

(www.fundsupermart.com, 4 September 2003)

Do You Need More Equity?

Our research desk shows how adding equities to an all bond portfolio may actually reduce risk and improve return.

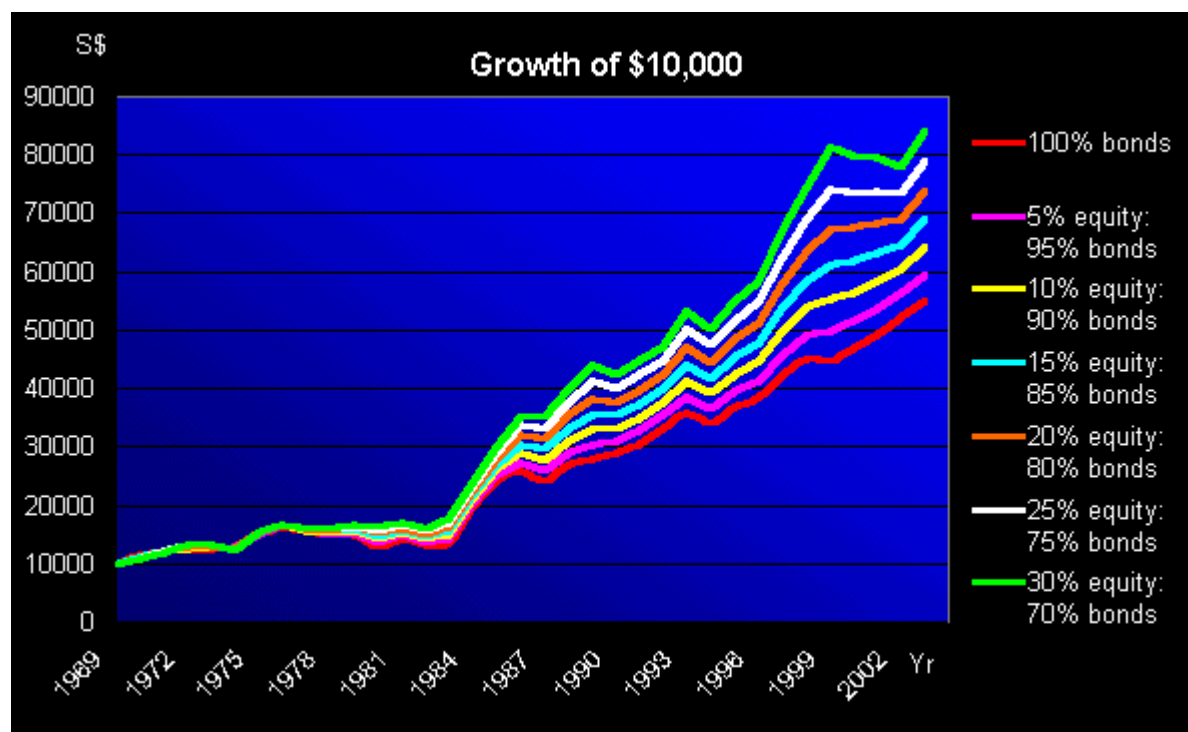
by Wong Sui Jau

ADDING EQUITIES TO AN ALL BOND PORTFOLIO

Investors generally have the impression that an all bond portfolio is safe. However the bond market can be subject to interest rate movements and as a result, bonds can still lose money in certain years. On the other hand, investors often feel that equities are much more volatile than bonds and the possibility of large losses is high. While this can be true, investors need to remember that the two asset classes have a very low correlation to each other. When equity funds were rising during the bull market, bond funds were mostly plodding along with low returns. Afterwards, when equity funds started suffering huge losses from 2000 onwards and the Fed started cutting interest rates, bond funds rose substantially in value.

Since the performance of bonds and equities are not correlated, then by combining the 2 asset classes, we can create a portfolio that should be even more stable than an all bond portfolio. Also, the return of such a portfolio might actually be higher even though it is less risky than an all bond portfolio.

We back tested the results of a variety of equity and bond portfolios over the last 34 years. Each portfolio started with an investment of S\$10,000.



