

News

Portfolios: A balancing act

Interest rate exposure especially acquired by way of investment in government bonds is a useful tool for equity investors. Government bonds provide a liquid hedge against volatility in equity returns. While cash reduces equity portfolio volatility, it does not provide the necessary interest rate exposure, which delivers a real defence when equity markets are under stress. Conversely, long-dated bonds do not stifle equity returns during an equity rally; equities still more than dominate the return stream even when bonds represent 50 per cent of the total portfolio.

In my recent article: 'Striking a balance' (Money Management, August 26); I referred to Australia's oversized (by OECD standards) allocation to equities. Reaction to the article indicates that further explanation on the value of interest rate exposure in a portfolio is appropriate.

This article looks back over previous conclusions and takes the analysis one step further to reinforce the value of including long-dated bonds in a balanced portfolio.

The problem

Popular misconceptions about so-called growth assets and what constitutes the definition of a balanced portfolio have distorted asset allocations leading to an over-allocation to higher risk assets, especially equities. Recently, the Cooper Review suggested the current definition of a balanced portfolio was "some balanced investment options have 80 per cent of so-called growth assets, while others have as little as 60 per cent".

This definition of a balanced fund summarised by the Cooper Review suggests that an allocation of 60 to 80 per cent of the portfolio to equities is normal in terms of defining a balanced portfolio when clearly it is not.

Conclusions from striking a balance

Before deciding on an appropriate mix of equities and bonds for their clients, financial planners were urged to consider the underlying components of each - see Figure 1. Specifically, the All Ordinaries ASX Accumulation Index was used to assess the characteristics of the equity market risk and return, while the UBS 0+ Year Government Bond Index was used to assess the bond market risk and return. Growth assets, like equities (Equity (e)) are represented, while defensive assets, like government bonds (Gov_0+ (g)), are also represented. Planners can then assess the risk and return characteristics of the various asset classes. Several portfolios are compared in Figure 1 where the 50 per cent equity and 50 per cent bond portfolio appears to best fit the idea of a balanced portfolio. Here, annual risk roughly equates to annual return.

You will see that adding a 50 per cent allocation of the portfolio to government bonds does not cut return in half; rather it only reduces return marginally. However, a 50 per cent allocation to government bonds reduces risk substantially; by almost half, as Figure 2 illustrates below.

The results are also consistent with analysis of the portfolios on a rolling annual basis as shown in Figure 3; allocations to equities of more than 50 per cent seems to be anything but balanced, especially in periods of low equity return.

Extension — long-dated bonds

Looking at how longer-dated bonds improve the diversification of the overall portfolio can extend the above analysis; adding interest rate exposure reduces the overall portfolio risk in the medium term. Accordingly, instead of using the 0+ year index, which currently has a modified duration of around four years, we can refer to the 10 year + index, which has a much longer modified duration - around eight years. Results for the various portfolios when the longer-dated bond index is used are shown in Figure 4. The 50/50 portfolio has a slightly better ratio of risk and return and the results are similar to Figure 1. Return and risk are both a little higher, which is logical as the portfolio reflects longer maturity dates. However, more return is added than risk which modestly improves the overall ratio of risk and return.

The results effectively mask what occurs in stress periods for equity returns, especially during 2009 as Figure 5 indicates. In particular, the annualised bond performance appears much stronger in 2009 in comparison with the performance recorded in Figure 3.

Stress periods — when long-dated bonds shine

As the analysis in my previous article, 'Striking a balance', indicated, adding bonds to a portfolio with a fairly low modified duration reduces portfolio risk substantially. This is because the addition of interest rate exposure increases portfolio diversification. When more interest rate exposure is added i.e. longer bonds replace shorter bonds, the benefits are even more pronounced especially during stress periods. Equity bear markets in 2000, 2002 and 2008 all substantiate the notion of long bonds generating better return outcomes than shorter bonds - see Figure 6. This is well illustrated by looking at the figures in late 2008 when the portfolio with long bonds outperformed the portfolio with the shorter-dated bonds by nearly 4.5 per cent. While the longer bond portfolio underperforms in periods when equities do well, the equity element of the portfolio will deliver gains that lead overall portfolio returns higher. Without sacrificing the benefits of holding equities in bull markets, planners can build a defensive cushion for their client portfolios by inclusion of long-dated bonds; see the right hand axis in Figure 6.

Conclusion

Simply put, if bonds diversify equity portfolios by adding interest rate exposure it is logical to conclude that longer-dated bonds will offer more diversification. The analysis confirms that this conclusion is reasonable.

Concerns by planners and their clients over the length (duration) of the allocation to bonds in client portfolios should be viewed in light of the illiquidity that often arises in a falling equity market. The evidence confirms that the presence of interest rate

exposure, particularly by investment in government bonds, is highly appropriate for equity investors providing, as it does, a liquid hedge against equity return volatility. While cash and term deposits alongside equities will reduce portfolio volatility, they do not provide sufficient interest rate exposure to stem the damage when equity markets fall.

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