

# LGC&D Wealth Management, LLC

## Educated Investor Feature Articles: 2007, Vol. 6

### You Can Be Too Conservative

**Overview:** As investors approach retirement, many consider whether they should lower their allocation to equities. Some have even questioned whether they should exclude equities altogether. However, it is rarely necessary to completely remove equities from a portfolio. The following article discusses how a prudent approach is to build a globally diversified portfolio of passively managed investments that reflect an individual's need, willingness and ability to take risk.

#### Risk Taking Ability

As individuals approach and enter retirement, their ability to take financial risks may decrease:

- s With a shorter investment horizon, they have less ability to wait out the inevitable bear markets.
- s If they are no longer working, they don't have the same ability to replace or recover from financial losses.
- s Their willingness to take risk, and suffer the psychological strains that bear markets can produce, is likely reduced.

Thus, it is logical for investors to lower their equity allocations when they reach, or even approach, the retirement stage of their lives. However, as you will see, it is possible to become too conservative. Let's look at the historical evidence.

We begin by considering the cases of investors A, B and C. Investor A is so conservative that he invests all of his financial assets in long-term government bonds (as proxied by a constant maturity 20-year Treasury strategy). Investor B is also conservative. While she invests the majority of her financial assets in long-term government bonds, she decides to allocate a small portion, 20 percent, of her portfolio to stocks. That allocation will be in the form of an investment in the S&P 500 Index. Investor C is a bit more aggressive, allocating 30 percent of his portfolio to the S&P 500 Index. The time frame we will consider is 1926–2006. The following table shows the returns and standard deviations (a measure of volatility and risk) of their portfolios.

	Investor A 100% Bonds	Investor B 80% Bonds/20% Stocks	Investor C 70% Bonds/30% Stocks
Annualized return	5.43%	6.77%	7.37%
Annual standard deviation	9.20%	8.79%	9.33%
Worst year	-9.19% (1967)	-12.92% (1931)	-16.73% (1931)
Worst year (post 1937)	-9.19%	-5.96% (1994)	-6.10% (1969)

	(1967)	
--	--------	--

We can make the following observations from the above data.

- s By adding a small allocation to stocks, Investor B earned 25 percent greater returns and experienced 4 percent less portfolio volatility than Investor A. The worst single year loss was greater for Portfolio B, but the loss was not that much greater — and the next greatest loss for Investor B was under 6 percent. Note that if we only consider the post-Great Depression era, Investor A would have experienced the greatest one-year loss. Important to note, this is not a suggestion to not consider the data from the Great Depression (that would be making the mistake of treating the unlikely as impossible), but it is worth noting.
- s By increasing the equity allocation even further to 30 percent, Investor C earned 36 percent greater returns than Investor A. And he only experienced 1 percent greater volatility. However, the worst single year loss grew to almost 17 percent. Once again, we note that if we exclude the period of the Great Depression, Investor A would have experienced the worst single year.

The conclusion we can draw from the evidence is that adding a small amount of equities to an all-bond portfolio raises returns while actually reducing volatility. While stocks are more volatile than bonds (the standard deviation of the S&P 500 Index at 20.1 is more than twice the standard deviation of long-term government bonds), they have low correlation to bonds. The correlation of the S&P 500 Index to long-term government bonds is just 0.12. And there are many periods when bonds produce negative returns while stocks produce great returns. Consider the evidence in the following table.

Year	S&P 500 Index	Long-Term Government Bond
1933	54.0%	-0.1%
1951	24.0%	-3.9%
1958	43.4%	-6.1%
1967	24.0%	-9.2%
1980	32.4%	-4.0%
1999	21.0%	-9.0%

Of course, there are also periods when bonds provided a safe haven from the storms that hit equities, as you can see in the following table.

Year	S&P 500 Index	Long-Term Government Bond
1930	-24.9%	4.7%
1937	-35.0%	0.2%
1957	-10.8%	7.5%
1962	-8.7%	6.9%
1974	-26.5%	4.4%
2000	-9.1%	21.5%
2002	-22.1%	17.8%

### More Effective Diversification

There are other ways investors can improve the efficiency of their portfolios. Let's look at two of them. The first relates to another mistake investors make when they become

very conservative. Because many investors believe that international equities are riskier than domestic stocks, they limit their equity holdings to only the United States. The evidence presented in the following table makes the case for why international equities should be included in portfolios.

Again, let's consider three investors. Investor A holds only long-term government bonds. Investor B adds a 20 percent allocation to the S&P 500 Index. Investor C diversifies his equity holdings. He adds a 10 percent allocation to both the S&P 500 Index and the MSCI EAFE Index. The data covers the period 1970–2006.

	Investor A 100% Bonds	Investor B 80% Bonds/ 20% S&P 500 Index	Investor C 80% Bonds/10% EAFE 10% S&P 500 Index
Annualized return	8.91%	9.61%	9.67%
Annual standard deviation	11.35%	10.48%	10.24%

By adding a 20 percent allocation to the S&P 500 Index, Investor B increased returns by 8 percent and also reduced volatility by 8 percent. Investor C did even better. His portfolio provided 9 percent higher returns and 10 percent less volatility than did Investor A's portfolio. Note that the historical evidence also suggests that including some allocation to small-cap and value stocks would further increase the efficiency of these portfolios. This is especially true on the international side where the greatest diversification benefits come from adding the stocks of smaller companies (international small-cap stocks have significantly lower correlation to U.S. stocks than do international large-caps).

Let's now look at another way to improve the efficiency of a portfolio, while still maintaining its conservative nature. This time we will shift the maturity of the bond holdings from long-term Treasury bonds to five-year Treasury notes. The time frame is 1926–2006. As you will see, the reduction in risk will allow investors to increase equity holdings even further, without increasing the volatility of the portfolio.

- s Investor A's portfolio is 80 percent long-term Treasury bonds/20 percent S&P 500 Index.
- s Investor B's portfolio is 70 percent five-year Treasury notes/30 percent S&P 500 Index.
- s Investor C's portfolio is 60 percent five-year Treasury notes/40 percent S&P 500 Index.

	Investor A 80% Long-Term Treasury Bonds/20% S&P 500 Index	Investor B 70% Five-Year Treasury Notes/ 30% S&P 500 Index	Investor C 60% Five-Year Treasury Notes/ 40% S&P 500 Index
Annualized return	6.77%	7.25%	7.83%
Annual standard deviation	8.79%	7.34%	8.85%

deviation			
-----------	--	--	--

By substituting shorter-term five-year Treasury notes for the long-term government bonds and adding a 30 percent allocation to equities, Investor B's portfolio produced 7 percent higher returns and reduced volatility by 16 percent. Investor C's portfolio outperformed Investor A's portfolio by 16 percent while producing less than 1 percent greater volatility. Both portfolios (B and C) were clearly more efficient than Portfolio A.

**Summary**

While investors may wish to reduce some of the equity risk inside their portfolio as they approach and enter retirement, the evidence suggests that a portfolio can actually become too conservative. Doing so might cause a portfolio to "fail," leaving an individual without the financial assets needed to support the lifestyle he or she has worked so hard to achieve.

Fortunately, it is not necessary to become so conservative that equities are actually excluded from a portfolio. The evidence suggests that portfolios with globally diversified equity allocations of as much as 30 to 40 percent, when combined with shorter-term fixed income assets, are likely to produce greater returns with similar, or even lower, volatility than that produced by a portfolio of "safe" longer-term government bonds.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Copyright © 2007, Buckingham Family of Financial Services.