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PERSPECTIVES

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Strike a Balance

By Bill Koehler, CFA

Several years ago, I was fortunate enough to be among a small group to hear legendary basketball coach John Wooden speak in Kansas City. It was a special opportunity. Widely regarded as the greatest coach in history irrespective of the sport, he had been retired from coaching for more than 15 years at the time, but he still commanded great respect for his willingness to share the thinking and methods that brought unparalleled success to his UCLA teams. I have since studied more of his writings and find myself reflecting on them from time to time. Though Coach Wooden passed away in 2010 at age 99, his timeless wisdom lives on.

One of the reasons I find his views worthwhile is that the vast majority of them have applicability far beyond a basketball court. For example, that day he told our group that one of the most important words in the English language is balance. He talked about balance in many contexts, one of which was the importance of physical balance. I vividly remember him explaining that the human head weighs 40 pounds. Though 79 years old at the time, he enthusiastically jumped into an athletic stance and then demonstrated, by leaning his head forward and then backward, but not *tipping over*, how poorly a player moves when he or she is unbalanced. We smiled and nodded. He had made his point.

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What's my point? Though Coach Wooden was not talking to our group that day about balance in the context of investment portfolios, the word balance is highly significant for investors, both individual and institutional. Just as he demonstrated that players move poorly if they are out of balance, portfolios are less efficient without proper balance. Of course, balance in the context of a portfolio refers to the proper mix between asset classes, primarily the allocation between stocks, bonds and cash. Zeroing in on the proper balance between stocks, bonds and cash remains the most consequential decision for any investor.

Balance in 2015

In evaluating the 2015 outlook for capital markets, the notion of balance is of particular importance. In our view, now is not the time to be overly enamored with any particular asset class. We don't see clear or obvious undervaluation or disequilibrium in any asset class at the moment. However, neither do we see any asset class that looks "bubbly" or clearly overvalued. In our view, it is a classic environment for a balanced approach, both in structuring a portfolio and in gauging the relative attractiveness of various asset classes, particularly the equity and fixed-income markets. As a longtime proponent of balanced portfolios, we are constantly aware of the importance of maintaining the proper balance in our clients' portfolios and the proper emotional balance in analyzing the capital markets.

Stocks

The S&P 500 posted its sixth consecutive year of gains in 2014, rising 13.7%, including dividends. History tells us this streak is closer to its end than its beginning. The longest such streak is nine years, from 1991 to 1999. While much has been written about the longevity of the stock market and its climb from its March 2009 lows, it is important to remember what stocks actually are: ownership claims on the earnings and dividends of businesses. The trick is to not pay too much for those claims. The fact remains that rising earnings are underpinning this market. Earnings in 2014 are projected to be up 8% versus 2013, to a record $117 per share for the S&P 500, and are expected to climb even higher in 2015. Over time, we believe our capitalist system will allow our economic engines to continue to progress. In our opinion, the big idea for all investors is to align their capital with the world's productive capacity by owning stocks.

Bonds

The Barclays Aggregate Index, which measures the performance of a broad range of bonds, returned 5.9% in 2014 – its best performance in three years. This performance followed a chorus of pundits that declared at the beginning of 2014 that rates were destined to rise in the ensuing 12 months as the Fed neared the end of its bond-buying programs. We were not part of that chorus. 2015 marks the 12th consecutive year that the Wall Street consensus is predicting rates will rise in the coming year. We will continue to take a balanced approach to our analysis of the fixed-income market and seek to maintain perspective by focusing on the facts. For example, the year-end 2.17% yield on the 10-year U.S. Treasury may look paltry, particularly relative to the 15% yields of September 1981, when the great bond bull market began. However, relative to the yields on sovereign debt issued by our global competitors, our yields look anything but paltry. In fact, in the context of other sovereign debt 10-year yields, our 2.17% looks high compared with Italy at 1.82% and the United Kingdom at 1.75%, and downright exorbitant versus France at 0.78% and Germany at 0.53%.

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A Unified Effort

A critical relationship to keep in mind in this environment is just how well stocks and bonds co-exist in a portfolio. Just as the objective of a basketball team, comprising many individuals, is to produce a unified effort, the goal of a well-balanced portfolio is to produce maximum return for a given minimum level of risk. Even investment professionals can sometimes fail to appreciate just how different the return pattern of stocks can be from the return pattern of bonds.

Earlier this year, while attending an East Coast investment conference, I good-naturedly quizzed a fellow investment professional I have known a long time. I said, "Dave, you know market history. I have three questions for you. Over the last 89 calendar years, in how many of those years has the S&P 500 been down? Of those down years, in how many of them have bonds (as defined by the 10-year U.S. Treasury Note) also posted a negative return? And what was the negative return figure for bonds in their worst year?"

Now Dave is a knowledgeable professional and he was in the ballpark on his answer to the first question when he said 28. The correct answer, with 2014 in the books, is 24. So, 73% of the time, the U.S. stock market has gone up. However, he was off on his guess for the number of years that bonds and stocks were both down in the same year. He said 7. The answer is three years: 1931, 1941 and 1969. The worst return for the bond market was in 1969, with a negative 5%! In only three years since 1926 have both stocks and bonds delivered negative returns in the same year! These facts are easily overlooked, yet speak to the power of balanced portfolios.

The Best Course of Action

What is the best course of action as we enter 2015? The best course of action for most investors is to maximize the probability of investment success. How? The same strategy we have prescribed for clients since 1966. Invest in a professionally managed, globally diversified, thoughtfully allocated, balanced portfolio of well-researched securities tailored to each investor's needs and objectives. Use active rebalancing strategies and manage clients' portfolios accordingly. I am convinced this approach works for investors and offers the best insurance against a portfolio *tipping over*. I suspect Coach Wooden would agree.

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