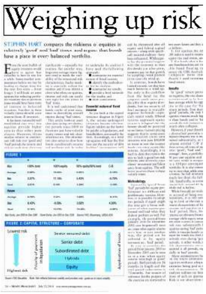
MEDIA MONITORS


Weighing up risk

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Weighing up risk

STEPHEN HART compares the riskiness of equities in relatively 'good' and 'bad' times, and argues that bonds have a place in every balanced portfolio.

Even the most bullish of equity investors would have to agree that volatility is here to stay for a while. Some market commentators believe we may be looking at choppy times for the next five years – if not longer. I will look at some options for reducing portfolio volatility that in previous times would have been more of interest to balanced investors, but that in these volatile times should draw interest from all investors.

It has been reasonably well established that over time equities provide higher returns than other asset classes. However, if you analyse returns in comparison with risk over 'good' and 'bad' periods the returns and risk for each asset class vary significantly – especially for equities. Put another way, long-term average return figures tend to mask the variability of the return and risk characteristics. Such a masking is especially evident for equities and if you inherit a client who relies on equities, returns and risk can easily turn ugly for the client in 'bad' times.

It is well understood that bonds can be of great assistance in diversifying overall returns during 'bad' times.

This article looks at asset class data during two distinctive periods since 2000 to illustrate just how volatile equity return and risk characteristics are. The information also serves to show how bonds can diversify returns and moderate risk. In order to undertake the analysis I have used the following approach:

- summarise the essential nature of fixed income;
- identify the methodology for the analysis;
- summarise the results;
- provide a brief rationale for the results; and
- draw conclusions.

Essential nature of fixed income

As you look at the capital structure diagram in Figure 1, the various rankings of investors become obvious. Equity holders are the last to be paid in a liquidation, and bondholders are usually the first. Accordingly, in a wind up equities will bear the first loss and the security of debt holders' investments will only be threatened after all equity and hybrid capital sources – along with specifically secured creditors – have been exhausted. While equity has the potential to grow with the economy so that dividends can also grow, investors pay for that growth by accepting a weak position in the case of a wind-up.

In contrast, bonds have limited growth, yet they fare much better in a wind-up. Not only is the cash flow from the bond (ie, the coupon) much more predictable than equity dividends, but the security of final payment is typically superior for bonds – especially senior bonds. If bond returns approach equity returns it is logical that the former should be preferred to the latter. Current pricing suggests that in some cases this situation exists and investors with just $50,000 to invest in over the counter bonds can enjoy equity-like returns. Accordingly, it is hard to deny that now is the time to lock in good low-risk returns and diversify your clients' investment portfolios away from equities. This will better position them in these volatile times.

Methodology

Separating 'good' from 'bad' periods for equity performance is a difficult and problematic exercise. However, it is possible to adopt two periods of equal length that may give a broad indication of when equities performed well and when they did not perform so well. For example, the period from January 2000 to December 2002 can be generally seen as a time when equity returns were low, or put another way, the period can be referred to by equity investors as a 'bad' period.

By way of contrast, the period from January 2003 to December 2005 can be seen to be a time when equity returns were high (a 'good' period). Both periods are 36 months in length and the total period under review is 72 months. Our sources of reference for the purpose of this exercise are restricted to

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two asset classes and they are as follows:

1. For equities, the ASX 200 index is used to estimate equity risk and return, and

2. For bonds (that is fixed rate bond securities, not variable based floating rate notes) the UBS Australian Composite Bond index (0+yrs) is used to estimate bond return.

Results

In 'good' return periods for equities, the risk characteristics tend to be lower

than average while the opposite is the case for 'bad' return periods. Even during 'good' periods, the risk for equities remains much higher than bonds and in 'bad' periods the risk increases and return often collapses.

However, if your client has a diversified portfolio the impact of equity risk is moderated substantially, as the column entitled 'C-B' displays across all types of markets: 'good', 'bad' and 'on average'. Here, a portfolio of 50 per cent equities and 50 per cent bonds is compared

to a 100 per cent equities portfolio. It is also interesting to note that while return is lower, the fall in return is much less than the fall in risk. Specifically, on average return falls around 41 bps, while risk is halved.

