

Bonds a steadying factor in a portfolio

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Most investors who can cope with share price volatility know you can make money faster from shares than saving money in the bank. The trouble with shares, however, is the volatility that can see you gain in a month what an interest investment might take years to deliver, juxtaposed with the volatility that can also in a very short time wipe out years of past investment returns and have investors wishing they left their money in the bank.

The volatility that shares can show is highlighted at the end of every month when attention focuses on how much the stock market has moved, as measured by an index like the S&P ASX 200. This particular index tracks the performance of the market's 200 largest companies. Another popular index is the All Ordinaries, which tracks the performance of the 500 largest companies.

So far during the 2010 calendar year, the share market – according to the ASX 200 index – has seen as many down months as up months. The average down month saw the market retreat 3.7 per cent while positive months have seen average rises of 3.1 per cent.

By comparison, during the 2009 year, there were only three down months and nine up months. Interestingly the average movement for both up and down months was 4.4 per cent. What was different in 2009 was the market's cumulative performance, when all the months are added together into an annual performance.

In 2009, the ASX 200 rallied nearly 27 per cent, but so far in 2010 there has been the usual volatility but virtually no progress. The major positive during 2010 as far as shares are concerned has been that up to late October the overall market has more or less held its ground.

These observations help to explain why many investors are not as excited about shares this year as they were last year, when the market recovered strongly after the 2007-2008 slump. It also provides insights into why investors are looking at alternatives such as property and fixed income investments.

What adding alternatives like fixed income investments to an investment portfolio can offer is less volatility. According to Dr Stephen Nash, head of strategy with fixed interest broker FIIG Securities, fixed income investments, or bonds as they are commonly known, can have a major stabilising effect on portfolio volatility.

A study he has done shows that over the long term – the last 20 years – the average monthly up and down performance from shares has been 3.31 per cent and 3.27 per cent respectively. Over the same period, the average annual cumulative performance has been 10.1 per cent.

By comparison the average down month from a fixed income portfolio has been 0.7 per cent while the average up month performance has been just under 1.3 per cent. The trade-off for this lower volatility is a lower long term cumulative return, an average annual return of just under 8.8 per cent. This supports the investing rule that lower volatility investments deliver lower returns, although they are not necessarily dramatically lower.

Having a portfolio that is half invested in shares and half in fixed income can reduce share volatility by about half, says Dr Nash, while delivering a better return than a straight fixed income portfolio. Over the period of the study the cumulative return from a 50:50 portfolio of fixed interest and shares was 9.45 per cent.

Dr Nash says one encouraging aspect of investing is that for both shares and fixed income investments, down months are less frequent than up months, although during more difficult economic times down month volatility tends to be worse than up months. This highlights the sense of reducing the severity of negative months by including fixed income in a share portfolio during recessions and adding shares to a fixed income portfolio during growth periods.