

Stocks and Bonds Diversification

November 2019 | CLIENT QUESTION

by Andrew Murphy, CFA | Director of Portfolio Management



In our **October Client Question of the Month**, we highlighted the benefits of a globally diversified investment portfolio as part of our total net worth approach. A diversified portfolio can lead to more consistent and less volatile results than a single asset class. Diversified portfolios can potentially decrease the odds that an investor will need to make a withdrawal after a significant market decline. This month we wanted to further emphasize the diversification benefits of holding equities (stocks) and fixed income (bonds) in an investment portfolio.

We will first outline the differences between stocks and bonds. A stock represents an ownership stake in a company. Stocks generally perform well when the company does well, and investors can receive a percentage of the firm's profits in the form of dividends. Over long-time periods, stock prices move with corporate earnings. If the company goes bankrupt, equity holders have the last claim on any residual cash. Bonds are a loan to an entity (governments, corporations, municipalities, etc.) who promises to pay back the principal with interest. Bond holders do not have an ownership interest in the company, but they do have a higher priority in the event of bankruptcy. Fixed income investors typically prefer the relative safety of bonds and are looking for interest income.

Next, we will point out that since interest rates are near historic lows, we've gotten a few questions about the role of fixed income in client portfolios. At Winthrop Wealth, fixed income serves three purposes: ballast, stability, and income.



Ballast: Equities and fixed income can sometimes have a negative correlation, meaning they move in opposite directions. This is especially noticeable during "flight-to-safety" environments when equity markets decline significantly and investors rush to buy bonds (this pushes bond prices up and yields down). The latest example of this occurrence was late 2018 (September 20th to December 24th) when the S&P 500 declined by -19.8% while the Bloomberg Barclays Aggregate Bond index increased by +1.6%.



Stability: As part of our overall process, we ensure that our client's upcoming cash flow needs are accounted for. Generally, we will invest the amount of upcoming cash flows in high-quality short-term fixed income. This adds stability to the portfolio as high-quality short-term fixed income has lower volatility than most asset classes.



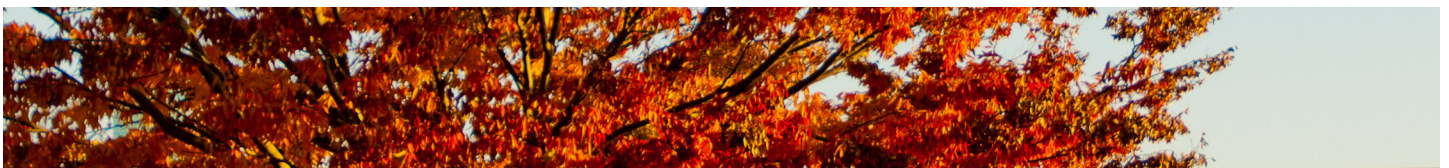
Income: Bond interest payments provide a predictable source of income. The current low interest rate environment, especially after adjusting for inflation, makes it difficult to achieve high income without sacrificing ballast and stability. In our opinion, the best course of action is to diversify across bond types, sectors, duration (interest rate sensitivity), and credit quality to achieve the best possible income while still providing the necessary ballast and stability.

Finally, to underscore the benefit of combining equities and fixed income, we examined the performance of various stock and bond portfolios over rolling periods. Our time-period runs from January 1976 to October 2019 – this is the longest possible data period we have for both the S&P 500 (stocks) and Bloomberg Barclays Aggregate Bond index (bonds). Rolling periods run from month-to-month over the stated time frame and allow for a larger data set than calendar year periods.

We would like to highlight several key conclusions from our analysis:

- **Returns were strong for both stocks and bonds.** From January 1976 through October 2019, the total annualized return was +11.2% for the S&P 500 and +7.3% for the Bloomberg Barclays Aggregate Bond index. This period had the tailwinds of beginning after the economic recession of 1973 to 1975 (equity markets bounce after recessions) and from falling interest rates (declining interest rates push bond prices up). The 10-Year Treasury peaked in 1981 at 15.8% before steadily declining to its current level below 2%. Going forward, we cannot predict that market returns will be this strong. We will continue to help our clients navigate through challenging markets by ensuring their short-term cash flow needs are covered, while managing the rest of their assets in globally diversified portfolios designed to meet longer-term goals.
- **Benefit of Diversification.** As discussed, stocks and bonds act as a ballast due to their negative correlation over certain time periods. The diversification effect is valuable over shorter time periods, especially if you need to make withdrawals from your portfolio. Note that the portfolio with the lowest decline over the 1-year rolling period is the 20% stocks and 80% bonds allocation. In this case, positive returns for bonds helped to offset a crash in the equity market. Also note, the low return for the diversified portfolios that are more heavily weighted in bonds (20/80 and 40/60) is still positive over 5- and 10-year rolling periods. Diversified portfolios can produce lower volatility and drawdowns than a single asset class.
- **Benefit of a long time horizon.** As the rolling time-period increases, the value of the lowest return increases and the range of returns (high – low) decreases. Markets can be extremely volatile in the short-term and equity drawdowns can be severe and occur suddenly. However, we also know that equity markets increase over time as the S&P 500 has produced a total annualized return of +9.4% from January 1928 through October 2019. In general, an investor with a long time horizon can afford a heavier allocation to equities because they are able to ride through challenging markets without needing to take withdrawals from their portfolio. The appropriate asset allocation is part of our financial planning process and will be determined by the clients' unique circumstances, including but not limited to, time-horizon and willingness and ability to take risk.

