The Benefits of a Balanced Portfolio

Why Most Investors Need Both Stocks and Bonds

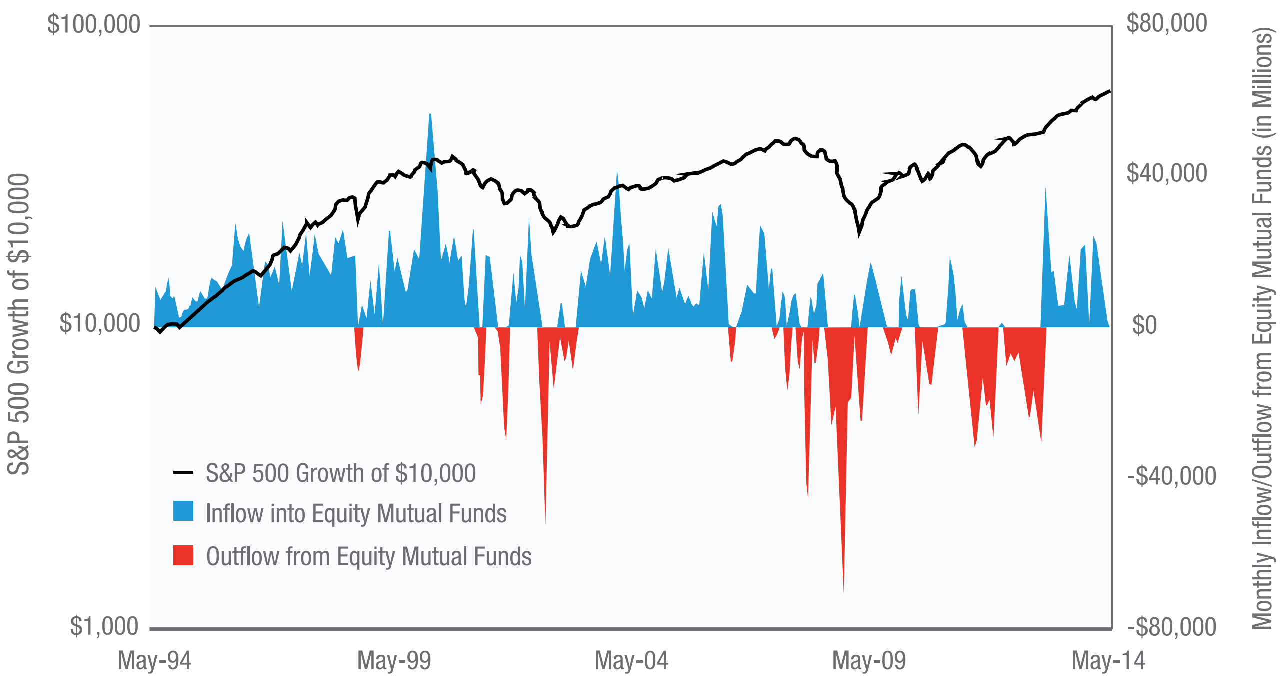
Too often investors try to selectively take advantage of up markets and avoid market downturns, but a look at flows in and out of mutual funds over time shows that investors tend to sell out of the market at inopportune times. By pairing the Investment Company Institute's data on fund flows with the performance of the S&P 500, we can see extreme buying spikes near market highs and peak selling near market lows.

Cycling in and out of stocks has not been a successful long-term investment approach. A better option is to find a portfolio allocation that will allow you to ride through and benefit from the stock market's inevitable ups and downs -- and for most investors, that's a balanced portfolio that includes both stocks and bonds.

Most investors need exposure to stocks to achieve their investment goals, because stocks have produced higher long-term returns. But the trade-off for these higher returns is volatility. Remember that, historically, stocks experience multiple 5% pullbacks each year and typically have one 10% correction a year. Bonds can cushion the volatility of stocks, and by doing so, they can help investors stay invested in stocks long term.

S&P 500 Performance and Equity Fund Flows

May 1994 - May 2014



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Balancing Growth & Stability

There's no 'perfect' allocation to stocks and bonds, but a classic allocation (and one commonly used by retirement plans) is 60% stocks and 40% bonds. One reason why this allocation is so popular is that it has been effective through multiple market cycles. This allocation also provides a balance between growth and stability: the stock exposure allows the portfolio to participate in market upswings, and the bond exposure provides a meaningful buffer against declines. Rebalancing to this allocation prompts investors to sell high and buy low.

We looked at how this allocation compared to a portfolio of 100% stocks (as measured by the S&P 500) and 100% bonds (as measured by the Barclays Aggregate Bond index). The chart shows the maximum, minimum and mean returns over every rolling 10-year time period from 1925 through 2013. (Looking at rolling time periods, each with a different monthly starting date, assures that we get a comprehensive picture of all the possible outcomes, regardless of when an investor happens to start investing).