Source: Fundsupermart.com

The chart above shows that the more equities we add to a portfolio, the higher the return, as equities outperform bonds in the long run. The actual numbers are shown in the table below:

Portfolio	Growth of \$10,000 after 34 years	Annualised return
100% Bonds	\$55,051	5.14%
95% Bonds & 5% equities	\$59,522	5.39%
90% Bonds & 10% equities	\$64,164	5.62%
85% Bonds & 15% equities	\$68,960	5.84%
80% Bonds & 20% equities	\$73,897	6.06%
75% Bonds & 25% equities	\$78,956	6.27%
70% Bonds & 30% equities	\$84,115	6.46%

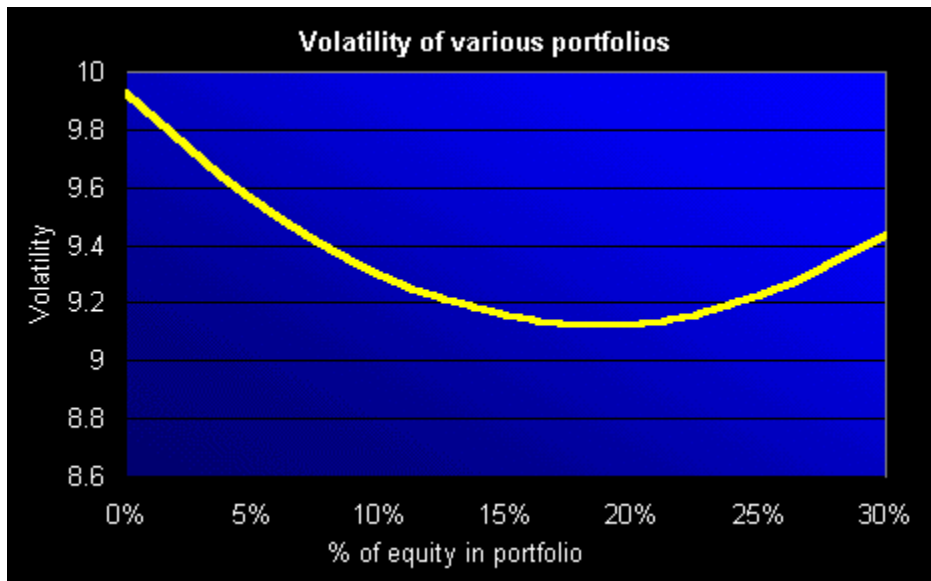
We realize here investors may worry that the addition of equities would make the portfolio more risky. This is not necessarily true as the the 2 asset classes do not always move in the same direction. That is why adding a certain amount of equities, can actually reduce the overall risk of the portfolio instead of increasing it.

We looked at how risky a portfolio with different amount of equities might be and compared this to an all bond portfolio.

Portfolio	No. of loss years	Average loss of down years	Worst performing year return	Volatility	No. of years with at least 2% return
100% Bonds	8	-5.43%	-12.58%	9.93	23
95% Bonds & 5% equities	6	-6.32%	-10.96%	9.56	22
90% Bonds & 10% equities	7	-4.92%	-9.34%	9.30	24
85% Bonds & 15% equities	8	-4.14%	-7.72%	9.16	24
80% Bonds & 20% equities	9	-3.63%	-6.77%	9.13	22
75% Bonds & 25% equities	10	-3.08%	-6.40%	9.23	22
70% Bonds & 30% equities	11	-3.03%	-7.19%	9.44	22

As you can see from the table above, the portfolios with 5 to 20% equities are more stable than the all bond portfolio. In general, they tend to do less badly in the loss making years, and even in their worst years, they don't see as great a drop as the all bond portfolio.

Taking into account risk, the portfolio with 20% equities and 80% bonds (highlighted in the table above) gives one of the best results amongst all the portfolios. We also note that the overall volatility of the portfolio decreases as more equities are added. Then at a certain point (20% equities; 80% bonds), the volatility reaches its lowest and increases from there on. That's because the increasing amount of equities being added to the portfolio, starts to have a larger influence on the portfolio's volatility.



Source: Fundsupermart.com

In conclusion, it would be advisable for investors with all bond or fixed income portfolios to consider adding a certain amount of equities. (Our suggested amount is 20%). This would create a portfolio that is more stable and less risky than an all bond portfolio, while actually being able to deliver higher returns than an all bond portfolio in the long run.

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