

A Balanced Approach: Less Risk, But Lower Potential Return

By **Stuart Ritter, CFP**

Article Highlights

- A 60% stock/40% bond portfolio delivered annual returns above 10% almost as frequently as the S&P 500.
- The balanced portfolio had 40% less volatility than an all-stock portfolio.
- Over a period of 30 years, the balanced portfolio could have returns that are 31% less than those of an all-stock portfolio.

The annual return of the S&P 500 index has been 10% or higher in more than half the years from 1926 through 2010. However, in more than a quarter of the years for this period, the index delivered a negative return.

But an allocation to bonds has tended to dampen the volatility of an all-stock portfolio—while only somewhat limiting positive outcomes.

For example, a balanced portfolio, composed of 60% stocks and 40% bonds, delivered annual returns above 10% almost as frequently as the S&P 500, but provided negative returns in slightly fewer than a quarter of the years.

As shown in Figure 1, the balanced portfolio's annual returns were less widely dispersed from the stock market's long-term average of 9.87%, as measured by the S&P 500.

Over the entire period, the balanced portfolio's annualized return was 8.52%, or 13.7% lower than that of the all-stock portfolio, but it displayed a 40% reduction in risk as measured by the difference in volatility for the two portfolios.

Moreover, the balanced portfolio's worst annual loss was 28% compared with 43% for the stock portfolio.

While the degree of risk reduction is significant—and it may be very appealing for many investors—those investing for very long-term goals also should consider the potential trade-off in terms of the balanced portfolio's record of lower returns.

For example, a \$10,000 initial investment in the bal-



anced portfolio for five years would have yielded roughly \$950 less, or 6% less, than the gains in the all-stock portfolio, assuming average returns were sustained.

But the balanced portfolio's historical record of having lost money less often may make this lower return an acceptable trade-off, particularly for those whose financial goals are not long term.

However, over a period of 30 years, the balanced portfolio could provide \$52,000 less, or almost 31% less, than the all-stock portfolio, assuming historical returns.

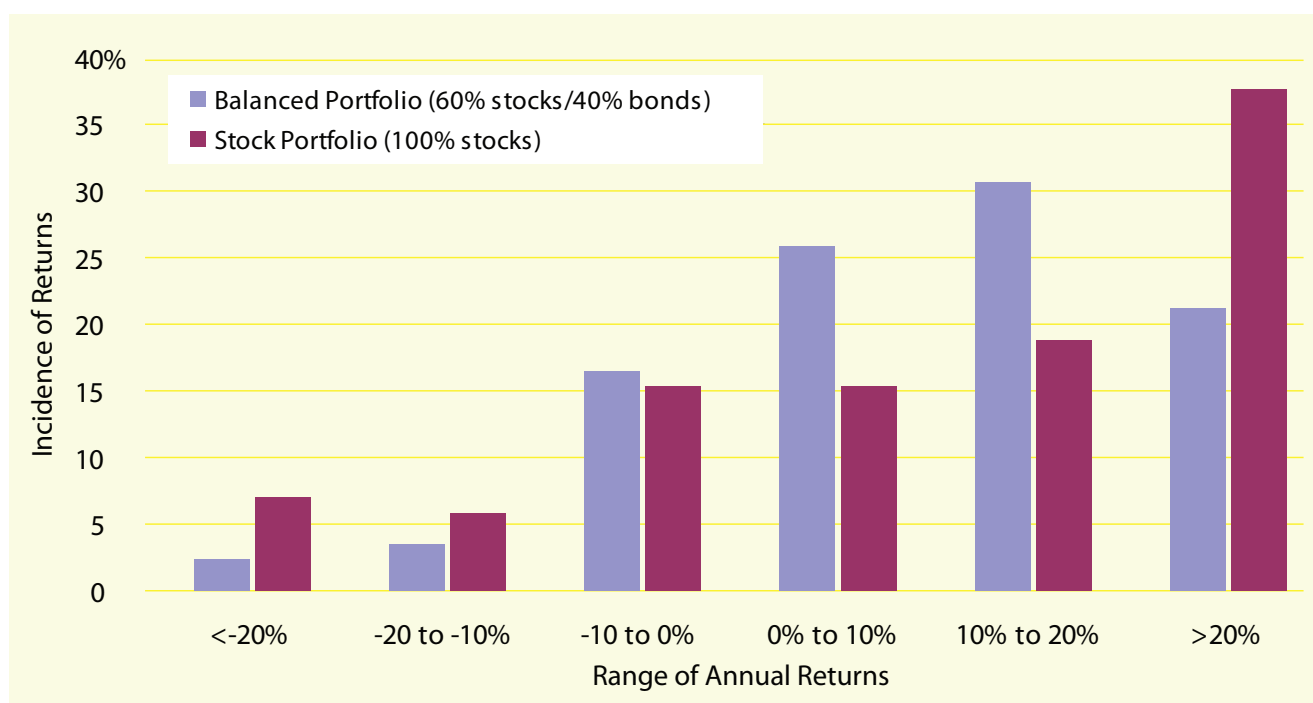
An annualized return of 9.87% versus 8.52% doesn't sound like that big of a difference. But compounded over time, it can add up.

How Much Risk?

So that begs the question: How should investors decide how much risk to take? T. Rowe Price advises investors to choose their investment allocations based primarily on the time horizons of their financial goals and personal circumstances as follows:

- When investing for shorter periods of time, investors should allocate more to bonds to dampen market risk. That decreases the chance of having a losing year or incurring substantial losses. Over shorter periods, investors may not end up giving up that much potential return using this more conservative strategy.
- In practice, a 60% stock/40% bond portfolio is

Figure 1. Distribution of Annual Returns 1926–2010 for All-Stock Portfolio Versus Balanced Portfolio



Stocks reflect the S&P 500 index and bonds reflect the Ibbotson Associates SBBI US Intermediate-Term Government Bond index.
Source: T. Rowe Price, based on Ibbotson data.

appropriate for a medium-term horizon—five to 10 years away from a financial goal. Whether saving for a child’s education or for a down payment on a home, avoiding large potential losses when the money is needed is the determining factor.

- For financial goals with much longer time horizons, such as saving

for retirement, a higher allocation to stocks may be needed—at least until investors approach their retirement date. With many years until they start withdrawing those assets, investors should try to look beyond periodic market downturns.

- Long-term investors can benefit

from the greater growth potential that a larger allocation to stocks could provide, and they have the time to ride out the increased volatility this approach entails. Shorter-term investors need to protect themselves more from the possibility of short-term losses just when they need the money. ▲

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