While I would not wish to be accused of being overly pessimistic, it is very sobering to look at the risk and return characteristics of fixed income and equities in the 'bad' period. Here, bond returns are elevated from the average while equity returns are close to zero. In contrast,

risk rises substantially for equities during 'bad' periods while it remains largely constant for bonds and does not subside even during 'good' periods. In other words, the risk characteristics are substantial in all periods, especially in 'bad' periods.

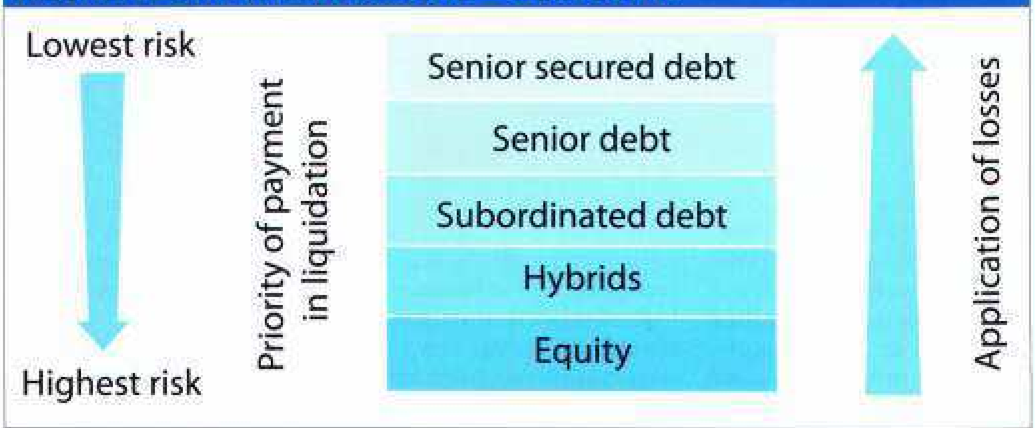
Many commentators focus on the return attributes of equities without adequate attention being paid to the risk characteristics. This analysis outlines the limitations of such an approach. Risk is not short-term for

FIGURE 1

	A	B	C	
Risk	100% bond	100% equity	50% equity/50% bond	C-B
Average	2.96%	10.20%	5.02%	-5.18%
Bad	3.27%	11.18%	5.43%	-5.75%
Good	2.51%	8.48%	4.38%	-4.10%
Return				
Average	6.79%	7.61%	7.20%	-0.41%
Bad	8.43%	-0.58%	3.92%	4.50%
Good	5.16%	15.79%	10.48%	-5.32%

Bad Equity, Jan 2000 to Dec 2002. Good Equity, Jan 2003 to Dec 2005. Source: FIIG, Bloomberg, UBSA, ASX.

FIGURE 2: CAPITAL STRUCTURE – CORPORATE



Source: FIIG Securities Note: Risk reflects historical volatility and provides only a guide as to future volatility.

equities – it is omnipresent. Faced with this risk, investors need a tool for diversification and bonds represent the primary means of diversifying market risk as well as offering a measure of protection against the risks that may occur in a wind up situation.

Rationale for results

The reason for the large fall in risk, relative to the fall in return, is that the asset classes are generally negatively correlated. That is, when equity markets fall, inflationary forces usually moderate – and that translates to lower short-term rates and higher (fixed-rate) bond prices. The opposite is also true. What is really important in these prevailing conditions where economic growth is less certain is that client portfolios without a bond allocation are effectively dependent upon at least a reasonable level of economic growth for return. An allocation to bonds smoothes out returns and creates less uncertainty for investors.

It is for this reason that an allocation to bonds features in most 'balanced' portfolio offerings – and the technique is of even greater importance in these uncertain times.

Conclusions

Investors should need little reminding that equity markets are volatile and that extended periods of 'good' and 'bad' equity returns exist over the medium term. When assessing average return and risk, investors tend to underemphasise the variability of return from equities; hence investment performance was analysed for periods of 'good' and 'bad' equity return. While the benefit of diversification into bonds is most evident in the 'bad' times, the merits of using bonds to diversify portfolio return are evident over all periods. Without bonds, the possibility that total portfolio return and risk become unacceptable over the medium term remains higher that it needs to be. From this we would have to conclude that when you are constructing a portfolio for a client, bonds are not an option but a necessity.

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