

Asset Allocation: It's Not Just All Stocks and Bonds

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In simple terms, asset allocation is the mix of different asset classes in a portfolio, with each asset having unique risk and return characteristics. Over longer time periods, stocks outperformed bonds, albeit with more risk, and bonds offered better returns than cash. The recent "lost decade" for stocks, however, serves as a reminder that traditional relationships between investments can remain out of balance for quite some time. Over the past decade, bonds have handsomely rewarded investors, with an average annual return over 6%, compared to an average annual loss of nearly 1% for stocks. So, do investors now simply "stay the course" and continue investing in bonds and maintain a fixed allocation to both bonds and stocks, particularly when short-term cash returns are virtually zero? Unfortunately, it's not that simple. Given the last ten years, it is unlikely that bonds will notch similar returns, or outperform stocks, in the current decade. Also, if inflation heats up in the coming decade as interest rates climb from historic lows, it will be tough for bond investors to maintain their purchasing power, i.e., keep up with inflation.

Therefore, the challenge for investors is to construct a portfolio of different assets that will at least grow versus the inflation rate over time. Over the next decade, we believe that high quality stocks will outperform bonds, despite the troubling economic environment. Consider that many high-quality stocks pay a growing dividend, are trading below their long term average valuation and carry a current yield that is higher than the interest rate on both Treasury bonds and the company's own debt. For instance, consider Procter & Gamble stock – the company's stock is trading at the same price it traded at the beginning of 2000, and its annual dividend yield is 3.1%. If the dividend grows and the stock price rises, the story gets even better.

So stocks are priced far more attractively now than a decade ago, and bonds are not as attractive. Aren't there other assets that can be invested in to help produce a reasonable return? Fortunately, yes. We believe other asset classes may deserve inclusion in a diversified portfolio from a risk/return standpoint: real assets and alternative assets.

Real assets provide a return by benefitting from basic supply and demand principles. As the world continues to grow and many emerging economies are building out their infrastructure, the prices for many "building blocks" such as oil, steel, natural gas and chemicals rise. Such price rises are associated with inflation, and as such, real assets are poised to benefit. Commodities, master limited partnerships, precious metals and real estate investment trusts, for example, are real assets that could add value to a portfolio.

Alternative assets are a broad group of investments that typically offer returns and risk somewhere between stock and bond returns. They earn a return by pursuing less common investment strategies, which are often less correlated to returns of stocks, bonds or real assets. High-yield bonds and absolute return mutual funds are examples.

A well-diversified portfolio would ideally have exposure to multiple asset classes, with the belief that one or more of the asset classes will thrive in different environments. We believe it is crucial to adapt a dynamic asset allocation as the return and risk characteristics of the underlying asset classes change, within reasonable ranges. We continue to expand both the depth and breadth of research on various asset classes as we strive to provide diversification and returns that can increase clients' purchasing power. In future articles, we will delve further into the details of real and alternative assets and the need to maintain a dynamic asset allocation. 