the EDUCATED INVESTOR FEATURE ARTICLE

Updated: April 2013

You Can Be Too Conservative

Overview: As investors approach retirement, many consider whether they should lower their allocation to equities. Some have even questioned whether they should exclude equities altogether. However, it is rarely necessary to completely remove equities from a portfolio. The following article discusses how a prudent approach is to build a globally diversified portfolio of passively managed investments that reflect an individual's need, willingness and ability to take risk.

Risk-Taking Ability

As individuals approach and enter retirement, their ability to take financial risks may decrease:

- With a shorter investment horizon, they have less ability to wait out the inevitable bear markets.
- If they are no longer working, they don't have the same ability to replace or recover from financial losses.
- Their willingness to take risk, and suffer the psychological strains that bear markets can produce, is likely reduced.

Thus, it is logical for investors to lower their equity allocations when they reach, or even approach, the retirement stage of their lives. However, as you will see, it is possible to become too conservative. Let's look at the historical evidence.

We begin by considering the cases of Investors A, B and C. Investor A is so conservative that all financial assets are invested in long-term government bonds (as proxied by a constant maturity 20-year Treasury strategy). Investor B is also conservative. The majority of this investor's financial assets are in long-term government bonds, but 20 percent of the portfolio is allocated to stocks. That allocation will be in the form of an investment in the S&P 500 Index. Investor C is a bit more aggressive, allocating 30 percent to the S&P 500 Index. The time frame we consider is 1926–2012. The following table shows the returns and standard deviations (a measure of volatility and risk) of their portfolios.

	Investor A 100% Bonds	Investor B 80% Bonds/20% Stocks	Investor C 70% Bonds/30% Stocks
Annualized return	5.7%	6.9%	7.5%
Annual standard deviation	9.7%	8.8%	9.2%
Worst year	−14.9% (2009)	−12.9% (1931)	−16.7% (1931)

Source: Dimensional Fund Advisors.

We can make the following observations from the above data.

- By adding a small allocation to stocks, Investor B earned higher returns and experienced less volatility than Investor A.
- By increasing the equity allocation even further to 30 percent, Investor C earned greater returns than Investors A and B. However, Investor C also experienced higher volatility than Investors A and B, and the worst single-year loss grew to almost 17 percent.

The conclusion we can draw from the evidence is that adding a small amount of equities to an all-bond portfolio raises returns while actually reducing volatility. While stocks are more volatile than bonds (the standard deviation of the S&P 500 Index at 20.2 is more than twice the standard deviation of long-term government bonds), they have low correlation to bonds. The correlation of the S&P 500 Index to long-term government bonds is just 0.01.

Intermediate-Term Bonds

Let's now look at another way to improve the efficiency of a portfolio, while still maintaining its conservative nature. This time we will shift the maturity of the bond holdings from long-term Treasury bonds to five-year Treasury notes. The time frame is 1926–2012. As you will see, reducing the risk will allow investors to increase equity holdings even further, without increasing the volatility of the portfolio.

- Investor B's portfolio is 80 percent long-term Treasury bonds/20 percent S&P 500 Index.
- Investor D's portfolio is 70 percent five-year Treasury notes/30 percent S&P 500 Index.
- Investor E's portfolio is 60 percent five-year Treasury notes/40 percent S&P 500 Index.

	Investor B 80% Long-Term Treasury Bonds/20% S&P 500 Index	Investor D 70% Five-Year Treasury Notes/ 30% S&P 500 Index	Investor E 60% Five-Year Treasury Notes/ 40% S&P 500 Index
Annualized return	6.9%	7.1%	7.7%
Annual standard deviation	8.8%	7.2%	8.7%

Source: Dimensional Fund Advisors.

By substituting shorter-term five-year Treasury notes for the long-term government bonds and adding a 30 percent allocation to equities, Investor D's portfolio produced higher returns and reduced volatility. Investor E's portfolio outperformed Investor B's portfolio while producing slightly less volatility. Both portfolios (D and E) were clearly more efficient than Portfolio B.

Summary

While investors may wish to reduce some of the equity risk inside their portfolio as they approach and enter retirement, the evidence suggests that a portfolio can actually become too conservative. Doing so might cause a portfolio to "fail," leaving an individual without the financial assets needed to support the lifestyle he or she has worked so hard to achieve.

Fortunately, it is not necessary to become so conservative that equities are actually excluded from a portfolio. The evidence suggests that portfolios with globally diversified equity allocations of as much as 20 to 30 percent, when combined with shorter-term fixed income assets, are likely to produce greater returns with similar, or even lower, volatility than that produced by a portfolio of "safe" longer-term government bonds.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Copyright © 2012, The BAM ALLIANCE.