

Traditional Balanced Funds No Longer Work

## Description

**What are balanced funds and how are they meant to work?**



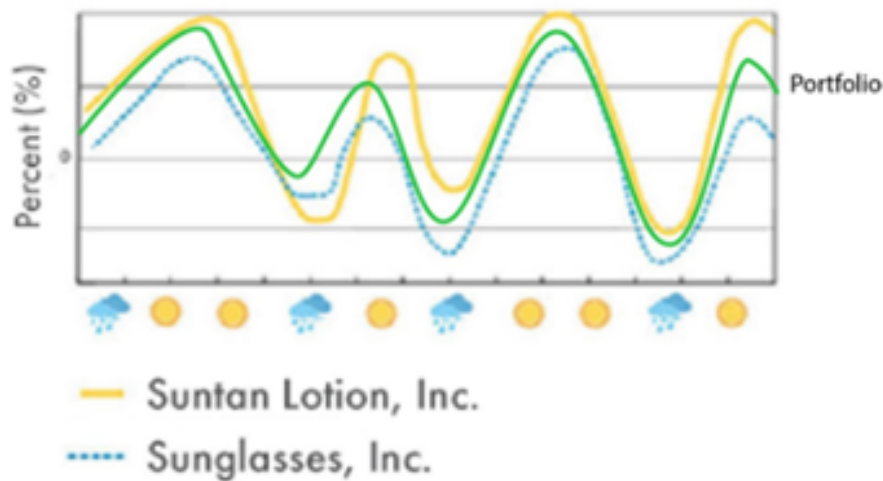
A balanced fund is a fund that has been appropriately diversified between negatively correlated (and sometimes non-correlated) assets. A balanced portfolio or financial plan is one which has also been appropriately diversified between negatively correlated (and sometimes non-correlated) assets.

Imagine you had a shop in a seaside town and you have space to stock two products. There are no weather reports. You may choose between sunglasses, suntan lotion & umbrellas. Or that you can invest in any 2 of 3 companies that make and sell these products. (Also umbrellas in this scenario are only used to protect from the rain, not the sun).

If you were selling suntan lotion & sunglasses, depending on whether it was sunny or raining your returns would look like:

## Diversification

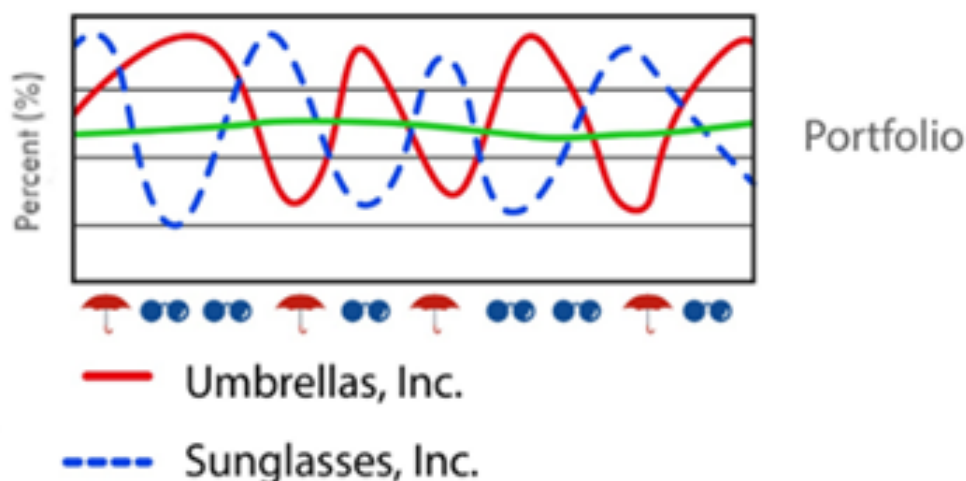
### Positive correlation



This chart is an example only and does not reflect the returns of any specific investment.

Where as if your portfolio consisted of 2 negatively correlated items (so people buy umbrellas when not buying sunglasses and vice versa it would look like:

## Diversification Negative correlation



This chart is an example only and does not reflect the returns of any specific investment.

Proper and adequate diversification is the most important ingredient of one's [financial plans](#). It is the ultimate risk mitigation and it actually can increase returns because periodic rebalancing means you are always selling high and buying low.

