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Trust & Investment Management Group

Market Risk and Reward

It's important to have realistic expectations about the trade-offs between risk and reward. A balanced, diversified portfolio can help reduce portfolio volatility. This table shows long-term average annual returns for various asset allocations between U.S. stocks and bonds, and the performance of those allocations during select equity bear and bull markets.

Asset Allocation	Average Annual Return 1926-2020	Inflation-Adjusted Average Annual Return 1926-2020	Number of Years With a Loss 1926-2020	Cumulative Return 1973 - 1974	Cumulative Return 3/31/2000 - 9/30/2002 ▼	Cumulative Return 9/30/2002 - 12/31/2007 ▲	Cumulative Return 12/31/2007 - 3/31/2009 ▼	Cumulative Return 3/31/2009 - 12/31/2020 ▲
100% Bonds	5.35%	2.42%	14 of 95	-4.82%	28.56%	26.12%	5.36%	64.69%
20% Bonds 80% Stocks	6.66%	3.70%	13 of 95	-11.85%	10.61%	40.04%	-6.18%	121.14%
40% Bonds 60% Stocks	7.82%	4.83%	17 of 95	-18.58%	-5.52%	55.06%	-16.81%	192.41%
60% Bonds 40% Stocks	8.84%	5.81%	22 of 95	-25.04%	-19.92%	71.23%	-26.59%	280.73%
80% Bonds 20% Stocks	9.70%	6.65%	24 of 95	-31.21%	-32.69%	88.60%	-35.57%	388.05%
100% Stocks	10.40%	7.33%	26 of 95	-37.12%	-43.92%	107.20%	-43.77%	515.72%
100% Cash	3.36%	0.48%	1 of 95	15.49%	10.25%	16.08%	1.84%	6.46%

Source: Vanguard as of December 31, 2020

▲ **Bull Market** ▼ **Bear Market**

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"When I was a kid, I got no respect. I had no friends. I remember the see-saw. I had to keep running from one end to the other."

– Rodney Dangerfield, *comedian*

Traditions are an important part of any culture. The best traditions are simple, repeatable, and produce feelings of comfort and joy when you reflect on them. Summer is a great time to look back on childhood traditions with family and friends. Summer traditions that I fondly remember from my childhood include long strolls on the boardwalk at the New Jersey shore, 4th of July fireworks shows over the lake at sleepaway camp and Sunday afternoon New York Mets baseball games with my father at Shea Stadium.

In the investing world, a traditional approach to asset allocation has been the idea of a 60/40 stocks/bonds diversified portfolio. The idea is that the 60% of the portfolio weight in stocks produces growth, or capital appreciation, of your principal over time at a rate a few points ahead of inflation while the 40% in bonds generates a steady stream of income and serves as a stabilizer when markets go south. If you remain fully invested in the markets at all times and rebalance your portfolio when the weights move more than a few percentage points away from the targets, you have done very well over the last century of investing.

More specifically, according to Vanguard's data, a 60/40 portfolio generated an inflation-adjusted

FRED – 10 Year Treasury Inflation-Indexed Security, Constant Maturity

U.S. recessions are shaded; the most recent end date is undecided.

Source: Board of Governors of the Federal Reserve System (US), *Federal Reserve Economic Data*, https://fred.stlouisfed.org/series/DFII10

average annual return of 5.81% from 1926-2020 and produced a loss in only 22 out of the 95 years. By comparison, a 100% all stock portfolio earned a 7.33% inflation-adjusted average annual return with losses in 26 out of the 95 years, while a 100% bond portfolio yielded a 2.42% inflation-adjusted average annual return with losses in 14 out of the 95 years.

Today, there are skeptics who question the 60/40 traditional investment approach. Some suggest you ditch bonds entirely claiming they are a loser's bet in a world of low interest rates and concerns of rising inflation. Others protest when they observe a 22x price-to-earnings multiple on the S&P 500 that stands out as expensive relative to recent and long-term history. With proxy, or substitute, asset classes available such as alternative assets, commodities, cryptocurrency, and gold, some believe we need to toss the 60/40 portfolio in the dumpster alongside our old VCRs, floppy disks and compact disc collections.

To be fair, "stocks" and "bonds" are not monolithic asset classes, and there are many skews and tilts we employ for our clients to squeeze out as much as possible from an expected risk versus return framework. This includes different allocations within equities by size (small, mid, large cap), style (growth, value), geography (US, developed international, emerging markets), unique characteristics (dividend payers, dividend growers, industry focused) and any other way you can add potential return opportunity to a portfolio without commensurately increasing risk. Most investors and clients appreciate the importance of equities today, and the debate lies within where to invest in the asset class and how much further the new bull market can go.

The focus of the rest of this blog entry is on defending the role and importance of fixed income. To be fair, the starting point for the expected return of a diversified fixed income portfolio is not great. The Federal Reserve has kept interest rates near zero for the past year, and it has signaled that it will not increase rates until 2023.