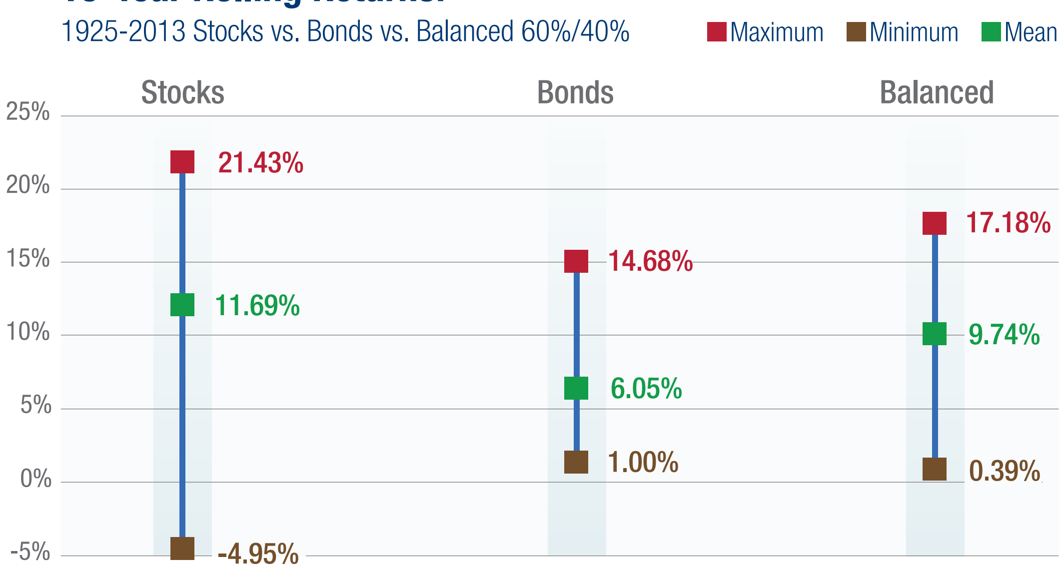
A 60/40 balanced portfolio generated higher average returns than a portfolio that held only bonds and lost less than a portfolio that held only stocks over the 10-year rolling periods from 1925 through 2013. In fact, it never lost money over any of these various 10-year periods.

The balanced portfolio had an average annual return of 9.74% compared to 11.69% for stocks and 6.05% for bonds. The balanced portfolio's worst 10-year performance was a small gain of 0.39%. Stocks, on the other hand, lost 4.95% a year during its worst 10-year period, and bonds gained 1.00% during its worst period.

Stocks had the highest average returns, as we expect. But few of us can stick with 100% stocks long enough to experience these gains. As Mark Hulbert wrote in his June 6, 2014 Wall Street Journal article "How Much Stock is Too Much": "many of the erstwhile all-stock investors who at some point bail out do so at the worst possible times—near the bottom of a bear market—and don't get back in until a bull-market recovery is well under way. As a result of this counterproductive behavior….it is extremely rare for an investor's real-world return to be anywhere close to an all-stock index fund's theoretical potential."

10-Year Rolling Returns:

1925-2013 Stocks vs. Bonds vs. Balanced 60%/40%



This table shows how a balanced portfolio can help you balance your long-term needs and goals

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4 Benefits of a Balanced Portfolio

How we allocate our portfolios to stocks and bonds matters. Our asset allocation isn't only about stocks and bonds, it's about how we balance our need to fund long-term investment goals and counter inflation with our desire to manage risk and participate in potential market gains.

1 Stay Invested

A balanced portfolio may help you stay invested long enough to reach your goals.

Many of us invest in order to fund long-term goals, like retirement. But it can be difficult to stay invested long term. In an attempt to benefit from up markets and avoid downturns, some investors add money to stocks near market highs and pulling money out of stocks during market lows – effectively buying high and selling low.

A portfolio that holds both stocks and bonds may be able to help us stay invested through the market's inevitable ups and downs. Over the 10-year rolling periods since 1925, a balanced portfolio lost less than stocks in down markets, and it had better average returns than bonds. This can help us stay invested long enough to reach our goals.

2 Counter the Impact of Inflation

A balanced portfolio frequently beat inflation.

Inflation erodes our purchasing power over time, and this can hinder our ability to fund our long-term goals. To counter inflation, we need our investments to outperform inflation.

In our study, we found a balanced portfolio beat inflation in almost every 10-year period since 1925. Out of the thousands of rolling 10-year time periods, there were just two periods when inflation beat a balanced portfolio.