The idea behind a balanced fund or portfolio is that you are always taking advantage of the difference in the rate of change of value of the different parts of your portfolio. And it works as long as we can reasonably expect different parts of the portfolio to increase in value over the same extended period. What that means is if we expect sunglasses sales to increase and umbrellas sales to increase over the next year, we don't need to know on which days or weeks either one will be better. And if one does considerably better than the other that is fine as long as over 2 or 3 years the other one picks up. However, if for some reason we believe that there will be less and less sunny days, using sunglasses to balance our portfolio makes less and less sense.

In traditional balanced portfolios sold by banks and most investment advisors the portfolios are balanced between equities and bonds (also called stocks and fixed income).

## What is Fixed Income?

When we talk about public fixed income investments we are generally talking about bonds. Bonds come in a variety of flavours but basically a bond is a loan made to a company or a government which pays a pre-defined rate of interest and returns the principal invested after a certain period. The return may be

paid in instalments or all as one lump sum at the end of the term depending on the type of the bond.

## How does a Fixed Income Product Work?[\[1\]](#)

We are going to use something called a zero coupon bond to illustrate the concept. It will accumulate simple interest at a set rate and pay the principle plus interest back at the end of the term.

So lets presume the current market rate for bonds is 1% for a 1 year, zero coupon bond. Weâ??ll call this â??your bondâ??. Your investment would look like this:

Year	You Buy the Bond for	Bond Face Amount	Interest Received	Principal Returned	Annual Cash Flow	Cumulative cash flow / profit
1	\$10,000	\$10,000	\$100	\$10,000	\$100	\$100

You would invest \$10,000 and at the end you would have earned \$100.

## What Happens to my Fixed Income Portfolio / Bonds When Interest Rates Increase?

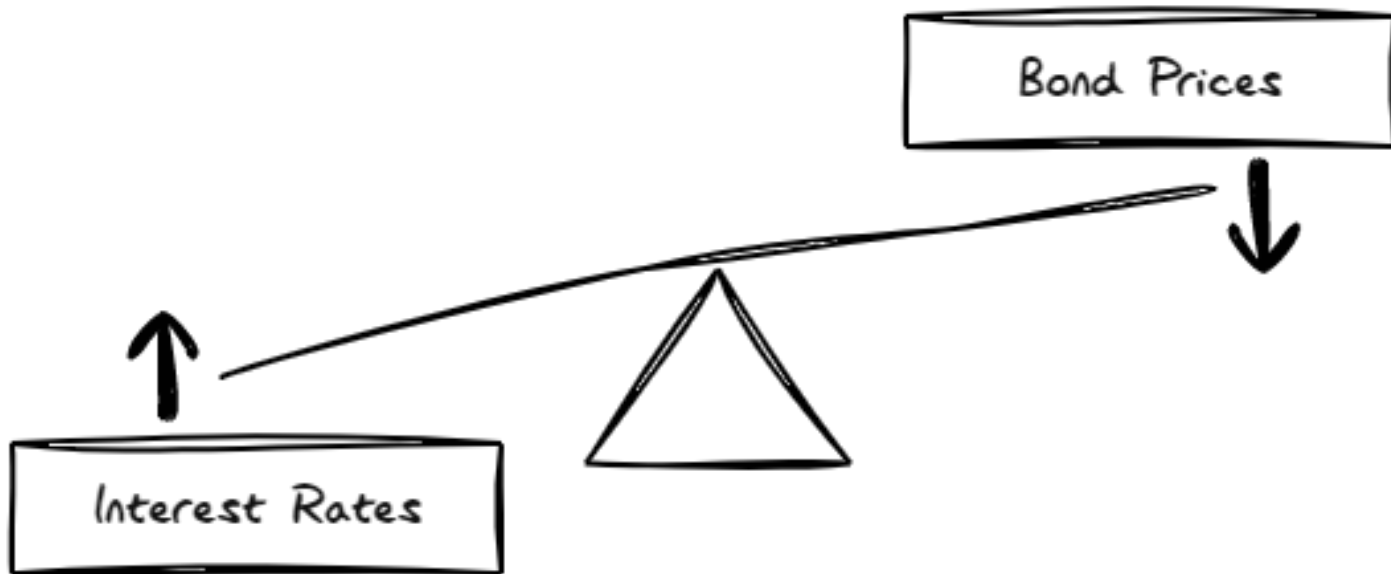
Letâ??s assume for arguments sake that 5 minutes and 17 seconds after you bought this bond the market interest rate rose from 1% to 2%. Now you, or anyone else, can purchase a new bond, from the same company or government with the same terms and get \$200. Like this:

Year	You Buy the Bond for	Bond Face Amount	Interest Received	Principal Returned	Annual Cash Flow	Cumulative cash flow / profit
1	\$10,000	\$10,000	\$200	\$10,000	\$200	\$200

When interest [rates increase](#) you and others would get a greater profit by purchasing the new bonds at a higher rate. This means if you want to sell your bond you have to sell at a discount so that the person buying it can get the same cash flow/profit as they would with a new bond available at the same higher rate. To earn the same \$200 from your bond that they can earn in the market someone would have to buy it for \$9,900.

Year	You Buy the Bond for	Bond Face Amount	Interest Received	Principal Returned	Annual Cash Flow	Cumulative cash flow / profit
1	\$9,900	\$10,000	\$100	\$10,000	\$200	\$200

Simply put â?? every time interest rates go up, the value of your bonds goes down.



This example isn't 100% accurate – we actually have to factor in some other minor details, but the example is adequate to illustrate the well established and proven principle that interest rate increases lead to bond price decreases. And the longer the term of the bond or the greater the interest [rate increase](#), the greater the fall in price of currently held bonds.

## What has happened to market correlations?

Here is what you need to know:

**Ninety (90!) percent of the returns of a balanced portfolio from 1930 to 2020 came between the years 1984 & 2007.**

From approximately 1980 until 2007 we saw a steady downtrend of interest rates. This meant that 5 and 10 year bonds didn't lose substantial value and were an adequate – hedge – or balancing factor. Bonds work in an environment of flat or reducing interest rates.

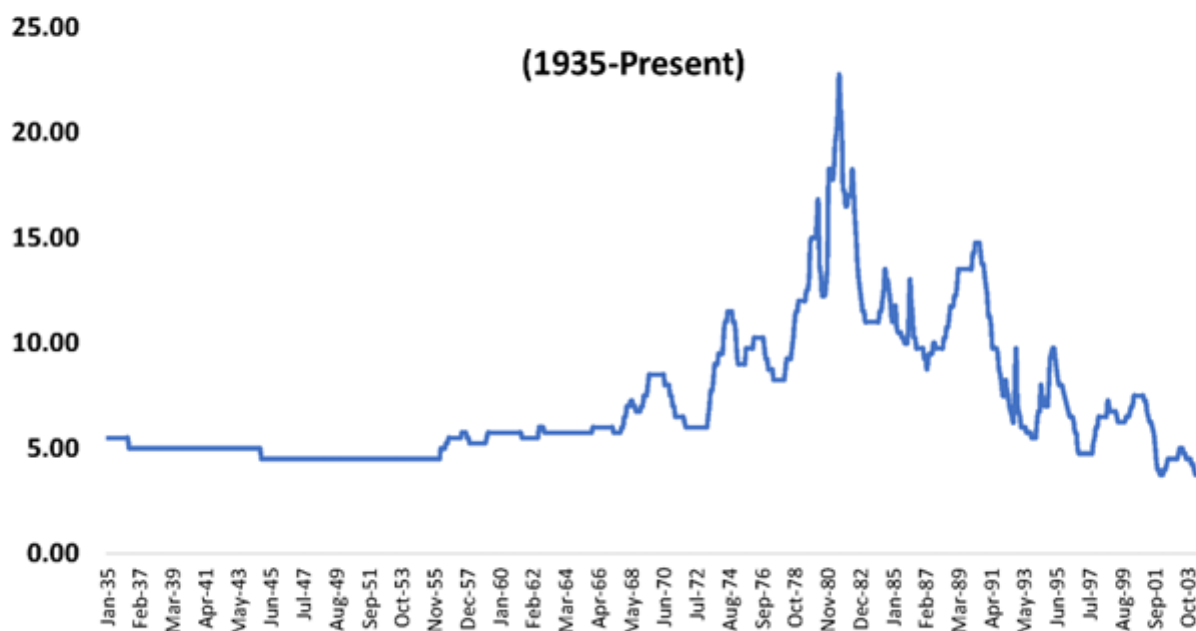
Here are the the 10 year treasury interest rates for the US from 1940 to 2020. Remember that most of the return on balance portfolios came between 1984 & 2007.