The 10-year Treasury bond yields about 1.50% on an absolute ("nominal") basis and when accounting for inflation, the yield is currently negative, which has only happened twice in the past 40 years.

Another headwind for fixed income returns is the fear of rising inflation. When inflation rises, the value of the coupon payment that you earn on your bond investments decreases in real terms. Inflation concerns are high today due to shortages in semiconductors, select commodities like lumber and labor shortages that are driving up prices and wages. While the Federal Reserve believes these inflationary pressures are transient, and the markets are expecting inflation to stabilize at 2.3% (based on the price of inflation-indexed bonds), we are exiting a period of unprecedented monetary and fiscal stimulus so it is possible inflation overshoots.

Despite the mixed picture for expected returns, it is important to take a step back and remind ourselves of why we still advocate for a full fixed income allocation. Fixed income is the broccoli to your Chilean sea bass. They are the yin to your equity yang. Your fixed income bucket serves as a natural insurance policy against losses on stocks because it tends to move up in price when stocks go down. On the other hand, when stocks move up in price, bonds historically will lag in returns, but they still produce rental income to you in the form of coupon payments.

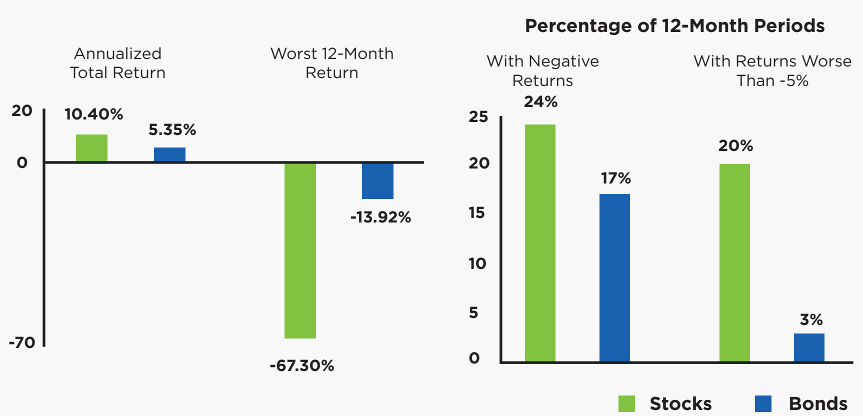
For example, from 1926-2020 the percentage of 12-month periods where stocks generated a negative return was 24% versus 17% for bonds. That does not seem like too bad a price to pay for higher growth, but the differences in downside protection are more visible when you learn that in 20% of those 12-months periods, stocks lost at least 5% while that was only true in 3% of those times for bonds.

What happens to your individual bond holdings, or your bond mutual fund returns if we do enter a cycle of rising interest rates and higher inflation? If you hold your individual bonds until maturity, you have the option to simply reinvest the principal that is returned to you at the new higher coupon rate.

If you own a bond mutual fund, you will continue to earn a consistent stream of income while the underlying fund absorbs a modest capital depreciation as yields, or prices, reset lower. A simple example is a bond fund that yields 2.5% for the next ten years. You will earn at least a cumulative 25% return via interest income (2.5% x 10 years) plus any bump up in coupon rates as interest rates increase during this period. If interest rates increase by a full percent, you might lose 4%-5% in a fund with duration (a measure of a bond's price sensitivity to changes in interest rates) of 4 to 5 years which would net out to a positive 20% return.

In addition, similar to equities, there are a wide range of options in the fixed income landscape to be opportunistic in structuring your risk/reward calculus that includes issuer type (government, agency, corporate), credit risk (AAA, high yield, junk), duration (short, intermediate, long), tax treatment (muni's, taxable), inflation and interest rate sensitivity (TIPS, floating rate loans) and geography (US, developed international, emerging markets). The key point is that markets are dynamic and constantly changing. Even though the fixed income return opportunity may look unappealing at face value, there are always opportunities to be found if one is diligent, thoughtful, and patient.

U.S. Financial Markets, 1926-2020



Source: Vanguard, *Market perspectives: May 2021* (April 27, 2021), https://advisors.vanguard.com/insights/article/marketperspectivesmay2021.

One final tradition, or ideal, comes to mind that many of my great teachers and mentors in life passed down to me. We never know with certainty what twists and turns life will present, and today is no different. In markets, a balanced approach, whatever that means to you, allows you the staying power to enjoy the fruits of compound interest over the long-term while absorbing the shocks that bear markets and turbulent times will inevitably bring. Enjoy your summer with family and friends, and let your portfolio be ready for whatever is to come in the future.

Sources:

1. Vanguard

2. *Economic Research Federal Reserve Bank of St. Louis:* fred.stlouisfed.org

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