3 Manage Risk

Like bonds, a balanced portfolio never had a negative 10-year period since 1925.

In order to stay invested, we need to manage risk. Stocks had higher average returns over the rolling 10-year periods since 1925, but stocks were also volatile. Returns ranged from a high of 21.43% to a low of -4.95%. Investors may not be able to stay invested in a portfolio that lost -4.95% over a 10-year period.

The balanced portfolio never lost money over any of these rolling 10-year time periods, and it had a narrower range of returns than stocks, meaning its returns were somewhat more predictable. (Bonds also never lost money over these 10-year periods, but they had lower average returns than the balanced portfolio.)

4 Participate through Market Cycles

A balanced portfolio has been effective over many market cycles.

Markets change, and we want to be able to participate in different market cycles. A 60%/40% portfolio has been effective in many kinds of market environments. Since 1925, there have been periods of high inflation and low inflation; there have been bull and bear market conditions and periods of higher and lower interest rates.

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5 Steps to Building a Balanced Portfolio

Whether you're starting from cash or changing your portfolio allocation, plan out how you'll shift to your target allocation, and try to make your allocation changes gradually. The goal is to get invested in an allocation that you can stay with. By making changes over time, you may be less likely to react emotionally if market conditions change.

① Start with fixed income

You can invest the fixed income portion of your portfolio right away. Bonds have typically had lower drawdowns than stocks so you're less likely to experience a severe sell-off just after buying into bond funds

② Invest in equities gradually

Get a substantial portion of your equity exposure invested (at least 30-50%) right away so you'll have the opportunity to participate in the gains, and then space out your subsequent purchases over time. We suggest if you are getting back in the market, focus first on core diversified equity funds or even balanced funds, which tend to be less volatile than more aggressive funds like sector or specialty funds.

③ Schedule your investments

Plan how you'll invest the rest of your portfolio in to equities. You might choose to invest another 10% in equities each month. Or, if you want to try to use market declines to your advantage, you might commit to investing another 10% in equities every month or every time the market pulls back 5%—whichever comes first. But stay on schedule — don't wait for the perfect day to buy, or you may never get invested.

④ Core, then explore

Once you've filled out your allocation to core stock funds, continue on to the more aggressive portion of your equity portfolio. Keep investing until you've reached your target allocation—regardless of what happens while you're building up your portfolio.

⑤ Fine-tune your allocation

Once you're invested, you can tweak your allocation over time. If your stock exposure has grown too large, wait until an equity fund you own is slated to be sold and then use the proceeds of sale to add to your bond positions to get back to your original target allocation.

If you need help, contact us. We manage hundreds of client portfolios. These portfolios started at different times, some clients add money to their accounts periodically while others are making withdrawals. But over time, these portfolios end up in sync because they're all following the same strategy. And over time, your portfolio will sync up with the strategy, too.

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Help Managing Your Balanced Portfolio

"I enjoy managing my stock funds," a subscriber told us recently, *"but I know I also need bond funds, and I'm just not comfortable selecting bond funds. What should I do?"*

Many investors feel like this subscriber: they know they need both stock funds for growth and bond funds for stability, but they find it daunting to manage both a portfolio of stock funds and a portfolio of bond funds. Fortunately, there are a variety of ways that investors can balance their portfolios. Here are three common options:

1 Do-It-Yourself

There are many resources that can help even beginning investors manage their own stock and bond fund portfolios. Our own NoLoad FundX newsletter is one of them: the newsletter includes model stock and model bond fund portfolios so you'll know exactly what funds to own, how much to allocate to each fund, and when to move on to other funds.

If it's too cumbersome to manage both stock and bond portfolios, balanced funds are another option. These funds invest in both stocks and bonds and are listed in the Class 4 section of NoLoad FundX. There, you'll see which balanced funds are currently bringing in the best returns.

2 Have Someone Do It For You

Not everyone enjoys managing their own portfolios. Some investors find that they don't have the time or the inclination to keep up with their stock and bond portfolios, or they have trouble taking action, even when they know what trades to make. These investors could opt to have someone else manage their balanced portfolio for them.

Here at FundX, we've been managing portfolios for clients since 1969 and managing fund portfolios for shareholders since 2001, and most of the clients that have been with us the longest have balanced accounts that include both stock and bond funds.

3 Do Some of It Yourself & Have an Advisor Do the Rest

Some investors find that a combination of these two options works best. If they like selecting stock funds, they might opt to have someone manage their bond portfolio, or vice versa. Some subscribers to NoLoad FundX use the newsletter for stock funds and then opt to buy the bond fund we manage rather than following the Flexible Income portfolio in the newsletter.

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