**Figure 5: Long-term US Treasury Yield, 1940 - 2020**



and along similar lines here is the Canadian prime rate history from 1935 to 2020:

# Prime Rate History



And this chart shows years when S&P/TSX was down significantly and what return the fixed income components had in those years.

	1982	1988	1990	1998	2003	2009	2011	2015	2018	2020
S&P/TSX Drawdown	-	-	-	-	-	-	-	-	-	-
FTSE TMX Canada Universe Bond Index Total Annual Returns	39%	15%	18%	19%	13%	32%	11%	11%	12%	34%
Canada 10-Year Yield	40%	15%	25%	13%	12%	10%	6%	1%	1.4%	10%
Balanced Portfolio with Fixed Income	16%	10%	11%	4.9%	4.7%	3.6%	1.9%	1.4%	2.0%	0.6%

90% of the returns of 60-40 stock-bond portfolio came from the 22 years between 1984 and 2007. Just 22 years drove 90% of the gains of that portfolio over 90 Years. Balanced Portfolio based on a 60-40 Equity/Fixed Income Split

As you can see up until 1990 interest rates were high enough that fixed income components alone provided an adequate hedge for market drops and created much needed security in balanced portfolios. As interest rates have continued to fall though those returns have reduced. And here is the truly scary thing – once interest rates start to rise, the return on the bond index will continue to decrease – remember the returns above are largely because of a decreasing interest rate

environment making currently owned bonds higher. As inflation and interest rates start climbing today those returns get substantially pushed down.

Traditional “balanced portfolios” from banks, mutual fund and insurance companies are no longer balanced or functioning as they should. (Except that the companies and people who sell them continue to make a profit).

Pension funds, big trusts, etc. have all moved to a model where they supplement investment in public markets with “alternative investments”. Alternative [investments can range from good to bad](#), appropriate to completely wrong, simply put, alternative investments are investments made by a conglomerate of investment managers for their clients that provide non-correlated income. Literally, everything from buying collectible art to property and pre-IPO web companies fall into alternative investments. While poor people have been buying overvalued stock and counting on demand always outgrowing supply the rich over Covid invested heavily in industrial property to rent, communications companies and internet companies at their last levels of financing but before they go public and multiply their values 5x, 10x and even 15x. Today these private companies are investing heavily in residential housing that they are renting creating strong cash flows to sustain portfolios through turbulent times while allowing capital growth. And health care. And many others.

I am a financial planner and I know that to effectively diversify a portfolio to increase returns and maximize downside it takes a team. Financial planners are NOT investment managers “our job is to help people clarify needs and goals, explain tax strategies and their pros and cons, help determine the correct allocation of assets based upon when they may be needed, probable usages, ensure that clients are able to sustain and prosper when markets take downswings and that their retirement isn’t at the mercy of a war in the Ukraine or an epidemic.

Your planner should have a team behind them who look at your investments every day (not change them, but they should be continually viewed), who have people who specialize in public equities, fixed income and alternatives and bring you the best options in these as and when they appear. We sell investment funds and RSPs and pension funds and our goal is to pair every client with the correct third party wealth manager, who we have vetted, work with and trust once they have an adequately sized portfolio. And to give you access to a range of solutions from diversified rental portfolios to private placement in technology and the health sector & the other unpredictable the same options as those that are available and used by places like the Yale Foundation, the Canadian Pension Plan etc. And we add the caveat that your portfolio must have adequate diversification and liquidity because you require your money when you need it not when markets happen to be on an upswing.

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[1] For the purposes of this illustration we have presumed that the bond is purchased at the beginning of the year and that coupon payments are made at the end of the year. We also haven’t calculated the time value of money. While important concepts they do not substantially change the illustration of the principle of bond prices vs interest rates.

## CATEGORY

1. Financial Planning
2. Wealth Creation & Economic Confidence

## POST TAG

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## Author

naoshad