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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- Investment in Exchange-Traded Funds (ETFs) today stands at $150 billion and is forecast to reach $500 billion by the year 2007, according to the Financial Research Corporation
- Despite frequently voiced opinions to the contrary, annual US stock market returns are independent, showing no year-to-year tendency for either persistence or reversal.

Volatility in the Stock and Bond Markets

Domestic stock and bond markets are considered to be the fundamental investment assets for investors. There is a general (and correct) perception that stocks generate higher long term returns than bonds at a cost of higher volatility. However, the risk and return relationship between stocks and bonds has evolved through time and has implications for modern portfolio construction. This month's article examines this relationship.

A fundamental idea in portfolio construction is the notion of *correlation* between asset classes. It is a measure of the independence of price movements of different assets through time. The objective of good investment management is to maximize portfolio return subject to the risk tolerance of the client. Assets with little or negative correlation generate portfolio returns with lower risk than portfolios composed of highly correlated assets. A well-constructed portfolio should include a variety of asset classes that move independently.

Correlation between stocks and bonds warrants special attention as these are core holdings in investor portfolios. The overall volatility of these key asset classes is also of concern. Charles Jones and Jack Wilson[1] examined returns of stocks and bonds from 1871 to 2000 in order to assess these measures.

Their findings indicate that the volatility of stock market returns has been remarkably consistent since the Great Depression. That volatility has remained within a narrow range of 12 to 18%. That is, annual returns in the stock market fell within 18 points of a 65 year average of 11% about 2/3 of the time. That level of return dispersion has been fairly constant since the Great Depression. Returns in the bond market have been more dynamic.

Over the past 130 years the volatility of aggregate US Stock market has been about 3 times that of its aggregate bond market. Since 1965, however, there has been a significant convergence in those volatility levels. Recently, bond market volatility has been at least half as large as the stock market. Moreover, the correlation measured between stocks and bonds has generally increased through time.

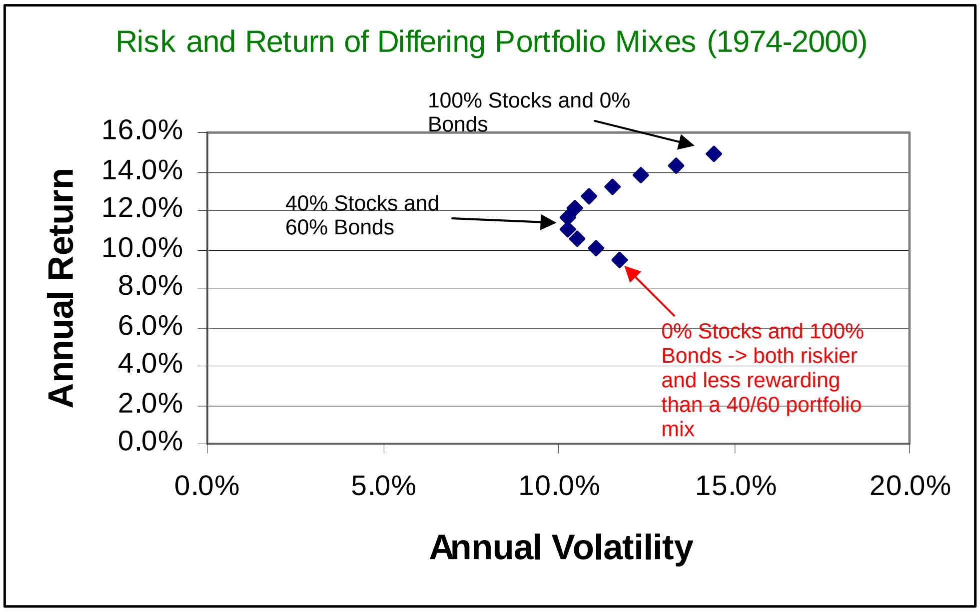
The implications of these historical trends weigh in mildly against bond allocation. Increased volatility and correlation with stocks indicate that the addition of fixed income to a core stock portfolio will do less to reduce the dispersion of portfolio returns.

From 1871 through 1946, a portfolio comprised of 100% bonds exhibited lower volatility than any portfolio with an equity component. That is no longer the case. the portfolio exhibiting the lowest volatility since 1974 has consisted of 40% stocks! After a certain point, the substitution of bonds for stocks increases risk. This phenomenon is illustrated in the table on the following page.

Increased bond volatility and correlation with stocks also argues for fixed income substitutes in an efficient portfolio. Real Estate Investment Trusts (REITs) are one option. They exhibit no more correlation to the aggregate stock market than bonds yet offer greater potential for capital appreciation. Foreign bond markets are another potential choice. Their historical returns compare favorably with US bonds but exhibit lower correlation to our stock market. Currently, most developed markets

[1] Changing Risks in Global Equity Portfolios, *Financial Analysts Journal*, Jan/Feb 2004

Market Volatility (continued)



"Today's market is unlikely to deliver the kind of equity returns that we've seen in the last 133 years. During that time frame, the United States emerged from its status as an agrarian backwater to the world's most powerful and diversified economy."

"In addition to lower real returns, foreign stock markets have experienced extended periods where equities lagged inflation."

pay higher bond interest than their US counterparts.

In the United States, stocks have generated returns in excess of inflation. Both short run and long run perspectives support this notion. From 1900 through 2002, stock market returns exceeded inflation by 6.3%. That suggests that an investor's buying power will double every eleven years. It is tempting for planners to rely on such optimistic data in constructing retirement plans for clients.

However, current market valuation levels as well as histories of foreign stock market returns argue against such positive assumptions. Corporate profits have surged in the past 12 months and are valued highly by the stock market. Interest rates have plummeted to their lowest levels in 40 years. Today's buoyant market is unlikely to deliver the kind of equity returns that we've seen in the last 133 years. During that time frame, the United States emerged from its status as an agrarian backwater to the world's most powerful and diversified economy. We can't repeat that track record over the next century.

Foreign stock market returns may offer a more realistic insight into the potential of future real returns. Indeed, most developed economies in the 20th century delivered lower real returns than those generated within the United States. Weighted by market capitalization, the developed world produced real returns of only 5.4% in the 20th century.

In addition to lower real returns, foreign stock markets have experienced extended periods when their performance lagged inflation. During the 20th century, the US equity market delivered returns in excess of inflation for *every* 20 year period. Not so in other developed markets. Foreign stock markets lagged inflation for nearly ¼ of the rolling 20 year periods in the last century. Unfortunately, many investors require purchasing power protection over a horizon no longer than that.

Prospects of inflation in the United States are muted. There is virtually no wage pressure. The Fed's Survey of Professional Forecasters reveals a consensus inflation estimate of 1.6% for calendar 2004. That's a low hurdle to clear for our capital markets. Yet the recent performance of our bond market as well as foreign stock markets indicates that more varied asset classes are required in efficient portfolio construction.