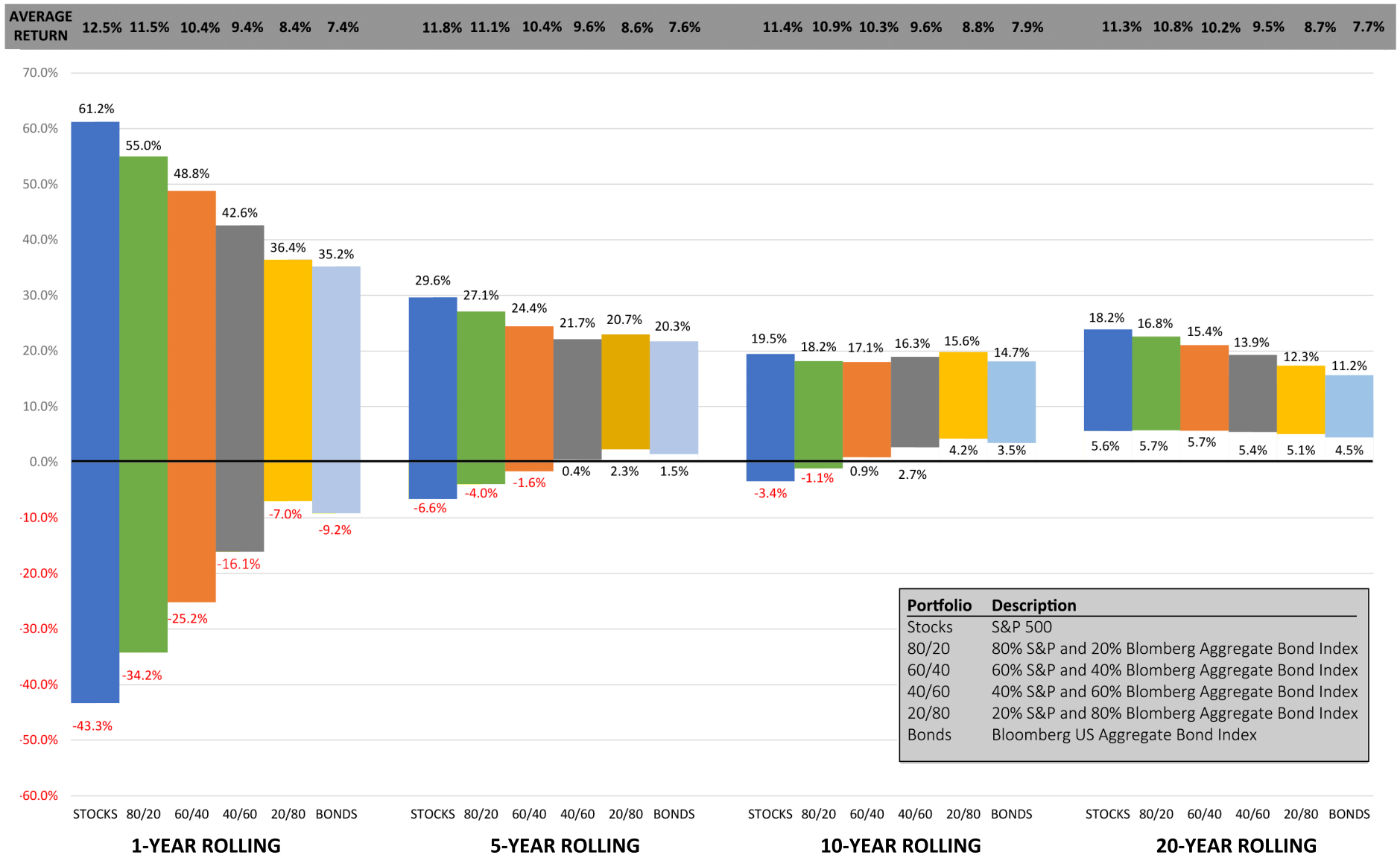
At Winthrop Wealth Management, we apply a total net worth approach to both comprehensive financial planning and investment management. Financial planning drives the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, optimizes account structures, considers tax minimization strategies, and continuously evaluates financial risks as circumstances and/or goals change. The investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. As always, please contact us if you have any updates to your personal or financial circumstances.



Portfolio Diversification

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Range of stock, bond, and portfolio returns
Annualized total returns from 1976-2019



Source: Bloomberg. Total annualized returns are calculated using 12-month rolling periods from January 1967 to October 2019. Portfolios are re-balanced annually.

WINTHROP WEALTH MANAGEMENT | 109 STATE STREET BOSTON, MA 02109 | WINTHROPWEALTH.COM | 617.530.1010

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No strategy assures success or protects against loss. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing. All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Past performance is no guarantee of future results. The hypothetical rates of return used are not representative of any specific security. Actual results will vary.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The S&P Midcap 400 Stock Index is an unmanaged index generally representative of the market for the stocks of mid-sized US companies.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Barclays Capital US Corporate High Yield Bond index is an index representative of the universe of fixed-rate, non-investment grade debt

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.