2010	15.06%	14.52%	12.53%	10.14%
2011	2.11%	10.07%	20.56%	28.23%
2012	16.00%	12.42%	7.32%	3.31%
2013	32.39%	17.70%	0.26%	-11.36%
2014	13.69%	16.80%	20.87%	23.87%

Source: 2015 Ibbotson SBBI Market Report; M.A. Co.

An asset allocation plan will employ many more than two asset classes. The historical performance of the asset classes is the starting point; the degree to which the classes move in synch or not is determined mathematically. With these coefficients in hand, the portfolio may be optimized. That means expected performance may be maximized for a given level of acceptable investment risk. Alternatively, risk may be minimized for a target level of return.

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