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Success is all in the mix

Michael Nairne, Serious Money

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You should think of your portfolio strategy as a blender that mixes investments to your own unique taste. The asset classes of cash, bonds and equities are the basic ingredients. What you are really blending, however, is the distinctive return and risk profiles of these assets and how they interrelate to each other.

Cash investments such as treasury bills are commonly viewed as riskless. Not so. Sure, they don't drop in value but they contain massive reinvestment risk--the possibility that future proceeds will have to be reinvested at lower interest rates. According to the Bank of Canada, the 30-day treasury bill rate fell from 4.3% in August 2007 to a rock-bottom 0.1% two years later. Even today, the rate is 0.5%. Try funding your retirement on that return.

Bonds offer the opportunity for higher yields but they introduce new risks into the blender. Short-term bonds have reinvestment risk, but as the maturity date is extended, interest-rate risk replaces

reinvestment risk. Bonds that offer a fixed rate of interest will fall in value when interest rates rise and in general, the longer the term of the bond the greater its interest-rate risk.

Today, worries about deflation and falling interest rates have made long-term bonds a winner, but inflation and rising rates may lurk on the horizon. The last time inflation seeped into the economy, after the Second World War, bonds became an underperforming investment for more than three decades. Courtesy of interest-rate risk, long-term bonds in Canada had a negative return (net of inflation) from 1948 through 1981. So much for the common wisdom that bonds are always a safe refuge for the conservative investor!

Bonds, particularly corporate bonds, also carry default risk. A promise to pay is not a guarantee of payment. Ask a bondholder of Lehman Brothers or Chrysler. And today, the gargantuan debts of many developed nations, including the United States, are introducing the spectre of default risk into these bonds. Fortunately, Canada's fiscal prudence has kept default risk at bay, at least for now.

Equities bring stock-market risk. As the inevitable swing of the business cycle lifts and erodes corporate profitability, equities rise and fall in value.

Investors demand compensation for greater risk so the higher volatility of equities historically has resulted in a return premium to treasury bills and bonds. Over the long run, equities have averaged an annual return about 6% higher than treasury bills and 4% or so to bonds.

Mixing these assets into an optimal blend suited to the taste of a particular investor is one of the key challenges of portfolio management. Most investors do this the old-fashioned way using rules of thumb. Increasingly, however, high-net-worth families are emulating institutional investors by hiring advisors who use fancy blenders such as optimization and asset-liability models to craft more precisely diversified portfolios. They know that their investment success depends on getting the recipe right.

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