FINANCIAL POST

Saturday, March 3, 2012

Portfolio diversity still your best bet

Michael Nairne, Serious Money

Jay Directo/AFP/Getty Images

Imagine it's January 2022 and you've just cracked open your latest investment statements. Are you smiling as you scan the numbers or are you cringing in despair? Of course, no one can predict with absolute certainty what returns will be over the next 10 years. However, several recent long-term forecasts by leading money managers and finance academics shed some light on what the future might hold.

Investors stashing their portfolios in the safe haven of cash should consider the impact on long-term returns. Vanguard's Investment Strategy Group expects real (i.e. inflation-adjusted) short-term interest rates to remain negative for some time to come and nominal returns from cash (e.g. treasury bills) to average less than 2.0% over the next decade.

Despite the current popularity of bonds, their return outlook is modest. Vanguard's median forecast for annual bond returns is centred in the 2% to 3% range, close to current yields. Its simulations of future interest rates indicate that the most likely scenario is rates will rise at some point. Today's bond investors will initially face capital losses before enjoying the benefit of higher yields later in the decade.

However, in about 20% of simulations, interest rates don't budge from current levels — primarily when deflationary conditions prevail, so rising rates are not a slam-dunk certainty.

Those investing in stocks have reason to be hopeful. Vanguard's median annual forecast for global equities is centred in the 6% to 9% range. When adjusted for potential inflation, Vanguard estimates that there is a 50% likelihood that global equities will match or beat the 6% annualized real return that has been experienced in the U.S. since 1926.

Vanguard is not alone in this view. In its 2012 Equity Gilt Study, Barclays concluded that current market valuations are consistent with future returns that are close to the historic experience. Their analysis suggests long-term real returns in the range of 4% for Japan, 5% for the U.S. and 6% for Europe and the U.K.

In a recent report by the CFA Research Institute, a number of heavyweight experts opined on the outlook for U.S. stocks. Although there was some divergence, the most common view was that investors today can reasonably expect stocks to outperform bonds over the long run — on average, by about 4% annually. Prudent investors won't bet the farm on stocks, though. In about 10% of its simulations on future U.S. equity performance, Vanguard calculated that stocks will suffer negative returns over the next 10 years.

Hence, there is about a one in 10 chance that stocks will suffer another lost decade.

Vanguard stresses that, notwithstanding today's low interest rates, the benefits of diversifying into both bonds and stocks remain intact. Bonds act as a source of stability and cash flow, moderating the volatility of equities.

The low correlation between bonds and stocks provides a powerful diversification effect — bonds often perform well when stocks languish and vice-versa. Stocks, on the other hand, are the engine of growth and return enhancement for a portfolio.

Still, unless the world goes into a prolonged slump, the lower expected return on bonds puts conservative investors at a disadvantage over the next decade.

Vanguard projects that the median real return for a portfolio comprised of 80% bonds and 20% stocks will be only 1.8% annually, well below the long-run historic average. This contrasts sharply with the real return forecasts of 3.8% for a balanced portfolio comprised equally of stocks and bonds or the 5.6% for a growth-oriented portfolio comprised of 20% bonds and 80% stocks.

None of these outcomes is assured. On the downside, all three portfolios have a modest chance of incurring low, single-digit negative real returns over the next decade. Conversely, there is a 50% chance returns will be better than the median forecast.

One thing is certain, though. Wise investors will diversify.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.